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Draft law transposing Pillar Two presented to parliament.

18 August 2023

Introduction

On 4 August 2023, the text of the draft law (the "**Draft Law**") transposing the Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise ("**MNE**") groups and large-scale domestic groups in the Union (the "**Directive**") was presented to Parliament. This Directive implements the Global Anti-Base Erosion ("**GloBE**") rules, also called "**Pillar Two**", agreed upon by the OECD/G20 Inclusive Framework on BEPS in the Statement to Address the Tax Challenges Arising from the Digitalisation of the Economy and the Detailed Implementation Plan, on 8 October 2021.

To ensure that large internationally operating businesses pay a minimum level of tax regardless of where they are headquartered or the jurisdictions they operate in, Pillar Two introduces a global minimum corporate tax rate set at 15% through a top-up tax using an effective tax rate test calculated on a jurisdictional basis and using a common definition of covered taxes and a tax base determined by reference to financial accounting income (with agreed adjustments consistent with the tax policy objectives of Pillar Two and mechanisms to address timing differences). The minimum tax would apply to MNE or large-scale domestic groups with a combined annual turnover above EUR 750 million. For more details about the GloBE Rules at OECD and European Union levels, read one of our previous articles.

In order to implement this minimum effective taxation in Luxembourg, the Draft Law provides for the introduction of three new taxes in Luxembourg law.

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The first two are based on the application of two interdependent rules, namely the income inclusion rule ("**IIR**[1]") and the undertaxed payments rule ("**UTPR**[2]"). Under the IIR, the minimum tax is paid at the level of the parent entity in proportion to its ownership interests in entities that have low-taxed income. The UTPR is designed to operate as a backstop to the IIR.

A qualified domestic top-up tax ("**QDMTT**[3]") will also be implemented, allowing Luxembourg to tax Luxembourgish low-taxed entities and prevent the application of the IIR and UTPR rules by other jurisdictions with respect to these entities.

In principle, the IIR and QDMTT are intended to come into effect for tax years beginning on or after 31 December 2023, while the UTPR will come into effect for tax years beginning on or after 31 December 2024.

These complex measures about to be implemented in Luxembourg are largely in line with the Directive. However, additional guidance and clarification, as well as additional complementary rules (in line with OECD guidance), are still required to address important Luxembourg-specific points.

Please see below a few selected issues.

Relevance of OECD Guidance

In line with Recital 24 of the Directive, the Draft Law acknowledges the GloBE rules published by the OECD on 20 December 2021 (the "**OECD Model Rules**") and related administrative guidance as sources of illustration and interpretation, even where such guidance was issued after the Directive. However, the Draft Law only considers "a number of guidelines and solutions identified at OECD level after the date of adoption of Directive". In this respect, explicit reference is, for example, made to OECD guidance published on 14 March 2022, 15 December 2022 and 2 February 2023.

An important point to note at this stage is that the 13 July 2023 OECD guidance is not explicitly mentioned in the Draft Law and part of the 2 February 2023 OECD guidance seems to not have been taken into consideration either. The OECD guidance notably included important safe harbour rules on QDMTT (including the possibility to perform the computations under local GAAP different from those of the ultimate parent entity ("**UPE**")) and on UTPR. At this stage it is thus unclear whether this possibility will be granted.

We expect the Draft Law to be amended so as to reflect the additional OECD guidance and to equip the Luxembourg Pillar Two rules with more flexibility, safe harbours and transitional rules to mitigate unnecessary adverse consequences for Luxembourg taxpayers.

Scope and carve-outs of the Draft Law

Annual group turnover of at least EUR 750 million

The new rules will apply to "constituent entities[4]" located in Luxembourg belonging to MNEs or large-scale domestic groups with a combined annual turnover equal to or above EUR 750 million in at least two of the four fiscal years preceding the tested fiscal year, as per the consolidated financial statements of the group parent entity. A "group" is defined by the Draft Law as a group of entities linked by virtue of their ownership or control structure and included in the consolidated financial statements of the ultimate parent entity (extending also to entities that are excluded from consolidation based on size, materiality or on the grounds that the entity is held

[1] *Règle d'inclusion du revenu* ("**RIR**") as per the wording used in the Draft Law drafted in French.

[2] *Règles des bénéfices insuffisament imposés* ("**RBII**") as per the wording used in the Draft Law drafted in French.

[3] *Impot national complémentaire qualifié* as per the wording used in the Draft Law drafted in French.

[4] A "constituent entity" as defined by the Draft Law means an entity or permanent establishment that is part of an MNE group or a large-scale domestic group.

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for sale). A group could also be a main entity and one or more permanent establishments, provided that such group is not part of another group based on the above consolidation threshold.

- **Deemed consolidation – legal uncertainty remains**

  Entities that do not prepare consolidated accounts on a line-by-line basis may nevertheless be considered to form a group with their subsidiaries and therefore be in the scope of Pillar Two (e.g. if they are not required to prepare accounts at all or they do not prepare accounts under an acceptable accounting standard).

  Previous OECD guidance already clarified that certain investment entities (e.g. under IFRS 10) that are exempt from line-by-line consolidation and that are merely required to fair value their investments (including where majority stakes are held in subsidiary companies) do not fall within the deemed consolidation rule, i.e. such entities do not qualify as parent entities of a group.

  The Draft Law unfortunately remains silent on this point. In order to have legal certainty and in light of the large number of Luxembourg investment fund vehicles concerned, it is particularly important to clarify whether Luxembourg-specific exemptions from consolidation vehicles companies or for most investment funds based on the respective special laws such as for reserved alternative investment funds, specialised investment funds or companies in risk capital ("**SICAR**") are consolidation exemptions comparable to the IFRS 10 investment entity exception.

Investment fund definition – positive clarification for seed investors

Government entities, international organisations, non-profit organisations, pension funds and investment funds that are ultimate parent entities of an MNE group are so-called excluded entities which are not subject to the GloBE rules. However, a number of Luxembourg investment funds will not be able to benefit from the carve-out rule as they will fail to meet all criteria.

While there are certain exemptions available for investment funds that carve them out entirely from the GloBE rules, this exemption will by no means automatically apply to all investment funds since a specific set of criteria needs to be fulfilled in order to be considered as an excluded entity. Typical cases where no carve-outs are available are single investor funds and other managed accounts (absent a number of investors at least some of which are unrelated parties).

The commentary to the Draft Law clarifies that a fund failing to meet the above diversified investor requirement merely for a short time (e.g. since the fund is still in the fundraising period) may still meet this criterion provided that the fund has been set up to pool the assets of a number of investors, at least some of which are unrelated.

New top-up tax

IIR

The Draft Law enables a Luxembourg UPE, intermediate parent entity ("**IPE**[5]") or partially owned parent entity ("**POPE**[6]") to collect the top-up tax (called IIR tax), for any low-taxed constituent entity held directly or indirectly by the Luxembourg parent entity.

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[5] An IPE is a constituent entity that owns, directly or indirectly, an ownership interest in another constituent entity in the same MNE group or large-scale domestic group and does not qualify as an ultimate parent entity, a partially owned parent entity, a permanent establishment or an investment entity.

[6] A POPE is a constituent entity that owns, directly or indirectly, an ownership interest in another constituent entity of the same MNE group or large-scale domestic group, and for which more than 20% of the ownership interest in its profits is held, directly or indirectly, by one or several persons that are not constituent entities of that MNE group or large-scale domestic group and does not qualify as a UPE, a permanent establishment or an investment entity

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Where the UPE is located in Luxembourg, it should therefore incur the primary obligation under this Draft Law to apply the IIR to its allocable share of top-up tax relating to all low-taxed constituent entities of the group (including itself if it is a low-taxed constituent entity).

In certain circumstances, the obligation to apply the IIR should move down to other constituent entities of the group located in Luxembourg.

First, when the UPE does not apply the IIR (e.g. it is an excluded entity or is located in a country that does not have a qualified IIR), IPEs located in Luxembourg will be obliged under this Draft Law to apply the IIR up to their allocable share of the top-up tax. In the case where an IPE that is required to apply the IIR owns a controlling interest in another IPE, the IIR should be applied by the first-mentioned IPE.

Second, regardless of whether the UPE is located in a jurisdiction that has a qualified IIR, POPEs located in Luxembourg that are more than 20% owned by interest holders outside the group will be obliged under this Draft Law to apply the IIR up to their allocable share of the top-up tax. Such POPEs should, however, not apply the IIR when they are wholly-owned by another POPE which is required to apply the IIR. To avoid double taxation, compensation mechanisms are foreseen.

UTPR

The UTPR is a backstop rule in cases where the top-up tax is not fully collected through IIR or a QDMTT. The Luxembourg UTPR would be applicable in two scenarios. First, when the UPE is an excluded entity or is located in a jurisdiction without a qualified IIR, the Luxembourgish constituent entities of the group will apply the UTPR to any residual amount of top-up tax that has not been subject to the IIR in proportion to an allocation formula based on their number of employees and tangible assets. The commentary to the articles of the Draft Law specifies how to determine the ratio. Second, where the UPE is located in a low-taxed jurisdiction, the Luxembourgish constituent entities will apply the UTPR to the constituent entities located in that jurisdiction, in case that jurisdiction does not apply the IIR to constituent entities in that jurisdiction. This situation is likely to arise with non-EU jurisdictions.

QDMTT

As allowed by the Directive, Luxembourg chose to implement a domestic top-up tax through the present Draft Law. It allows Luxembourg to collect a top-up tax for low-taxed Luxembourg entities in priority to any other jurisdiction applying an IIR or a UTPR for those entities. The commentary to the Draft Law clearly underlines that the intention is to have the Luxembourg domestic top-up tax being treated as a “qualified” domestic top-up tax for Pillar Two purposes.

- **Safe harbour for the IIR and the UTPR rules in case of foreign QDMTT**

  According to the Directive, when this election is exercised, the parent entity applying the IIR will be obliged to give credit for the QDMTT tax when calculating the top-up tax in respect of the relevant jurisdiction. To avoid increased compliance costs for MNE groups and administrative burdens for tax authorities, the OECD provided, however, for a QDMTT Safe Harbour in its 13 July 2023 guidance. The QDMTT Safe Harbour is intended to provide a practical solution which excludes the application of the GloBE Rules (i.e. the QDMTT to be credited against the top-up tax) in other jurisdictions by deeming the top-up tax payable under the GloBE Rules to be zero. This is the solution retained by Luxembourg in the Draft Law.

  Indeed, the Draft Law provides for a safe harbour for the IIR and the UTPR rules, where a low-taxed constituent entity has been subject, in its jurisdiction, to a QDMTT which is calculated in accordance with the UPE's qualifying financial accounting standard or International Financial Reporting Standards IFRS or IFRS adopted by the European Union under Regulation (EC) No 1606/2002. If the foreign QDMTT meets this condition, no top-up tax will be calculated in accordance with the Draft Law for the foreign constituent entities located in the jurisdiction which applies this QDMTT and therefore no top-up tax will

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be allocated to the parent entities and constituent entities located in Luxembourg for the purposes of the application of the IIR and the UTPR. The Luxembourg safe harbour rules diverge from the 13 July 2023 OECD guidance but have the advantage of being easier and more straightforward in their current form. However, it remains to be seen what the practical modalities of application of this safe harbour will be, which require some additional guidance and clarification.

Lack of alignment between the Luxembourg participation exemption and Pillar Two

In order to enable the comparability of the effective tax rate ("**ETR**") determined for each jurisdiction in which the group's constituent entities are located, the Draft Law contains detailed rules determining the qualifying income or loss of a constituent entity (denominator of the ETR computation) which differ in certain respects from the rules of ordinary Luxembourg tax law.

The starting point is the net financial accounting result according to the accounting standard used for group consolidation purposes at the UPE level, before any consolidation adjustments for intra-group transactions. The financial accounting net income or loss is then subject to a series of adjustments designed in particular to take account of any discrepancies between the accounting rules and the tax rules generally accepted by OECD member countries.

In that respect, there is an exclusion for dividend income or other distributions received or accrued in respect of an ownership interest, except for ownership interests held by the group in an entity, that carries rights to less than 10 % of the profits, capital or reserves, or voting rights of that entity at the date of the distribution or disposition (a "**Portfolio Shareholding**") and that has been economically owned by the constituent entity that receives or accrues the dividend or other distribution for less than one year at the date of the distribution. This means that only dividends received or accrued in respect of Portfolio Shareholdings of less than one year are included in the qualifying income or loss. It is also specified in the commentary to the articles that for reasons of simplicity, the Draft Law does not prohibit the inclusion of expenses relating to excluded dividends.

In addition, there is an exclusion for gains and losses from shareholdings provided that an ownership interest of at least 10% is held in an entity (irrespective of the holding period).

These rules are not aligned with the Luxembourg participation exemption regime since Luxembourg companies may also rely on the acquisition cost criterion (i.e. EUR 1.2m for dividends and liquidation proceeds and EUR 6 m for capital gains) to exempt dividend income or capital gains. Similarly, companies relying on the commitment-based 12-month holding period could face a divergence with the Pillar Two rules.

Therefore, it would have been desirable to enable an opting-out from the Luxembourg participation exemption regime (as is already possible in other jurisdictions) in order to align the Luxembourg tax result with the GloBE income.

Moreover, the 2 February 2023 OECD guidance specifically allowed for the so-called "equity gain or loss inclusion election" to mitigate such mismatches. This is notably relevant as the Luxembourg participation exemption regime allows for a deduction of write-downs in value on qualifying shares (subject to certain recapture rules) while such losses are only deductible for Portfolio Shareholdings under Pillar Two.

Such optionality will be key to keep Luxembourg's competitiveness in an international environment by allowing Luxembourg taxpayers to mitigate adverse tax consequences as well as an increased administrative burden as a result of timing and/or permanent differences.

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Covered taxes: Further clarifications and the need to modernise the tax credit system

In addition to the tax base, determining an effective tax rate involves identifying the taxes borne by the group in a given jurisdiction (numerator of the ETR computation). To this end, the Draft Law contains rules for identifying qualifying taxes at the level of each constituent entity. Thus, the tax burden borne by a constituent entity in a given jurisdiction must meet certain technical characteristics in order to qualify as a "covered tax" within the meaning of the Draft Law and be taken into account in determining the effective tax rate.

Covered taxes include:

i. taxes recorded in the financial accounts of a constituent entity with respect to its income or profits, or its share of the income or profits of a constituent entity in which it owns an ownership interest;

ii. taxes on distributed profits, deemed profit distributions, and non-business expenses imposed under an eligible distribution tax system;

iii. taxes imposed in lieu of a generally applicable corporate income tax; and

iv. taxes levied by reference to retained earnings and corporate equity, including taxes on multiple components based on income and equity.

The covered taxes of the constituent entity are adjusted according to rules set out in the Draft Law.

The commentary also clarifies that net wealth tax (next to corporate income and municipal business tax) are considered as covered taxes. It would further be desirable to clarify whether subscription tax and the solidarity surcharge computed on the corporate income tax are equally considered as covered taxes.

In addition, the Luxembourg tax credit for investment does not currently meet the Pillar Two requirements to qualify as a qualified refundable tax credit ("**QRTC**"). Hence, it would be strongly desirable if Luxembourg provided for an opt-out from the tax credit to avoid negative tax consequences.

In the context of Pillar Two, the Belgian draft bill on Pillar Two aligned its R&D tax credit and specifically also included the possibility to opt out of the benefit of such tax credit.

Determination of the effective tax rate and computation of the top-up tax

The GloBE income and adjusted covered taxes of the constituent entities are aggregated on a jurisdictional basis. The ETR is obtained by dividing the adjusted covered taxes of the group (corporate and equivalent taxes as defined above) by the net qualifying income earned by the constituent entities of the group in that jurisdiction (as defined above). The ETR is calculated by fiscal year. If the adjusted covered taxes divided by the GloBE income result in an effective tax rate of at least 15%, no top-up tax is due for that jurisdiction. On the other hand, if the rate is less than 15%, the difference between 15% and the calculated effective tax rate is the top-up tax rate.

To determine the top-up tax due for a jurisdiction, this rate is multiplied by the so-called "excess profit". The excess profit is determined by subtracting a substance-based income exclusion ("**SBIE**") which is calculated on a jurisdictional basis (based on employee costs and the net book value of tangible assets as defined by the Draft Law), from the GloBE income. If the amount of the SBIE exceeds the amount of the GloBE income, there will be no excess profit and consequently no top-up tax.

The Draft Law provides for an optional de *minimis* exclusion for groups that have an average revenue of less than EUR 10 000 000 and an average qualifying income or loss of less than EUR 1 000 000 in a jurisdiction. Such groups should not pay a top-up tax even if their effective tax rate is below the minimum tax rate jurisdiction.

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Administrative provisions and transitional rules

Insofar as three new taxes related to minimum effective taxation are created, the Draft law contains a number of provisions necessary to determine, in particular, the entities liable for the payment of these taxes. It is important to note that the statute of limitation for top-up taxes amounts to ten years (compared to a regular period of five years applicable for other income taxes).

The Draft Law and related draft Grand-Ducal regulation mention that all Luxembourg constituent entities belonging to in-scope groups shall electronically register with the Luxembourg direct tax authorities and sets out the filing of information, the tax filing and the payment obligations. In principle, constituent entities located in Luxembourg shall file a top-up tax information return with the *Administration des contributions directes* ("**ACD**") and a top up tax return no later than fifteen months after the last day of the reportable fiscal year. A Luxembourg Grand Ducal regulation will provide for more practical aspects in this respect. IIR tax, UTPR Tax and the QDMTT will have to be paid no later than one month after the filing of the top-up tax return.

The Draft Law also includes special rules for the treatment of deferred tax assets and liabilities and transferred assets for groups entering into the scope of the Pillar Two rules. There are also rules foreseeing: transitional relief for the SBIE; an initial-phase exemption to apply the IIR and the UTPR for certain groups; the recognition that some EU member states could elect to delay the application of the IIR and UTPR for six years if they have no more than twelve UPEs of in-scope groups ; rules regarding transitional relief for filing obligations.

Entry into force

The IIR and QDMTT are expected to come into effect for tax years beginning on or after 31 December 2023, while the UTPR will come into effect for tax years beginning on or after 31 December 2024.

Do you have further questions?

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