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Luxembourg's new Pillar Two draft law explained: Side-by-side solution, new safe harbours, and key technical clarifications

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On 17 July 2026, the Luxembourg Government submitted a draft law (the "**Draft Law**") to Parliament amending the existing law dated 22 December 2023 on minimum effective taxation for multinational enterprise ("**MNE**") groups and large-scale domestic groups (the "**Pillar Two Law**"), as amended. Its main purpose is to implement the "side-by-side" solution agreed upon at OECD level.

The Draft Law is specifically intended to implement a number of protection regimes (safe harbours), including the side-by-side solution, an agreement reached by the OECD Inclusive Framework on 5 January 2026 (hereinafter the "**Agreed Administrative Guidance of January 2026**"), as well as certain simplifications, in the application of the Pillar Two rules. The Draft Law should therefore be applicable and interpreted in light of the Agreed Administrative Guidance of January 2026.

This package of measures responds to the need, identified within the framework of the international implementation of the Pillar Two rules, to facilitate the practical application of the system. In particular, the side-by-side safe harbour allows certain jurisdictions' tax systems (particularly relevant for US-parented groups) to coexist with the Pillar Two rules through specific safe harbours, rather than being fully subject to the Income Inclusion Rule ("**IIR**") and Undertaxed Profit Rule ("**UTPR**") mechanisms.

In this newsletter, we examine the key provisions of the Draft Law, together with their practical implications and underlying rationale.

At a glance

- Luxembourg submitted a Draft Law to Parliament on 17 July 2026 amending its Pillar Two Law to implement the OECD's side-by-side solution and introduce several new safe harbours.
- The side-by-side safe harbour allows Luxembourg entities of MNE groups headed by a UPE in a qualifying jurisdiction to have their IIR and UTPR top-up taxes reduced to zero, without affecting Luxembourg's Qualified Domestic Minimum Top-up Tax ("**QDMTT**").
- A related Ultimate Parent Entities ("**UPE**")-specific safe harbour shields UPEs from UTPR exposure where their home jurisdiction has a qualifying domestic minimum tax system, though no jurisdiction currently qualifies.

- A new safe harbour for qualified tax incentives allows certain substance-based tax credits, including some refundable and transferable ones, to be neutralised in the top-up tax calculation, potentially benefiting Luxembourg's Article 152bis investment tax credit.
- A simplified effective tax rate ("**ETR**") safe harbour lets groups rely on financial accounting data, rather than full GloBE calculations, to demonstrate a jurisdiction's ETR is at or above 15% or that it has a simplified loss.
- The transitional Country-by-Country Reporting ("**CbCR**") safe harbour is extended by one year, now covering fiscal years beginning on or before 31 December 2027.
- A technical clarification aligns Luxembourg's QDMTT rules with OECD guidance on deferred tax transitional provisions, applying retroactively to fiscal years from 31 December 2023.
- A minor fix extends the transitional UTPR safe harbour deadline to 3 January 2027 to accommodate groups with 53-week fiscal years.
- Unless stated otherwise, the new measures are generally expected to apply from fiscal years beginning on or after 1 January 2026, pending completion of the legislative process.

Side-by-side safe harbour

Underlying Rationale

The stated purpose (per the commentary to the Draft Law) is to **avoid subjecting MNE groups to burdensome and unnecessary compliance obligations in light of** the objectives of Pillar Two – specifically where the Ultimate Parent Entity's ("**UPE**") home jurisdiction already has a tax system that:

- ensures, **in an equivalent manner,** the policy objectives of the Pillar Two rules,
- a **minimum level of taxation,**
- on **both domestic and foreign operations** of the group.

In other words, if the home jurisdiction of the parent company already achieves the 15% minimum tax objective through its domestic rules, there is no need to also apply the full Pillar Two framework to the group's Luxembourg entities as well.

The side-by-side regime was primarily negotiated to accommodate concerns raised by the **United States** ("**US**"). The US has its own minimum tax system (Global Intangible Low-Taxed Income "**GILTI**", and its successor rules) that does **not** technically qualify as a Pillar Two-compliant IIR/UTPR system but achieves broadly similar outcomes. Rather than imposing full Pillar Two compliance on US-parented MNE groups, the side-by-side solution allows these two systems to coexist.

Key Mechanism

According to the Draft Law, Luxembourg constitutive entities of an MNE group whose UPE is in a jurisdiction eligible for the qualified side-by-side regime will have their top-up taxes due in accordance with the IIR and UTPR reduced to zero.

Importantly, this safe harbour does not affect the application of the (Luxembourg) QDMTT, so it **only results in the non-application of the IIR and UTPR.**

As a result, if a Luxembourg constituent entity is low-taxed, Luxembourg can still collect its own QDMTT.

How It Works

For calculating top-up taxes under the IIR and UTPR, an election by the filing constitutive entity under the Draft Law may reduce to zero the top-up tax payable in respect of all constitutive entities of an MNE group in a given fiscal year, provided that the group's UPE is located in a side-by-side eligible jurisdiction.

This provision thus confers upon the filing entity a discretionary right to elect for the neutralisation of the top-up tax otherwise chargeable under the IIR and UTPR mechanisms, subject strictly to the condition that for the relevant fiscal year, the UPE jurisdiction is recognised as maintaining a qualified side-by-side regime. Joint ventures and entities affiliated with a joint venture can also benefit from this option.

KEY ELIGIBILITY CONDITIONS

The Draft Law sets out the cumulative conditions pursuant to which a jurisdiction shall be recognised as possessing a qualified side-by-side regime. It requires that the UPE's jurisdiction:

- disposes of a qualified domestic tax system meeting the three following conditions:
    - *Minimum nominal corporate tax rate:* A nominal corporate tax rate of at least 20% applies in the jurisdiction, after accounting for preferential adjustments applicable to all income of constituent entities of an MNE group falling within the scope of this law.
    - *Qualified domestic minimum top-up tax or alternative minimum tax*: A QDMTT or an alternative minimum tax based on the fiscal year's results applies, with a nominal tax rate of at least 15%, applicable to a substantial portion of the aggregate income from the MNE group's operations (within scope of the Pillar Two Law) in that jurisdiction.
    - *No material risk of under-taxation*: There is no material risk that MNE groups within scope of the Pillar Two Law, whose UPE is located in that same jurisdiction, would be subject to an ETR below 15% on all profits from domestic operations (hereinafter the "**Qualifying Domestic Tax System**").
    - The Qualifying Domestic Tax System must have **entered into force by 1 January 2026 at the latest**.

- disposes of a qualified worldwide tax system that:
    - *taxes foreign income broadly*: It applies a comprehensive foreign-source income tax regime to resident companies, capturing both active and passive income from foreign branches and controlled foreign companies, with only minimal exclusions aligned with the minimum tax goals.
    - *prevents BEPS risks:* It has robust anti-base erosion and profit shifting mechanisms in place.
    - *ensures minimum effective taxation:* There is no material risk that MNE groups within scope of the Pillar Two Law whose UPE is in that jurisdiction would face an ETR below 15% on their foreign operational profits (hereinafter the "**Qualifying Worldwide Tax System**").

- grants a tax credit in respect of a QDMTT levied by another jurisdiction under the same conditions applied to any other covered tax; and

- is considered by the OECD Inclusive Framework as satisfying the conditions corresponding to the foregoing three criteria for the fiscal year in respect of which the election for the safe harbour is exercised. Qualifying jurisdictions shall appear in a central record registry maintained and published by the OECD. As at the date of the publication of this article, the US is the only jurisdiction on the central record registry.

UTPR safe harbour concerning the Ultimate Parent Entity (UPE)

UNDERLYING RATIONALE

The purpose of this safe harbour is to avoid subjecting the **UPE itself** to a UTPR top-up tax charge when the UPE is located in a jurisdiction that already has a **Qualified Domestic Tax System**.

The intention is to avoid a redundant (and potentially punitive) application of the UTPR on **UPEs** in eligible jurisdictions. This is clearly designed to accommodate the **US GILTI-style regime**, since the US is a UPE jurisdiction for many in-scope MNE groups but does not have a UTPR/IIR.

KEY MECHANISM

The Draft Law introduces a **UTPR-specific carve-out** protecting UPEs located in eligible jurisdictions. It complements the broader side-by-side safe harbour by ensuring that even where the wider relief might not fully apply, the UPE itself is specifically insulated from UTPR top-up exposure tied to its own group.

While the side-by-side safe harbour can zero out both the IIR and UTPR exposure of Luxembourg entities within a qualifying group, the UPE-specific regime **only removes the UTPR** at the level of, or in relation to, the UPE.

Like the side-by-side safe harbour, the UPE safe harbour is a permanent safe harbour.

HOW IT WORKS

At the election of the filing constituent entity, the UTPR tax owed by the UPE and other constituent entities located in the same jurisdiction may be reduced to zero, provided that this jurisdiction has, for the relevant fiscal year, a qualifying regime concerning the UPE.

KEY ELIGIBILITY CONDITIONS

A jurisdiction is recognised as having such a qualifying regime if:

- its Qualifying Domestic Tax System was adopted and entered into force no later than 1 January 2026. As for the side-by side safe harbour, a "Qualifying Domestic Tax System" is a tax regime that:
  - imposes a nominal rate of at least 20%,
  - includes a QDMTT or an alternative minimum tax of at least 15% applicable to a substantial portion of the group's income in the jurisdiction, and
  - does not present a significant risk that the group's effective domestic tax rate would be below 15%.
- the OECD Inclusive Framework confirms, for the relevant fiscal year, that these conditions are met.
  - As with the side-by-side regime, the recognition is expected to be reflected through **inclusion in the OECD's central record** of jurisdictions with transitional qualified status.
  - As of the filing date of the Draft Law, **no jurisdiction is considered by the OECD Inclusive Framework as having such a qualifying regime concerning the UPE.**

Safe harbour concerning qualified tax incentives

UNDERLYING RATIONALE

The Draft Law establishes a safe harbour regime concerning qualified tax incentives, in response to the fact that the initial Pillar Two rules dated 2021 distinguished between tax credits based on their specific technical characteristics.

Specifically, the original Pillar Two framework distinguished between qualified refundable tax credits, treated favorably as income, and other tax credits (non-refundable, or refundable only over a longer period), treated less favorably as a reduction of covered taxes, thereby potentially triggering top-up taxes even where the incentive of both credits was economically similar in effect.

This safe harbour draws on OECD work with a more substance-based approach, i.e. ignoring the technical form of an incentive with a focus on whether such incentive is genuinely tied to real economic activity in the jurisdiction. This will concern the treatment of certain tax incentives linked to substantial economic activity, for example, those determined on the basis of expenditures incurred or the volume of production of tangible goods in a jurisdiction.

Applicable to all groups falling within the scope of the Pillar Two rules, this regime seeks to reconcile two objectives: allowing States to maintain legitimate tax incentives for economic policy purposes, while preserving the integrity and underlying objectives of the Pillar Two rules.

KEY MECHANISM

This regime strictly regulates the use of tax incentives (tax credits, enhanced deductions, exemptions, preferential rates) so that they do not result in an undue reduction of the top-up tax due under Pillar Two, while recognising their legitimacy when they are linked to genuine economic substance (employment and tangible investment). It allows certain qualified tax incentives — including some refundable and transferable credits — to be neutralised in the top-up tax calculation, provided they meet substance-based conditions.

A "qualified tax incentive" is a tax benefit that is generally available and calculated on the basis of expenditures incurred or the volume of tangible goods produced locally (“**Qualified Tax Incentive**”). This includes certain qualified refundable tax credits and marketable/transferable tax credits, provided that their amount remains proportionate to the expenditures incurred (an incentive whose benefit exceeds the expenditures is not qualified).

HOW IT WORKS

At the election of the filing constituent entity, the amount of top-up tax corresponding to Qualified Tax Incentives for the relevant tax year may be reduced to zero. This amount of top-up tax corresponds to the difference between the top-up tax calculated with application of the safe harbour, and the amount that would have been calculated without it.

The adjusted covered taxes amount is increased by the lower of the following two amounts:

- the actual amount of Qualified Tax Incentives used during the year; and
- a substance-based limit, calculated
  - either as 5.5% of the higher of eligible payroll costs and depreciation on eligible tangible assets,
  - or (on an elective basis) as 1% of the carrying value of eligible tangible assets (excluding land and other non-depreciable assets). In order to avoid any double counting, if the filing constituent entity revokes the election relating to the 1% asset-based limit, depreciation related to an asset already taken into account in a prior calculation is excluded from future calculations.

While some uncertainties remain, we are of the view that the Luxembourg investment tax credit provided for by article 152bis of the Luxembourg income tax law, should be eligible to that safe harbour and should qualify as a Qualified Tax Incentive, despite the fact that it may not be treated as a qualified refundable tax credit or a marketable/transferable tax credit under current Pillar Two rules.

Safe harbour simplifying the Effective Tax Rate (ETR) calculation

UNDERLYING RATIONALE

Under the ordinary Pillar Two rules, calculating the ETR requires a full, detailed application of the GloBE rules: computing GloBE income/loss with numerous technical adjustments, adjusted covered taxes with detailed reconciliations, allocation of taxes among entities, treatment of deferred taxes, etc. This is a complex and resource-intensive exercise.

This safe harbour exists as requiring MNE groups to perform the full, complex Pillar Two calculation in every jurisdiction is often unnecessary and disproportionate — particularly in high-tax jurisdictions where the outcome (an ETR at or above 15%) is virtually certain. A simplified calculation, based on financial accounting data, allows

MNE groups and tax administrations to quickly identify low-risk jurisdictions without going through the detailed GloBE mechanics.

The Draft Law notes this simplification maintains "a compatible approach with the objectives of Pillar Two." In other words, it is not a way to escape the substance of the minimum tax, and only available where the outcome (ETR ≥ 15%) would very likely be the same as under the full calculation.

KEY MECHANISM

This regime provides that, upon election, the top-up tax due in respect of a tested jurisdiction shall be reduced to zero where the conditions prescribed for that purpose are satisfied. This is fulfilled where the companies concerned meets an ETR of at least 15% determined based on a simplified method of calculation.

HOW IT WORKS

The Draft Law sets out the mechanics and data source for the simplified ETR safe harbour.

The top-up tax for a tested jurisdiction in respect of a fiscal year is, upon election exercised by the filing constituent entity, reduced to zero where:

- **Route A:** the tested jurisdiction has a simplified ETR that is equal to or greater than the minimum tax rate. The simplified ETR is obtained by dividing the simplified taxes by the simplified profit.
- **Route B:** the tested jurisdiction has a simplified loss.
    - the jurisdiction simply has a loss under the simplified calculation (no profit means no ETR concern, so it automatically qualifies).

As a general rule, the simplified profit or loss and the simplified taxes of a tested jurisdiction are calculated using the financial accounting data used in the preparation of the consolidated financial statements of the MNE group or the large-scale domestic group. Using the same financial accounting figures already prepared for the group's consolidated financial statements avoids groups having to prepare separate, jurisdiction-specific GloBE-compliant accounts just to run the safe harbour test.

By way of derogation, if a jurisdiction's own QDMTT is legally required to be computed using a different standard – either the local accounting standard used for statutory accounts, or an OECD-approved standard adjusted to avoid competitive distortion – then that standard must be used instead for the simplified calculation, to ensure consistency between the domestic top-up tax computation and the safe harbour test in the same jurisdiction.

The simplified calculations are based on specific concepts, such as the tested jurisdiction, simplified profit or loss, and simplified taxes. Specific rules apply to certain entities or specific situations, in particular investment entities, joint ventures and joint venture affiliates, mergers and acquisitions, certain optional adjustments and allocation mechanisms.

KEY ELIGIBILITY CONDITIONS

The simplified ETR calculations are based on three principal features.

- <u>Excluded entities:</u> The safe harbour may not be invoked in respect of stateless constituent entities, investment entities and insurance investment entities, nor for tested jurisdictions where a balance remains outstanding on the deemed distribution tax recapture account.
- <u>The "once out, stay out" principle:</u> Where a filing constituent entity has availed itself of the safe harbour in respect of a given tested jurisdiction, and subsequently ceases to do so – whether by choice or by reason of failing to satisfy the applicable conditions – requalification for that jurisdiction is subject to a further qualifying period of twenty-four months during which no top-up tax liability may have arisen under either the ordinary GloBE rules or the *de minimis* safe harbour.

- **Anti-abuse principles:** The determination of simplified profit or loss and simplified taxes is subject to four cardinal principles, designed to safeguard the integrity of the regime against manipulation:
  - *the matching principle*, whereby intragroup income and the corresponding expense must be recognised in the same fiscal year by both parties;
  - *the principle of full allocation*, whereby the entire profit or loss of a constituent entity is attributed to the tested jurisdiction to which that entity belongs, without partial allocation;
  - *the principle of single counting of expenses and losses*, precluding the deduction of any given expense or loss in more than one tested jurisdiction; and
  - *the principle of single counting of taxes*, precluding the recognition of the same tax in more than one tested jurisdiction.

Any breach of these principles gives rise to a corrective adjustment, excluding the relevant item from the calculation applicable to the jurisdiction concerned.

The safe harbour applies to fiscal years beginning on or after 31 December 2026. Earlier application, in respect of fiscal years beginning on or after 31 December 2025, is nonetheless permitted.

Transitional Country-by-Country Reporting (“CbCR”) safe harbour

The Draft Law further amends the transitional CbCR safe harbour. The transitional CbCR safe harbour is a well-established relief mechanism (originally agreed at OECD level and already transposed into Luxembourg's Pillar Two Law) that allows MNE groups to avoid performing the full, complex GloBE ETR calculations for a given jurisdiction during the early years of Pillar Two implementation. Instead, groups can rely on simplified tests based on data already reported in their CbCR (such as revenue, profit before tax, and a simplified ETR calculated from CbCR figures) to demonstrate that a jurisdiction poses low risk and therefore owes no top-up tax there.

This regime exists precisely because the ordinary Pillar Two calculations are highly detailed and resource-intensive. Requiring full compliance from day one, i.e., before systems, data, and processes were mature, would have imposed a disproportionate administrative burden. The transitional safe harbour was therefore designed as a temporary bridge, not a permanent feature.

The amendment proposed under the Draft Law seeks to extend, by one additional fiscal year, the period during which in-scope groups may avail themselves of this safe harbour regime. Accordingly, this safe harbour regime may be applied in respect of **fiscal years beginning on or before 31 December 2027.**

Technical clarifications on the application of the QDMTT

The Draft Law amends the Pillar Two Law so that Luxembourg's rules on when the QDMTT safe harbour election may be exercised are brought into line with this January 2025 OECD guidance. The clarification specifies that this election is only available in respect of jurisdictions that apply rules corresponding to specific transitional provisions related deferred tax accounting. This may potentially have some impact on Swiss entities of MNE groups due to certain Swiss cantonal tax measures, such as targeted tax credits or similar benefits introduced after 30 November 2021.

The clarification addresses certain deferred tax assets arising after 30 November 2021 from tax benefits, elections, basis step-ups or newly introduced corporate income taxes. It generally excludes the deferred tax expense arising on reversal of those assets from the GloBE ETR calculation, subject to a limited grace-period exception. The measure is intended to prevent transitional tax attributes from being used to shelter future low-taxed income and undermine the Pillar Two minimum-tax rules.

This clarification will apply **to fiscal years starting from 31 December 2023** (fully retroactive to the original law's entry into force).

UTPR transitional period – Fiscal year adjustments

Underlying Rationale

The Draft Law addresses a narrow but practically important timing anomaly affecting MNE groups that use a 53-week fiscal year (a practice for groups that align their financial year to a fixed weekday, e.g. "the last Sunday of December", which occasionally produces a 53-week rather than 52-week year).

The transitional UTPR safe harbour is currently available only for fiscal years ending on or before 31 December 2026. A group with a standard 52-week year ending in late December would typically close its fiscal year on or before that date.

However, a group whose fiscal year happens to run 53 weeks in the relevant period might find that its year-end falls just after 31 December 2026, for example on 3 January 2027, purely as a mechanical consequence of the extra week, not because of any deliberate choice or different treatment.

If the cut-off date were left strictly on 31 December 2026, such a group would be excluded from the transitional UTPR safe harbour for that year, even though nothing about its economic or tax situation differs from a group with a standard year-end. This would be an unintended, purely calendar-driven disadvantage.

What Is Proposed

To prevent this unintended gap in coverage, the deadline for the transitional UTPR safe harbour is extended from 31 December 2026 to 3 January 2027. This adjustment is calibrated precisely to capture the small number of groups whose 53-week fiscal year would otherwise cause them to fall just outside the original cut-off, ensuring they are not penalised simply because of the length of their accounting period.

What's next?

The Draft Law was submitted to the Luxembourg Parliament on 17 July 2026 and will now follow the legislative process. As currently drafted, the law will **apply retroactively with staggered effective dates**. Unless mentioned otherwise, the **general rule** is that the new safe harbours and various provisions of the Draft Law **will be applicable for fiscal years starting from 1 January 2026.**

This is essentially a **technical maintenance update** to Luxembourg's Pillar Two law, primarily designed to incorporate new OECD international agreements (the side-by-side solution and administrative guidance) to keep Luxembourg's implementation consistent with evolving global standards, while offering relief from double-layered top-up taxation for groups already covered by equivalent foreign regimes (mainly aimed at accommodating the US tax system's interaction with Pillar Two).

Questions?

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