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OECD releases guidance for Pillar Two, including GILTI coexistence and QDMTT design

FEBRUARY 7, 2023 6 MIN READ

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On February 2, 2023, the OECD/G20 Inclusive Framework on BEPS released Administrative Guidance on the GloBE Model Rules (Pillar Two) (Administrative Guidance).

The publication of the Administrative Guidance follows the release of the model Global Anti-Base Erosion (GloBE) rules in December 2021, the Commentary and illustrative Examples in March 2022, as well as rules for certain temporary and permanent safe harbours and transitional penalty relief in December 2022. For more information on the model GloBE rules and other Pillar Two documents see our Osler Updates "OECD releases model rules for global minimum tax" and "OECD releases three Pillar Two documents, including guidance on safe harbours"

Pillar Two proposed to introduce a 15% global minimum tax on the income of large multinational enterprises (MNEs) that have annual consolidated revenues of EUR 750 million or more.

According to the OECD, the release of the Administrative Guidance finalizes the implementation framework set out in the October 2021 Statement pursuant to which the OECD/G20 Inclusive Framework announced that they had agreed to a two-pillar approach to tax reform to address the taxation of the digital economy and unresolved BEPS issues. Although the publication of the Administrative Guidance is an important milestone as countries like Canada consult and work towards implementing the model GloBE rules in domestic legislation, there are still important aspects of Pillar Two that remain unaddressed.

Treaty compatibility

The Administrative Guidance contains a consensus statement that the model GloBE rules (including the income inclusion rule (IIR) and the UTPR) are designed to be compatible with the UN and OECD model tax treaties. This statement is consistent with earlier statements made in the original Pillar Two blueprint that the IIR and UTPR are compatible with tax treaties, but is made against a background of ongoing debates about whether Pillar Two (and in particular, the UTPR) is in fact consistent with existing tax treaties. As a result, treaty compatibility remains an open issue notwithstanding the OECD's desire to have Pillar Two implemented without amending existing tax treaties.

GILTI coexistence

Significantly, the Administrative Guidance addresses how Pillar Two will coexist with the US global intangible low-taxed income (GILTI) regime.

GILTI (in its current form) did not appear to meet the requirements to be considered a qualified IIR for Pillar Two purposes. The Administrative Guidance concludes that GILTI will instead be considered a qualifying Blended Controlled Foreign Corporation (CFC) Tax Regime. Article 4.3.2(c) of the model GloBE rules requires CFC taxes to be allocated to the constituent entity that earned the income subject to the CFC tax rather than to the parent entity up the chain that pays the CFC tax. As a result, GILTI taxes may be allocated, fully or partially, to the relevant foreign jurisdictions rather than to the United States.

The Administrative Guidance proposes a simplified methodology to allocate GILTI taxes under Article 4.3.2(c) of the model GloBE rules. The simplified methodology involves allocating GILTI taxes to constituent entities located in low-tax jurisdictions where the effective tax rate is below 15%. The prescribed formula allocates GILTI taxes to the relevant low tax jurisdiction based on a ratio of income to the entity's effective tax rate in the jurisdiction. The simplified methodology is transitional (until 2027), and the Inclusive Framework will re-assess the methodology at a later date. This guidance gives the U.S. an opportunity to amend its GILTI rules to allow them to be treated as a qualified IIR for purposes of Pillar Two rather than a Blended CFC Tax Regime. Importantly, if the U.S. continues to not have a qualified IIR then other countries could seek to tax certain low-taxed income of U.S. corporations (and their subsidiaries) under the UTPR.

The Administrative Guidance includes two practical examples demonstrating how GILTI taxes will be allocated under Article 4.3.2(c) of the model GloBE rules.

Qualified domestic minimum top-up tax

The Administrative Gidance also provides details regarding the design of qualified domestic top-up taxes (QDMTT). The QDMTT concept was introduced in December, 2021 and allows jurisdictions to introduce a domestic top-up tax that is aligned with Pillar Two and applies to domestic entities that are within the scope of Pillar Two. For countries that implement a QDMTT, such taxes will ensure that the Pillar Two top-up tax is paid in the jurisdiction where the relevant income is earned by the MNE, rather than in other jurisdictions that could otherwise tax such income under an IIR or UTPR.

Given that a QDMTT offsets the global minimum tax liability under Pillar Two, it is critical for stakeholders to have a clear understanding of whether a particular domestic minimum (top-up) tax "qualifies" as a QDMTT. In this regard, the Administrative Guidance states that, in order for a domestic minimum tax to be treated as functionally equivalent to a QDMTT for Pillar Two purposes, the domestic rules must be consistent with the design of the model GloBE rules and must result in outcomes that are consistent with the model GloBE rules.

Other issues addressed in the Administrative Guidance

In addition to the GILTI and QDMTT matters, the Administrative Guidance addresses many other important topics and issues, broadly covering:

- The scope of the model GloBE rules (and, in particular, aspects relating to the application of the rules to MNEs that have consolidated revenues of at least EUR 750 million).
- The treatment of various income (loss) elements and taxes under the model GloBE rules.
- The application of the model GloBE rules to insurance companies, and
- The treatment of deferred tax assets and transactions similar to asset transfers in the transition period under the model GloBE rules.

Despite the release of the Administrative Guidance, certain implementation issues and important aspects of Pillar Two remain unresolved. The safe harbour rules for QDMTTs, and the re-considered treatment of Investment Entities and Insurance Investment Entities under the model GloBE rules, are only two examples of the key Pillar Two issues that remain outstanding.

The Administrative Guidance will ultimately be incorporated into the Commentary to the model GloBE rules and illustrative Examples. The revised Commentary (and any accompanying illustrative Examples) are set to be released later in 2023.

Next steps

Canada has announced its intention to implement Pillar Two, along with a domestic top-up tax. It is expected that Canada will release domestic legislation implementing the IIR under Pillar Two later in 2023. The EU has announced its intention to implement the IIR with effect for fiscal years starting on or after December 31, 2023, and the UTPR one year later. Canada previously announced its plans to implement those rules with effect from 2023 and 2024, respectively. It is likely that Canada will seek to align its timing with that of the EU.

In the meantime, the OECD/G20 Inclusive Framework will continue work on addressing the outstanding Pillar Two issues and on finalizing the treaty-based subject to tax rule (STTR) and the multilateral instrument that would facilitate the implementation of the STTR.