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# ATOZ ALERT

## The GloBE Rules of the OECD and the EU: overview and the big picture for investment funds

**24 December 2021**

The Global Anti-Base Erosion ("**GloBE**") rules, also called "Pillar Two", provide for a co-ordinated system of taxation intended to ensure large multinational enterprise ("**MNE**") groups pay a minimum level of tax on the income arising in each of the jurisdictions where they operate.

The model rules to give effect to the GloBE rules (the "**OECD Model Rules**") initially expected to be released by the end of November 2021 were finally published by the OECD on 20 December 2021.

Because of this delay, it was uncertain whether the EU would be able to publish a directive proposal for the implementation of the GloBE rules at European Union level on 22 December, as previously announced. Nevertheless, they did it and provided us with a nice seasonal gesture: a proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union ("**GloBE Directive Proposal**"). The GloBE Directive Proposal follows closely, with some differences to ensure its compatibility with EU law, the OECD Model Rules and sets out how to calculate and apply the OECD global minimum taxation so that it is properly and consistently applied across the EU.

The OECD Model Rules and the GloBE Directive Proposal (the "**GloBE Regulations**") are drafted in a complex way and a first reading does not allow to understand all their nuances and implications. Nevertheless, we have tried to provide a "big picture" of what they involve in general and for investment funds in particular.

### Mechanism of Pillar Two

Pillar Two aims at developing rules 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. For that purpose, the GloBE Regulations impose 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).

Pillar Two relies on two rules to be implemented in national domestic tax laws, and a treaty-based rule. The GloBE Regulations deal with the domestic tax rules and include:

- an Income Inclusion Rule ("**IIR**"), which imposes top-up tax on a parent entity in respect of the low taxed income of a constituent entity; and
- an Undertaxed Payment Rule ("**UTPR**"), which denies deductions to the extent that the low tax income of a constituent entity is not subject to tax under an IIR,

together named as the "GloBE Rules".

The treaty-based rule (i.e., the Subject to Tax Rule ("**STTR**")) that allows source jurisdictions to impose limited source taxation on certain related party payments that are subject to tax below a minimum rate of 9% is not dealt with by the GloBE Regulations. Since this will be for jurisdictions to implement individually, there will be no EU action in relation to the STTR.

## Scope and carve-outs of the GloBE Regulations

The OECD Model Rules apply to groups of MNEs that have a combined annual group turnover of at least EUR 750 million based on consolidated financial statements in at least two of the four fiscal years immediately preceding the tested fiscal year. This threshold was decided by the OECD Inclusive Framework in order to ensure consistency with existing international corporate tax policies such as the rules on Country-by-Country Reporting. An MNE Group means any group that includes at least one entity or permanent establishment that is not located in the jurisdiction of the parent entity. However, at EU level, to ensure compliance with the fundamental freedoms, the GloBE Directive Proposal also targets large-scale domestic groups that have a combined annual group turnover of at least EUR 750 million based on consolidated financial statements. An entity or permanent establishment that is part of an MNE group or a large-scale domestic group is considered as a constituent entity.

Government entities, international organisations, non-profit organisations, pension funds and investment funds that are ultimate parent entities ("**UPEs**") of an MNE group (the "**Excluded Entities**") are not subject to the GloBE Rules. Investment funds and real estate investment vehicles are excluded from the scope only when they are at the top of the ownership structure. An ultimate parent entity is indeed defined as an entity that owns, directly or indirectly, a controlling interest in any other entity and that is not owned, directly or indirectly, by another entity with a controlling interest in it. A controlling interest means an ownership interest in an entity whereby the interest holder is required, or would have been required, to consolidate the assets, liabilities, income, expenses and cash flows of the entity on a line-by-line basis, in accordance with an acceptable financial accounting standard.

Under the GloBE Directive Proposal,

- An investment fund is an entity or arrangement that is designed to pool financial or non-financial assets from a number of mostly non-related investors; that invests in accordance with a defined investment policy; that allows investors to reduce transaction, research and analytical costs or to spread risk collectively; that is primarily designed to generate investment income or gains, or protection against a particular or general event or outcome; the investors of which have a right to return from the assets of the fund or income earned on those assets, based on the contribution they made; an entity that is, or its management, subject to the regulatory regime for investment funds in the jurisdiction in which it is established or managed; and that is managed by investment fund management professionals on behalf of the investors.
- A real estate investment vehicle means a widely held entity that holds predominantly immovable property and that is subject to a single level of taxation, either in its hands or in the hands of its interest holders, with at most one year of deferral.

Finally, entities that are owned under certain conditions at at least 95% or 85% by Excluded Entities are also excluded from the scope of the GloBE Rules. This last exclusion targets mainly holding companies, but could also target investment funds owned by Excluded Entities such as the pension fund for example.

## Effective Tax Rate and Top-Up Tax

According to the GloBE Regulations, where the effective tax rate of a jurisdiction in which constituent entities are located is below the minimum tax rate for a fiscal year, the MNE group (and the large-scale domestic group in the EU) shall compute the top-up tax for that jurisdiction. The top-up tax shall be computed on a jurisdictional basis. This top-up tax percentage is then multiplied by the income of that jurisdiction for the year in question.

The top-up tax percentage for a jurisdiction for a fiscal year shall be computed in accordance with the following formula:

***Top-up tax percentage = minimum tax rate – effective tax rate***

The GloBE Regulations set the minimum effective tax rate at 15% and describe how to calculate the effective tax rate ("**ETR**") of an MNE group (or a large-scale domestic group) in a jurisdiction. The ETR is obtained by dividing the adjusted covered taxes of the group (corporate and equivalent taxes) by the net qualifying income earned by the constituent entities of the group in that jurisdiction. The ETR is calculated by fiscal year.

When investment entities are not UPEs, and thus are not Excluded Entities, they are subject to the GloBE Regulations. However, the adjusted covered taxes and qualifying income or loss of constituent entities that are investment entities are excluded from the calculation of the effective tax rate. The consequence of this exclusion is however unclear, at this stage, as the GloBE Regulations also provide for specific rules for the determination of the effective tax rate and top-up tax of an investment entity that is not a tax transparent entity and that has not made an election to be treated as tax transparent or to apply a taxable distribution method. In that case, the effective tax rate of such investment entity shall be computed separately from the effective tax rate of the jurisdiction in which it is located. Under these specific rules for these investment entities, the effective tax rate shall notably be equal to its adjusted covered taxes divided by an amount equal to the allocable share of the MNE group in the qualifying income or loss of the investment entity. In respect of the calculation of the top-up tax of an investment entity, it shall be an amount equal to the top-up tax percentage of the investment entity multiplied by an amount equal to the difference between the allocable share of the MNE Group in the qualifying income of the investment entity's and the substance-based income exclusion computed for the investment entity.

The top-up tax due for the constituent entities located in a jurisdiction shall be equal to zero for a fiscal year if, for such fiscal year the average qualifying revenue of the constituent entities located in that jurisdiction is less than EUR 10 000 000 and the average qualifying income or loss of that jurisdiction is a loss or is less than EUR 1 000 000.

## What is the net qualifying income to be taken into account?

The qualifying income or loss of each constituent entity used for the calculation of the effective tax rate and the top-up tax shall be computed by making the adjustments to the financial accounting net income or loss of the constituent entity for the fiscal year before any consolidation adjustments for intra-group transactions, as determined under the accounting standard used in the preparation of the consolidated financial statements of the ultimate parent entity.

To determine its qualifying income or loss, the financial accounting net income or loss of a constituent entity shall notably be adjusted by the amounts of "excluded dividends" and "excluded equity gains or losses".

According to the GloBE Directive Proposal, 'excluded dividend' means a dividend or another distribution received or accrued in respect of an ownership interest, except a dividend or another distribution received or accrued in respect of: (i) an ownership interest in an entity of less than 10% (a "**Portfolio Shareholding**") in respect of which a constituent entity is entitled to all or substantially all of the rights to profits, capital or reserves, irrespective of whether the constituent entity owns the legal ownership of such portfolio, for less than one year at the date of the distribution; and (ii) an ownership interest in an investment entity that is subject to an election to apply a taxable distribution method. 'Excluded equity gain or loss' means a net gain or loss, included in the financial accounting net income or loss of the constituent entity, arising from: (i) gains and losses arising from changes in the fair value of an ownership interest, except for a portfolio shareholding; (ii) profits or losses in respect of an ownership interest that is included under the equity method of accounting; and (iii) gains and losses from the disposal of an ownership interest, except for the disposal of a Portfolio Shareholding. Dividend and Capital gains qualifying for the participation exemption should thus be excluded for the computation of the ETR.

The GloBE Regulations also provide for a specific international shipping income exclusion and substance base income exclusion.

The substance carve-out is based on a formula, which aims to reduce the impact of Pillar 2 on MNE groups in a jurisdiction, where they are carrying out real economic activities. In this respect, the net qualifying income for a jurisdiction shall be reduced, for the purpose of calculating the top-up tax, by an amount equal to the sum of the payroll carve-out and the tangible asset carve-out for each constituent entity located in the jurisdiction. The payroll carve-out and the tangible asset carve-out of a constituent entity located in a jurisdiction shall be equal to 5 % respectively (1) of its eligible payroll costs of eligible employees who perform activities for the MNE group in such jurisdiction, with the exception, and (2) of the carrying value of the eligible tangible assets located in the jurisdiction, with the exception. The substance-based income exclusion shall not include the payroll carve-out and the tangible asset carve-out of investment entities.

For the calculation of the substance carve-out of an investment entity that is not a tax transparent entity and that has not made an election to be treated as tax transparent or to apply a taxable distribution method, the eligible tangible assets and eligible payroll costs of eligible employees taken into account for the substance carve-out shall be reduced in proportion to the allocable share of the MNE group in the qualifying income of the investment entity divided by the total qualifying income of such investment entity.

Moreover, the financial accounting net income or loss of a constituent entity that is a flow-through entity (i.e. tax transparent) shall be reduced, in principle, by the amount allocable to its constituent entity-owners in accordance with their ownership interests in the flow-through entity. Specific rules apply in this respect if the flow-through entity is a UPE. This reduction probably explains why an ETR and a top-up tax shall be computed only for investment entities that are not tax transparent entities and that have not made an election to be treated as tax transparent or to apply a taxable distribution method. In the latter cases, the income or loss of the investment entity should indeed be allocated to its entity owners and thus taken into consideration for the ETR and the top-up tax at that upper level.

## Allocation of the Top-up tax

### Income inclusion Rule (IIR)

The IIR imposes a top-up tax on a parent entity in respect of the low-taxed income of constituent entities. The IIR applies on a top-down basis, which means that it is applied by the entity that is at, or near, the top of the ownership chain in the MNE Group, which is normally the UPE. However, in case where the UPE does not apply the IIR, one or more intermediate parent entities ("**IPE**") will have to apply the IIR to their low-taxed constituent entities.

The OECD Model Rules provide that the jurisdictions which apply the IIR should take into account the ETR of foreign constituent entities only. In addition, the GloBE Directive Proposal provides that the Member State of a constituent entity applying the IIR, which is usually the jurisdiction of the UPE, is required to ensure effective taxation at the minimum agreed level not only of foreign subsidiaries but also of all constituent entities resident in that Member State and permanent establishments of the MNE group established in that Member State. In this respect, the EU makes use of an option offered in the Commentary to the Model Rules (not available yet).

In addition, in order to preserve the sovereignty of Member States, the GloBE Directive Proposal also provides that a Member State can opt to apply the top-up tax domestically to constituent entities located in its territory (the "**Domestic Top-up Tax**"). This election allows that the top-up tax is charged and collected in a jurisdiction in which low-level of taxation occurred, instead of collecting all the additional tax at the level of the UPE. When this election is exercised, the parent entity applying the IIR will be obliged to grant a credit for the qualified domestic top-up tax when calculating the top-up tax in respect of the relevant jurisdiction.

The IIR shall be operational from 1 January 2023.

**The Undertaxed Payments Rule (UTPR)**

The UTPR allocates the top-up tax to a jurisdiction to the extent the low-tax income of a constituent entity is not subject to tax under an IIR. The UTPR acts thus as a backstop to the IIR and applies in situations where there is no qualifying IIR in the jurisdiction of the UPE or where a low level of taxation arises in the jurisdiction of the UPE.

In circumstances where the UPE is located outside the EU in a jurisdiction that does not apply a qualifying IIR, all its constituent entities in jurisdictions with an appropriate UTPR framework will be subject to the UTPR. In this circumstance, constituent entities of such an MNE group that are located in a Member State will be apportioned, and will have to pay in their Member State, a share of the top-up tax linked to the low-taxed subsidiaries of the MNE group.

Where the jurisdiction of the UPE operates a qualifying IIR but the UPE, together with its subsidiaries located in that same jurisdiction, are low-taxed, the top-up tax corresponding to the low-taxed UPE and its domestic subsidiaries will be charged through the UTPR to all the eligible entities across the MNE Group.

The UTPR allocates top-up tax to jurisdictions based on a two-factor formula: the carrying value of tangible assets in the jurisdiction and the number of employees in the jurisdiction.

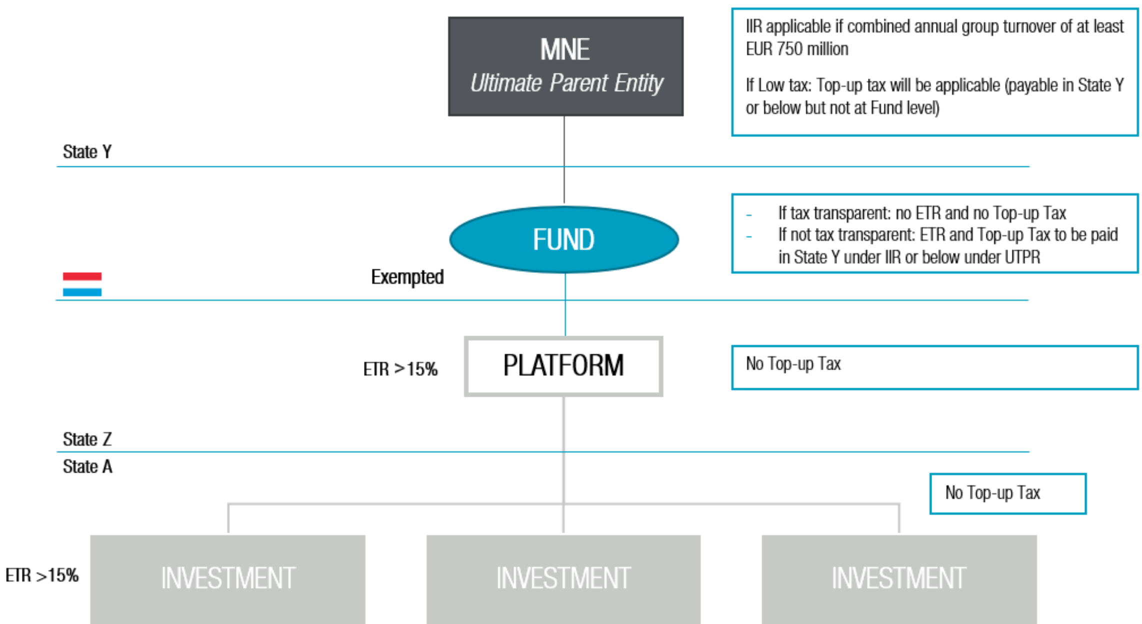
Constituent entities that are investment entities and pension funds shall not be subject to the UTPR top-up tax.

The GloBE Regulations finally provide for an exclusion from the UTPR for MNEs in the initial phase of their international activity, defined as those MNEs that have a maximum of EUR 50 million tangible assets abroad and that operate in no more than five other jurisdictions.

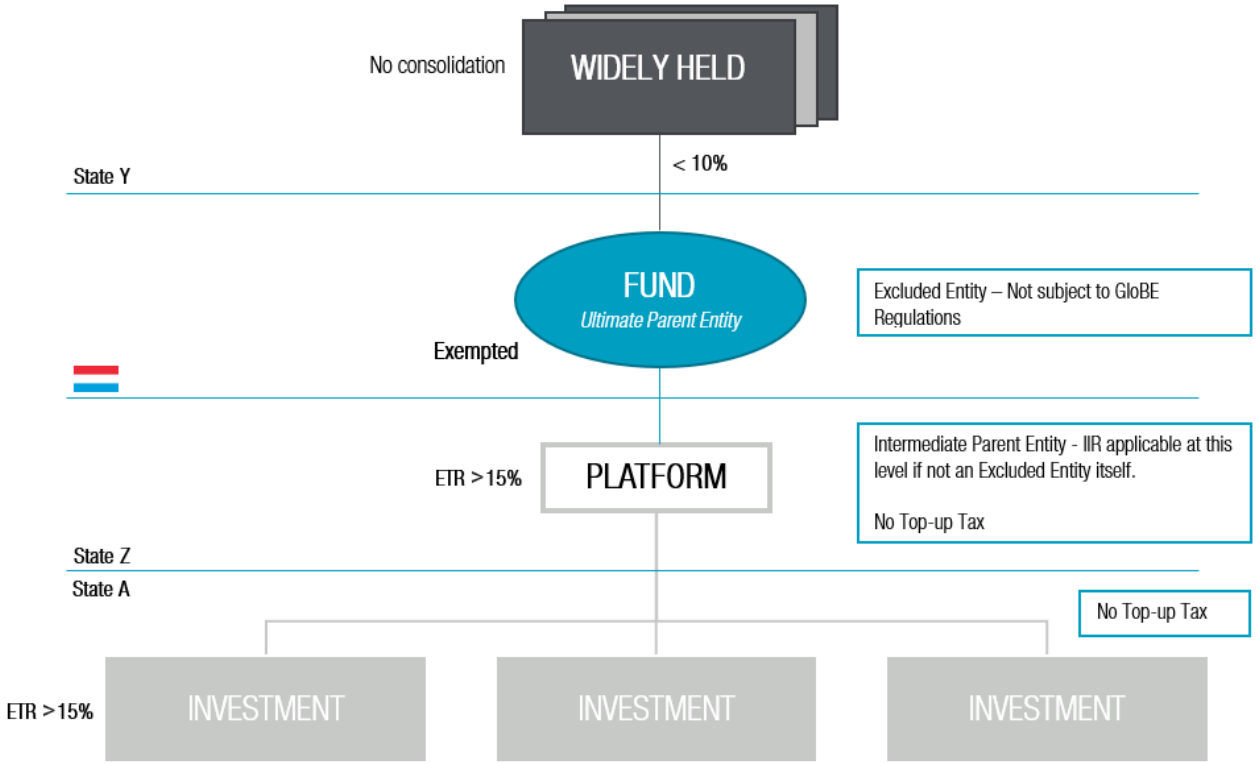
The UPTR is required to be implemented one year later than the IIR, thus in 2024.

## Case studies

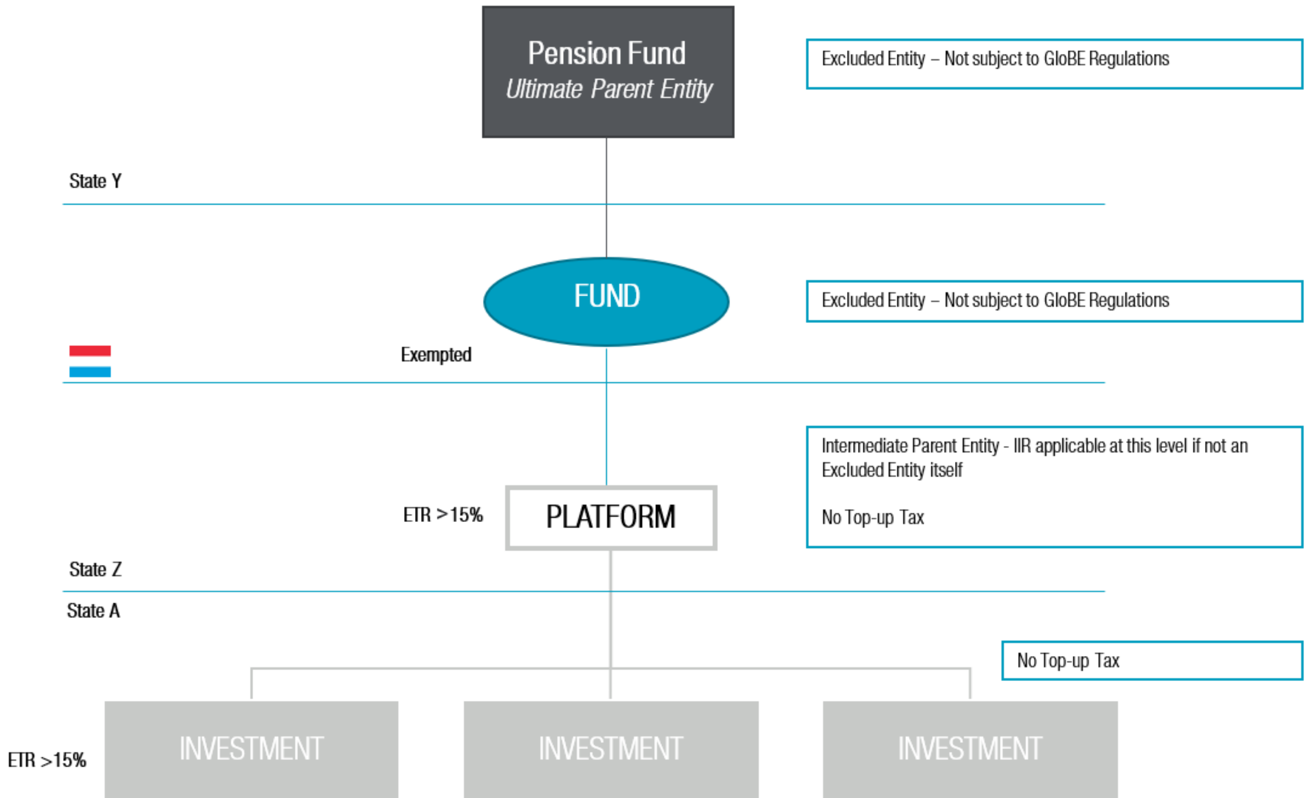
**Case Study A**



## Case Study B




## Case Study C



## Implication and next steps

The OECD should still develop the Model Rules, notably by publishing its Commentaries, for bringing Pillar Two into domestic legislation during 2022, to be effective in 2023, with the UTPR coming into effect in 2024. A multilateral instrument ("**MLI**") will be developed by the Inclusive Framework by mid-2022 to facilitate the swift and consistent implementation of the STTR in relevant bilateral treaties.

The European Commission plans to adopt the GloBE Directive Proposal by April 2022. Taking into account the complexity of the topic and the uncertainties it brings, we believe that the adoption of such a directive proposal by Member States, in a very short delay, would be like signing a blank check.

A first reading of the GloBE Regulations does not allow to understand and determine all their tax implications for MNEs and Investment Funds captured within its scope. Companies should thus assess their existing structures and determine whether changes should be considered as well as the operational and financial implications of the top-up tax.

## Do you have further questions?

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