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OECD Pillar Two – further guidance

On 17 June 2024, the G20/OECD Inclusive Framework ('OECD Inclusive Framework') published further administrative guidance on the implementation of the Pillar Two global minimum tax rules ('Pillar Two'), together with details of the processes for determining that countries' local implementations of the Pillar Two rules are 'qualified'.

The Pillar Two global minimum tax rules have been agreed by more than 140 members of the OECD Inclusive Framework. Countries are in the process of implementing rules in domestic legislation which will begin to apply from January 2024.

Deloitte comments

The OECD Inclusive Framework continues to publish guidance on the interpretation and application of aspects of the Pillar Two global minimum tax rules, with a view to enabling their consistent application and provide simplifications where possible.

This is the fourth set of administrative guidance and covers a range of areas such as the practical application of the deferred tax liability recapture rule, how to deal with divergences between Pillar Two and accounting carrying values, the allocation of cross-border current and deferred taxes, the allocation of profits and taxes in groups including flow-through entities, and the treatment of securitisation vehicles.

Businesses will need to work through the new guidance with reference to their facts and group entities to ensure that the effect of the new guidance is understood and reflected in calculations. Of particular note is the requirement for additional deferred tax to be calculated on differences between Pillar Two carrying values and corporate income tax carrying values, solely for the purposes of the Pillar Two calculations.

A large part of the guidance relates to situations affecting US multinationals where the model rules and existing commentary did not sit comfortably with either GAAP accounting treatment or the specialisms of the US corporate income tax regime (including the check-the-box rules). For example, the application of the Pillar Two rules to flow-through entities has been challenging from the start. The latest guidance deals with some concerns regarding mismatches arising in relation to reverse hybrids.

The guidance sets out that further work will be undertaken in some areas, including situations where there are losses in a main entity with permanent establishments or parent entities of CFCs and hybrid entities, and also in relation to securitisation vehicles. Further guidance on hybrid arbitrage arrangements in the main Pillar Two rules is also expected.

The OECD Inclusive Framework continues its work on mechanisms for dispute resolution in relation to differences of interpretation (including between tax authorities) of the Pillar Two rules.

The OECD Inclusive Framework's Pillar Two rules ('model rules'), applicable to large multinational groups with annual consolidated group revenue of **at least €750 million**, will result in 'top-up' tax amounts to bring the overall tax on profits in each country where a group operates up to a 15% minimum effective tax rate. The key components are: **qualified domestic minimum top-up taxes** (**QDMTT**) which allow countries to charge any top-up taxes due in respect of local profits; the **income inclusion rule** (**IIR**) under which parent company countries apply the top-up tax rules on a top-down basis; and the **undertaxed profits rule** (**UTPR**) which will apply as a secondary (backstop) rule where the other rules have not been fully applied.

The guidance will be incorporated into the OECD's commentary to the model rules at a future date. There are also a number of additional examples which will be included in the OECD's published examples illustrating the application of the model rules.

The new guidance covers six distinct areas: **recapture of deferred tax liabilities**; **divergences between Pillar Two basis and accounting carrying values**; allocation of **cross-border**

current taxes; allocation of **cross-border deferred taxes**; allocation of profits and taxes in **groups including flow-through entities**; and the treatment of **securitisation vehicles**.

Recapture of deferred tax liabilities

The model rules include a deferred tax liability recapture rule, that requires the benefit of some deferred tax liabilities (e.g. in relation to intangible fixed assets) that are taken into account in the Pillar Two calculations, to be tracked and then recaptured if they do not reverse within five years.

Some businesses raised questions about whether it would be necessary to track deferred tax liabilities on an item-by-item basis. The latest guidance sets out approaches on how to apply the deferred tax recapture rule in practice. For example, group entities will be permitted to track deferred tax liabilities on a '**General Ledger account**' basis. Simplified tracking approaches can also be permitted on a less detailed '**Aggregate DTL Category**' basis (i.e. two or more general ledger accounts within the same balance sheet or sub-balance sheet account) where the composition of the category does not include assets that are likely to be liable to deferred tax liability recapture. Specific general ledger accounts **cannot be aggregated** with other accounts, including: **non-amortisable intangible assets**, including **goodwill**; **intangibles** with an **accounting life of more than 5 years**; **related party receivables and payables**; and '**swinging accounts**' where net asset and net liability positions can arise at different points of the life of the relevant assets/liabilities. General ledger accounts which would always only generate deferred tax assets are also generally excluded from an Aggregate DTL Category.

Deferred tax liabilities that would otherwise be covered by an exception to the recapture (e.g. deferred tax liabilities in respect of tangible fixed assets) will become subject to recapture if tracked as part of a general ledger or Aggregate DTL Category.

The default **method for calculating the amount of the recapture** of liabilities within an Aggregate DTL Category is **last-in, first-out ('LIFO')**. In some circumstances groups may choose to use the **first-in, first-out ('FIFO')** method. Where an 'Aggregate DTL Category' contains only short-term deferred tax liabilities which will reverse within five years, entities can benefit from a simplification to remove the need for tracking. Guidance is also provided on the methodology for determining whether any reversals are attributable to deferred tax liabilities that arose before the group came within the scope of Pillar Two.

The guidance also includes a clarification on the exceptions to the recapture rule: deferred tax liabilities associated with cost recovery allowances on leased property will be within the scope of the exception if the leased property is a tangible asset.

Divergences between Pillar Two basis and accounting carrying values

There are a number of areas in the model rules which require an entity to determine its Pillar Two income or loss by reference to values which may differ from the carrying values reflected in the financial accounts used in the preparation of the consolidated financial statements. Examples include: **pension accruals**; **stock-based compensation**; **intra-group asset transfers accounted for at cost**; elections to use the **realisation method** in lieu of fair value accounting; and adjustments following **acquisitions or disposals of entities**. The guidance provides clarifications on how the **total deferred tax adjustment amount** should **be calculated using Pillar Two (GloBE) carrying values** in these areas. The guidance also clarifies the limited extent to which such divergences are taken into account for the purposes of applying the **transition rules**, and how Pillar Two deferred tax amounts are calculated following intragroup transfers accounted for at cost and subsequently amortised/impaired. The **substance-based income exclusion** continues to be calculated using accounting carrying values.

Allocation of cross-border current taxes

Under the model rules, covered tax amounts included within the financial accounts of a 'main entity' but relating to the profits of its permanent establishment, are generally allocated to the permanent establishment country for effective tax rate calculation purposes. Some countries allow for '**cross-crediting**' – i.e. foreign taxes paid on one source of income can give rise to foreign tax credits which can be used against income arising in a different country. The existing guidance on 'cross-crediting' is significantly expanded and sets out a formulaic **mechanism for determining the allocations of covered tax amounts** to each permanent establishment where cross-crediting rules apply to the main entity. The mechanism uses a four-step process, together with allocation keys, to apportion amounts. Modifications apply where cross-crediting involves taxable distributions and/or is applied by reference to separate 'baskets' of foreign income. The same principles also apply in respect of the **'cross-crediting'** of **taxes on CFCs**(other than taxes arising under a 'blended CFC tax regime' such as US GILTI, for which specific guidance issued in February 2023 remains applicable) and also **hybrid** and **reverse hybrid entities**.

Allocation of cross-border deferred taxes

Expanded guidance is provided on the principles relevant to **allocating deferred taxes between group entities** where a deferred tax balance in the financial accounts of one entity arises due to the income of a different Pillar Two entity. The guidance focuses on deferred tax associated with CFC rules and sets out a **formulaic five-step approach** for calculating the Pillar Two **re-allocation of associated deferred tax amounts of a parent to its CFC**. Several numerical examples are given which illustrate the interaction with deferred tax from credits for the underlying tax of the CFC itself, requirements to recast deferred tax amounts to 15% and/or the passive income limitation. The guidance states that the **same principles will also apply** to allocation of similar deferred taxes from a main entity to **permanent establishments**, and from parent entities to **hybrid and reverse hybrid entities**.

The new guidance also expands existing commentary that sets out a **'Substitute Loss Carry-forward DTA' mechanism** to address situations where a parent entity has a current year domestic tax loss which is used against current year foreign CFC income with a corresponding carry forward of excess foreign tax credits. This mechanism is **extended** to situations involving **permanent establishments, hybrid entities and reverse hybrid entities**, and also to similar situations involving the interaction of domestic tax losses brought forward and foreign tax credits.

Allocation of profits and taxes in groups including flow-through entities

Additional guidance has been released in respect of **the allocation of profits and taxes to and from 'flow-through entities'** (i.e. broadly, entities which are treated as transparent in their country of creation). The guidance addresses situations where **a flow-through entity is itself held directly by another flow-through entity**. In such cases, classification of entities as 'tax transparent' or 'reverse hybrids', and reallocations of profits and taxes, will generally be determined by the tax law of the entity closest in the ownership chain which is itself not a flow-through entity (the **'Reference Entity'**). The guidance includes situations where the ultimate parent of a group is a flow-through entity, or where there is a minority interest in a flow-through entity. The guidance also confirms how CFC taxes, initially attributable to a flow-through entity, should be treated under the general reallocation rules for flow-through entities.

The **definition of a hybrid entity has been expanded** such that an entity can be treated as a hybrid entity by reference to its tax treatment in the jurisdiction of **an *indirect* owner**, enabling in some circumstances for taxes paid by the indirect owner to be allocated to the hybrid entity. An entity can also be treated as a hybrid entity where its local tax jurisdiction does not have a corporate income tax regime. The guidance also sets out circumstances where **taxes paid by an *indirect* owner in respect of a reverse hybrid entity** are allocated to the reverse hybrid.

Treatment of securitisation vehicles

Additional guidance has been issued on the treatment of groups with **special purpose vehicles used for the purposes of securitisation transactions**. The guidance notes the importance for the sector that securitisation entities remain 'bankruptcy remote'. Where a special purpose vehicle meets the guidance's definition of a securitisation entity (including having non-group investors), countries can exclude these entities from the scope of their QDMTTs. However, the 'switch-off rule' would apply such that a group with an excluded securitisation entity would not benefit from the QDMTT Safe Harbour for that country. Alternatively, countries may choose to design their

QDMTTs so that any QDMTT top-up tax liabilities in respect of securitisation entities are imposed on other group entities located in the same country, in which case the QDMTT Safe Harbour would remain available for that country.

The OECD Inclusive Framework will consider issuing further administrative guidance to address issues associated with securitisation entities e.g. in respect of hedging arrangements.

Qualified status under Pillar Two

The Pillar Two global minimum tax rules incorporate an **agreed rule order**, which prevents a country from levying top-up tax in respect of low tax profits where those profits have already been subject to top-up tax under **'qualified' rules** in another country. A separate questions and answers document published by the OECD Inclusive Framework describes agreed processes for common assessment of the 'qualified' rules status of countries' implementations of **domestic minimum top-up tax rules**, **income inclusion rules**, and **undertaxed profits rules**; as well as assessing whether a country's qualified domestic minimum top-up tax satisfies the additional criteria for the **QDMTT Safe Harbour** to apply.

A **simplified transitional qualification mechanism** will apply initially based on **self-certification by an implementing country**. An implementing country will provide the OECD Inclusive Framework with information on the main features of their (draft or enacted) legislation. If the rules contain some minor inconsistencies, a country can still make a self-certification where these are expected to be addressed within an agreed timeframe. If no questions are received from other Inclusive Framework countries, or if any such questions are resolved, the rules will be **recorded on the OECD website as having transitional qualified status**. If questions cannot be resolved and a required level of opposition is reached ('consensus minus one' - i.e. all or all but one of the reviewing countries have agreed that the self-certification should be rejected) then the country's rules will not have transitional qualified status. If the rejection requirements are not reached, the country's rules will have transitional qualified status, but they will also be prioritised for early full legislative review under the Peer Review process. All implementing countries will be required to respect any transitional qualified status.

A **full Peer Review process** will be introduced, involving both **a full legislative review** of whether domestic legislation achieves **outcomes consistent** with the model rules, and **ongoing monitoring** to ensure that a country's **rules are in practice applied and administered consistently** with the model rules. Any loss of transitional qualified status as a result of a Peer Review will not be retrospective but will only apply for accounting periods that begin on or after the date that the status changes.

Next steps

The OECD Inclusive Framework will continue to release further agreed guidance on an ongoing basis. It is expected that future guidance will include the treatment of hybrid arbitrage arrangements in the main Pillar Two rules.

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