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Client Alert

February 2023

International - Pillar Two: OECD Inclusive Framework releases Administrative Guidance on the GloBE Rules

The Administrative Guidance provides guidelines for the local implementation of the GloBE Rules, the recognition of the US' GILTI regime and the design of the Qualified Domestic Minimum Top-up Tax.

In brief

On 2 February 2023, the OECD/G20 Inclusive Framework on BEPS ("**IF**") released technical guidance ("**Administrative Guidance**") to assist governments in the local implementation of the Global Anti-Base Erosion Model Rules ("**GloBE Rules**"). This should help governments to correctly apply the GloBE Rules to large Multinational Enterprises ("**MNE**") from the start of 2024. Moreover, it aims to ensure a coordinated and harmonized implementation of the GloBE Rules. The Administrative Guidance takes the form of a modification to the original version of the Commentary that was issued in March 2022.

The IF has stated that it will continue to release additional guidance in order to ensure a harmonized and coordinated implementation of the GloBE Rules.

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Scope

The Administrative Guidance sets out some clarifications regarding the scope of the GloBE Rules:

- **Monetary thresholds**: Considering that the GloBE Rules contain several monetary thresholds expressed in euro, and in order to ensure a coordinated and consistent application of the GloBE Rules globally, guidance is included in the Administrative Guidance to ensure that, for those jurisdictions that introduce the GloBE Rules using a different currency, the local threshold will have to be, generally, based on the foreign exchange rates published by the European Central Bank ("**ECB**") or, if not available, the jurisdiction's Central Bank.
- **Deemed consolidation test**: The definition of an MNE Group for the GloBE Rules includes all entities that would consolidate into the Consolidated Financial Statements of an Ultimate Parent Entity if that entity had prepared Consolidated Financial Statements. This deemed consolidation test is designed to broaden the definition of Group to include those entities that are not required by local law to prepare Consolidated Financial Statements. If an entity does not prepare Consolidated Financial Statements under local law, it may still be deemed to be part of a Group for the purposes of the GloBE Rules if it would be required to consolidate under Authorized Financial Accounting Standards, if those standards had been applied. Some examples illustrating the above are included as part of the GloBE Model Rules Examples.
- **Consolidated deferred tax amounts**: The Administrative Guidance clarifies that if the individual financial accounts of a Constituent Entity do not include its deferred tax expense, but its deferred tax expense is recorded in the MNE Group's consolidated financial accounts, it will be included in the calculation of the Total Deferred Tax Adjustment Amount for that Constituent Entity.
- **Sovereign wealth funds and the definition of Ultimate Parent Entity ("UPE")**: The Administrative Guidance recognizes that sovereign wealth funds that meet the definition of a Governmental Entity should not be treated as an UPE for the purposes of the GloBE Rules and will not be considered part of an MNE Group.
- **Definition of "Excluded Entity"**: Some further guidance has been issued regarding the requirements to be met in order to qualify for the exclusion from the scope of application of the GloBE Rules by entities at least (in)directly owned for 95% by an

Excluded Entity. The definition of Excluded Entity considers the totality of the activities of an entity, including the activities of all its permanent establishments.

- **Meaning of "ancillary" for Non-Profit Organizations**: Non-Profit Organizations are Excluded Entities. However, these may carry out limited trading activities through subsidiaries to raise funds for their charitable activities, which could make them become subject to the GloBE Rules. In this regard, the Administrative Guidance includes a bright-line test[1] in order to determine the 'ancillary' activities of wholly owned subsidiaries of Non-Profit Organizations and, if passed, include them within the exclusion.

Income & taxes

Allocating GILTI Taxes

- For a limited time, the IF will apply a simplified allocation formula to deal with Blended CFC Tax Regimes like the U.S. GILTI regime. Instead of tracing GILTI taxes incurred to a specific Constituent Entity—a complex and fraught task—the new rule allocates GILTI taxes incurred to entities in jurisdictions where the GloBE Jurisdictional ETR falls below 13.125%. This rate, termed the "Applicable Rate," is the rate at which foreign taxes would generally offset GILTI taxes through foreign tax credits. The formula allocates taxes in proportion to the Constituent Entity's income as declared on U.S. federal income tax returns. This simplified formula does not apply to accounting periods ending after 30 June 2027, at which point the IF will need to decide how to address the U.S. GILTI regime going forward.

Intra-group transactions accounted at cost

- The OECD Commentary assumes that intra-group transactions will normally be accounted for at fair market value, with adjustments to eliminate intra-group income on consolidation. However, some MNE Groups account for intra-group transactions at cost. The Administrative Guidance confirms that the arm's-length principle applies to intra-group transactions, so that the transfer of assets or liabilities should be recorded at fair market value regardless of the accounting method used. Disposals that are part of a "GloBE Reorganisation", however, can still be at book value for GloBE income purposes.

Excluded Equity Gains or Losses and hedges of investments in foreign operations

- MNE Groups commonly hedge foreign currency risks arising from their holdings in subsidiaries where the subsidiary's activities are conducted in a currency other than the functional currency of the parent entity. The hedged risk is the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of the parent entity of that foreign operation.

- For accounting purposes, these hedges are often included in the profit and loss account of the parent entity. However, jurisdictions often have rules that exempt the profit and loss on these hedges from corporate income tax (which typically mirrors the fact that the capital gains on the shares in the subsidiary are themselves exempt from tax under applicable participation exemptions). The Administrative Guidance states that the treatment of a net investment hedge for GloBE purposes should be aligned with the treatment of the equity investment it is hedging (at the election of the MNE Group).

Excluded Dividends - Asymmetric treatment of dividends and distributions

- One of the adjustments to GloBE income is for "**Excluded Dividends**" - this covers most dividend payments made by one Constituent Entity to another and reflects the fact that dividends of controlled entities are exempt under tax rules of many jurisdictions. The definition of "Excluded Dividends" is broad and stretches to "other distributions".

- The OECD is concerned about the use of asymmetric financial instruments to increase the Effective Tax Rate ("ETR"). There is already an anti-avoidance rule in Article 3.2.7 that counteracts a shifting of GloBE income out of a low-tax jurisdiction into a high-tax jurisdiction. However, this is not triggered in circumstances where the issuer and the holder are residents of the same tax jurisdiction. The guidance seeks to ensure that Constituent Entities treat financial instruments the same way for the purposes of GloBE income.

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[1] The activities of an entity where 100% of the value is (in)directly owned by the Non-profit Organization will be deemed to be ancillary if the aggregate revenue of all Group Entities (excluding revenue derived by the Non-profit Organization or by an Entity that is an Excluded entity) is less than EUR 750 million or 25% of the revenue of the MNE Group (if lower).

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- A similar issue arises where a Constituent Entity issues a compound financial instrument (i.e. financial instruments that contain both a debt and an equity component, such as a convertible bond). IFRS and US GAAP require the debt and equity components of the compound financial instrument to be separately identified. The Excluded Dividends rule could in theory apply to all distributions (debt or equity). To address this, the Administrative Guidance also notes that where an ownership Interest is in a compound financial instrument, only amounts received or accrued in respect of the equity component should be treated as an Excluded Dividend.

Treatment of debt releases

- Where an entity is released from an obligation to pay a debt, this will typically give rise to income in that entity's accounts (which would, on first principles, ordinarily be taxable in a jurisdiction). However, it is common for jurisdictions to provide special provisions to exempt debt releases for companies in financial distress and undergoing corporate rescue procedures. The policy objective is to ensure the survival of the company (and associated employment). The IF has agreed to support this tax policy objective by allowing an adjustment to GloBE income for debt releases in corporate rescues. However, this adjustment will only apply in one of three prescribed scenarios: (i.) in the event of a statutory insolvency, (ii.) where it is reasonable to conclude the debtor would be insolvent within 12 months but for the release; or (iii.) where the creditor is a third party and the debtor's liabilities are in excess of the fair market value of its assets.

Accrued Pension Expenses

- Different accounting standards have different treatments for pension expenses associated with defined benefit pension plans. Article 3.2.1(i) of the Model Rules ensures that the pension expenses of a company are equal to its net contributions (i.e. its contributions less any earnings of the pension plan refunded to the company) irrespective of the accounting standard it applies to compute its GloBE income or loss. Accrued Pension Expenses are pension liability expenses that are provided through a Pension Fund. The amounts contributed to the pension scheme are the only pension expense amounts that can be included in the GloBE income or loss to ensure that the treatment of pension expenses under the GloBE Rules corresponds to the timing of the applicable deduction for corporate income tax purposes.

Covered Taxes on deemed distributions

- Intra-group dividend withholding tax is treated as a Covered Tax of the dividend payer under the GloBE Rules (Article 4.3.2(e)). The OECD Administrative Guidance confirms that withholding taxes paid on *deemed* distributions need to also be allocated to the Constituent Entity that made the distribution.

Excess Negative Tax Carry-forward guidance

- In calculating the ETR in a jurisdiction, the GloBE Rules consider current tax expenses as well as deferred tax expenses. Certain provisions are included in the GloBE Rules to prevent deferred tax expenses from permanently shielding a GloBE tax liability. The IF agreed, and that has been reflected in the Administrative Guidance, that jurisdictions must adopt an administrative procedure containing a methodology for the carry forward of Excess Negative Tax Expense (depending on the circumstances, the administrative procedure is either elective or mandatory).

Loss-making Parent Entities of CFCs

- CFC regimes often treat foreign CFC income as part of the domestic taxable income of the parent entity. Generally, such regimes allow taxpayers to use foreign tax credits ("FTCs") and/or domestic losses to offset tax imposed on that foreign-sourced income. Where domestic losses are used against foreign-sourced income, this can lead to the loss of FTCs, or alternatively, the regime may allow these FTCs to be carried forward in lieu of the domestic losses that would otherwise be carried forward. The Administrative Guidance seeks to ensure functionally equivalent outcomes for domestic sourced losses and foreign-sourced income in the same fiscal year, irrespective of whether jurisdictions permit a loss carry-forward or foreign tax credit carry-forward.

Equity Gain or Loss inclusion election and Qualified Flow-Through tax benefits

- Article 3.2.1(c) of the Model Rules excludes gains, profits or losses attributable to certain ownership Interests from GloBE income or loss. This also excludes income profits that might be attributable to an investor in respect of its interest in an overseas' Tax Transparent Entity. At the same time, Article 4.1.3(a) reduces Covered Taxes in respect of such amounts in order to try to achieve symmetry of treatment. However, this symmetry is not perfect and falls short in relation to the treatment of losses. The OECD Administrative Guidance sets out the possibility to make an Equity Investment Inclusion Election for jurisdictions that include profit, gain or losses of an equity investment in the domestic tax base. Further guidance on this will be forthcoming.

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- At the same time, the IF has determined that a special rule will apply to "Qualified Flow-Through Tax Benefits", i.e. tax credits and tax benefits of losses that flow to an investor as a return of (rather than a return on) the investor's investment. The OECD Administrative Guidance provides guidance on how this will operate.

Application of GloBE Rules to insurance companies

- The Administrative Guidance provides additional guidance specifically for Insurance Investment Entities. We prepared a detailed overview where we address these specific items in the Annex to this alert.

Transition

Deferred Tax Assets ("DTAs") and Tax Credits

- Article 4.4.1(e) of the Model Rules deals with deferred tax expenses with respect to the generation and use of tax credits. It does not apply to DTAs .As such, DTAs related to tax credit carry-forwards should therefore be taken into account in the Adjusted Covered Taxes computation.
- A simplified approach is provided for recasting DTAs related to tax credits where the domestic tax rate is equal to or higher than the Minimum Rate. The recast is not allowed if the domestic tax rate is lower than the Minimum Rate.
- Relieving guidance is provided for existing refundable tax credits whereby it is confirmed that the settlement of existing refundable tax credits should not reduce Adjusted Covered Taxes, irrespective of whether this refundable tax credit qualifies as a Qualified Refundable Tax Credit.
- Relieving guidance is provided for existing DTAs, whereby it is confirmed that an MNE Group is not required to undertake a full ETR calculation. Existing deferred tax attributes should be available, notwithstanding the adjustments made in Article 4.4, which contains the mechanisms to deal with temporary differences.

Applicability of transitional rules for similar asset transfers

- The OECD Administrative Guidance now clarifies that all transactions and corporate restructurings that are accounted for and similar to an asset transfer, regardless of form of the transaction and whether it takes place within a single Entity or among Entities, fall within the scope of "transfer of an asset" under Article 9.1.3 of the Model Rules.

Asset carrying value and deferred taxes

- The OECD Administrative Guidance also deals with the transfer of assets, as codified in Article 9.1.3 of the Model Rules. The term "basis" under Article 9.1.3 should be read as the carrying value of an asset. The term "transfer of assets" includes (i) cross-border and domestic transactions that are treated like a sale of assets from an accounting perspective, but also (ii) deemed transfers of assets within the same entity (e.g. relocation or migration of an Entity or a change to fair value accounting). However, leases and licenses are out of scope of Article 9.1.3.
- DTAs or DTLs arising from transferred assets at carrying value should be ignored for the purposes of the GloBE income or loss computation, unless (i) tax is paid with respect to this transaction and (ii) any gain derived from the disposition was included for taxable purposes. The DTA created under this exception cannot exceed the 15% Minimum Rate multiplied by the difference between the local tax basis and the GloBE carrying basis. The creation of a DTA under this exception should not reduce the Adjusted Covered Taxes. On the flip side, transactions that were once recorded at fair market value in the financial accounts, may be re-recorded at carrying value for GloBE purposes if the Constituent Entity were otherwise be entitled to take into account a DTA under Article 9.1.3.

Qualified Domestic Minimum Top-up Taxes

General

- When assessing whether a minimum tax qualifies as a Qualified Domestic Minimum Top-Up Tax ("QDMTT"), the minimum tax must be (i) consistent with the design of the GloBE Rules; and (ii) provide for outcomes that are consistent with the GloBE

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Rules. This assessment requires a case-by-case analysis whereby the existing outcomes under domestic law should be taken into account.

Consistent design

- The simplest way to be consistent with the design of the GloBE Rules would be to mirror the GloBE Rules into domestic tax legislation. However, the OECD Administrative Guidance acknowledges that this approach may result in complexity. Customization of the QDMTT in each jurisdiction is expected and allowed, as long as this can be justified in the context of the local domestic tax system and results in functionally equivalent outcomes.

Consistent outcome

- Variation in outcomes between the minimum tax and the GloBE Rules are allowed, as long as these variations (i) systematically produce a greater tax liability, or (ii) systematically do not produce a lower tax liability than the tax liability that would be expected under the GloBE Rules.
- The OECD confirmed that the jurisdiction that implements the minimum tax may use financial accounting standards that differ from the Authorized Financial Accounting Standard used in the Consolidated Statements. Hence, jurisdictions may either use an Acceptable Financial Accounting Standard or an Authorized Financial Accounting Standards adjusted to prevent Material Competitive Distortions. This is because local tax authorities would likely be more familiar with local accounting standards than the one used by the Ultimate Parent Entity in another jurisdiction.
- The following items under the GloBE Rules should, in any event, be included in the minimum tax in order to be respected as a QDMTT:
  - Scope:
    - The minimum tax must apply to domestic Constituent Entities of an MNE Group that meet the EUR 750 million threshold.
    - The minimum tax must follow (i.) the definitions under the GloBE Rules and the computation of income and taxes consistent with the GloBE Rules in order to produce functionally equivalent outcomes as the GloBE Rules.
    - The minimum tax must determine a separate ETR and Top-Up Tax for Minority Owned Constituent Entities and Joint Ventures. With respect to Joint Ventures, jurisdictions may choose to not impose minimum tax, or alternatively to impose the Top-Up Tax related to the Joint Ventures from Constituent Entities located in the same jurisdiction
  - Charging Provisions
    - In lieu of the charging provisions under the GloBE Rules, the minimum tax must impose a Top-Up Tax with respect to the domestic Excess Profits.
  - GloBE Income or Loss
    - The minimum tax must include similar rules as the ones addressed in Chapter 3 of the Model Rules (i.e. GloBE Income or Loss computation), whereby the following deviations are allowed:
      - The minimum tax can be computed using an Authorized Financial Accounting Standard that differs from the one used in the Consolidated Financial Statements. This is because local tax authorities would be more familiar with local accounting standards than the one used by the UPE in another jurisdiction.
      - The minimum tax does not include the adjustments under Chapter 3 of the Model Rules that are not relevant in the context of the domestic tax system.
  - Adjusted Covered Taxes
    - The minimum tax must include similar rules as the ones addressed in Chapter 4 of the Model Rules (i.e. Adjusted Covered Taxes), including the adoption of deferred tax accounting rules. The minimum tax does not need to contain a GloBE Loss Election.
    - The minimum tax can opt to exclude taxes on the income of a foreign CFC, Hybrid Entity or Permanent Establishment from the Adjusted Covered Taxes.

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- Other
  - The minimum tax is not required to have a Substance-Based Income Exclusion.
  - The minimum tax is not required to have a De Minimis Exclusion.
  - The minimum tax must have rules that are similar or functionally equivalent as the ones addressed in Chapter 6 (i.e. Corporate restructurings and holding structures) and Chapter 9 (i.e. Transition Rules) of the Model Rules.
- The IF will set-up a multilateral review process in 2023 to assess whether a domestic minimum tax of a jurisdiction is consistent with the GloBE Rules and should thus qualify as a QDMTT. The IF will also work on the introduction of a QDMTT Safe Harbour, which would provide compliance simplifications for jurisdictions that implement the QDMTT. Lastly, the IF will consider whether it will provide further guidance with respect to the identification of benefits related to a QDMTT.

Next steps

The IF indicated throughout the Administrative Guidance that further work will be needed for various outstanding items related to the GloBE Rules. The Administrative Guidance will be updated on a rolling basis when more clarity is needed.

An updated version of the Commentary containing the clarifications with respect to the GloBE Rules will be published later this year.

Baker McKenzie will continue to closely monitor the developments.

Keywords

BEPS; Corporate Tax; Pillar 2; OECD

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Annex: Application of GloBE Rules to insurance companies

Taxable Distribution Method Election for Insurance Investment Entities

- According to Article 7.6 of the GloBE Rules, Investment Entities can make an election to apply the Taxable Distribution Method to account for income that is earned through Investment Entities. This election was only available for Investment Entities. The Administrative Guidance now confirms that Insurance Investment Entities should also be eligible for this election.
- The Taxable Distribution Method election is only available if the Constituent Entity-owner can reasonably be expected to be subject to tax at a rate that equals or exceeds the Minimum Rate. The Administrative Guidance clarifies that taxes arising on distributions and taxes incurred by Investment Entities and Insurance Investment Entities should be taken into account for this assessment.
- The IF will consider whether the treatment of Investment Entities and Insurance Investment Entities under Article 7.6 will require simplifications and further clarifications in the future.

Exclusion of Insurance Investment Entities

- The Intermediate Parent Entity and Partially-Owned Parent Entity definitions exclude, among others, Investment Entities. Insurance Investment Entities are not excluded from these respective definitions. The Administrative Guidance now clarifies that Insurance Investment Entities should also be excluded from the Intermediate Parent Entity and Partially-Owned Parent Entity definitions.

Restricted Tier One Capital

- The GloBE Rules provide for specific provisions in Article 3.2.10 to treat Additional Tier One Capital, which banks are required to issue, as a debt instrument. Considering the similarities with Restricted Tier One Capital, which insurance companies are required to issue, the Restricted Tier One Capital will be treated in the same manner as Additional Tier One Capital.

Liabilities from securities

- Insurance companies often hold investments on behalf of policyholders. From an accounting perspective, the income of insurance companies' dividend is generally reduced with expenses from liabilities of the policyholders. The Administrative Guidance has now confirmed that these expenses are - as an exception to the general rule - not deductible for GloBE purposes if these are linked to Excluded Dividends or Excluded Equity Gains or Losses.

Simplification for Short-Term Portfolio Shareholdings

- Dividends from Short-Term Portfolio Shareholdings are not eligible for the Excluded Dividends. Insurance companies expressed that the differentiation of Short-Term and Long-Term Portfolio Shareholdings may often be burdensome. The Administrative Guidance introduced a simplified approach under which Constituent Entities (read: all, including insurance companies) can elect to include dividends from all Portfolio Shareholdings in the GloBE Income or Loss Computation.

Mutual insurance companies

- Investment Entities and Insurance Investment Entities can, under the conditions of Article 7.5, be elected to be treated as Tax Transparent. It was not clear whether mutual insurance companies could meet the conditions under Article 7.5. The Administrative Guidance now clarifies that mutual insurance companies should be able to make the Article 7.5 election for Investment Entities and Insurance Investment Entities.

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