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1 Executive Summary

Note for WP11 Delegates

An Executive Summary will be incorporated into the next version of this Report, which will be circulated to Delegates at the end of August following receipt of delegates written comments on this document. The Executive summary will set out the context of the Pillar 2, the work involved in its preparation and provide an overview of the structure of the report with a summary of the contents of each chapter. The Executive Summary will also address the grandfather/co-existence with the United States "GILTI" rules.

2 Scope of the GloBE rules

2.1. Overview

1. The income inclusion and undertaxed payments rules (together, the GloBE rules) provide a systematic solution that is designed to ensure that internationally operating businesses pay a minimum level of tax regardless of where they are headquartered or the jurisdictions they operate in.¹ The mechanisms for computing and collecting such a minimum level of tax will be described in Chapter 3 and Chapter 4. This chapter (Chapter 2) sets out a description of those internationally operating businesses and their constituent entities that are within scope of the GloBE rules.

2. In line with the requirements for CbCR, an MNE Group will generally consist of those enterprises that are required to consolidate their accounts with those of the ultimate parent entity. Section 2.2 sets out the definition of an MNE Group and a methodology for identifying the various constituent entities that make-up each MNE Group. This methodology is based on principles that are derived from those currently used by IF members under BEPS Action 13 for Country-by-Country Reporting purposes. Both membership and measurement of an MNE Group is therefore based on the accounting principles that are applied, or that would be applied, by an MNE group in preparing consolidated financial statements for financial reporting purposes.

3. The GloBE rules are not intended to apply to certain ultimate parent entities such as investment and pension funds, governmental entities such as sovereign wealth funds, and international and non-profit bodies, which typically benefit from an exclusion or an exemption from tax under the laws of the jurisdiction where they are incorporated. Section 2.3 provides the list of parent entities² that are excluded from the scope of the GloBE rules.

4. As for CbCR, the application of the GloBE Rules is confined to MNE Groups that have total consolidated group revenue above €750 million or equivalent in the immediately preceding fiscal year of the group. Section 2.4 discusses the methodology for computing that revenue threshold and its implications in relation to the GloBE rules.

¹ See paragraph 55 of OECD (2019), Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, OECD/G20 Inclusive Framework on BEPS, OECD, Paris

² This language will be required if there is an industry specific exclusion such as for International Shipping.

2.2. Identifying the Constituent Entities in the Group

Groups and Entities within the Scope of the GloBE rules

Group

The term “Group” means a collection of enterprises³ related through ownership or control such that it is either required to prepare consolidated financial statements for financial reporting purposes under applicable accounting principles or would be so required if equity interests in any of the enterprises were traded on a public securities exchange.⁴

MNE Group

The term “MNE Group” means any Group that includes two or more enterprises the tax residence for which is in different jurisdictions or includes an enterprise that is resident for tax purposes in one jurisdiction and is subject to tax with respect to the business carried out through a permanent establishment in another jurisdiction.⁵

Constituent Entity

The term “Constituent Entity” means

- (a) any separate business unit of an MNE Group that is included in the consolidated financial statements of the MNE Group for financial reporting purposes, or would be so included if equity interests in such MNE Group were traded on a public securities exchange;
- (b) any such business unit that is, or would be, excluded from the MNE Group’s consolidated financial statements solely on size or materiality grounds; and
- (c) any permanent establishment of any separate business unit of the MNE Group included in (a) or (b) above provided the business unit prepares a separate financial statement for such permanent establishment for financial reporting, regulatory, tax reporting, or internal management control purposes.⁶

A Constituent Entity does not include, however, a business unit that is an Excluded Entity.

Ultimate Parent Entity (UPE)

The term “Ultimate Parent Entity” or “UPE” means a Constituent Entity of an MNE Group that meets the following criteria:

- (a) it owns directly or indirectly a sufficient interest in one or more other Constituent Entities of such MNE Group such that it is required to prepare Consolidated Financial Statements under accounting principles generally applied in its jurisdiction of tax residence, or would be so required if its equity interests were traded on a public securities exchange in its jurisdiction of tax residence; and
- (b) there is no other Constituent Entity of such MNE Group that owns directly or indirectly an interest described in paragraph (a) above in the first mentioned Constituent Entity.

5. The definitions set out in the box above define the entities and operations that make up an MNE Group. These definitions are the same as those that are used for CbCR with minor drafting changes to accommodate the different design of the GloBE rules,⁷ which is, in turn, built on the standards used for

determining whether the operation of two enterprises or business units should be consolidated for financial reporting purposes.

6. Using the consolidation standard under financial accounting to define the scope of an MNE Group and the Constituent Entities within that group has a number of advantages. The rules that determine when an MNE is required to consolidate for accounting purposes are robust, comprehensive and relatively consistent across accounting standards. The use of a financial accounting standard also has benefits from the compliance perspective, because the application of the standard will, in many cases, be subject to review by independent financial accounting auditors. A definition of an MNE Group based on the relevant financial accounting standards may even reduce the incentive for that MNE Group to adopt structures designed to artificially exclude or include subsidiaries from the group. For example, an MNE may have an incentive to include a loss-making entity within its group in order to reduce its GloBE tax base in a jurisdiction. Aligning the definition of the MNE Group with that used for financial reporting purposes would, however, mean that including such an entity for GloBE purposes would have a corresponding deleterious impact on its consolidated profit for financial reporting purposes.

7. The definitions set out in the box above are based on those agreed under BEPS Action 13. The Final Report on Action 13 adopted a three-tiered approach to transfer pricing documentation consisting of the master file, the local file and the CbCR report. The CbCR report requires an MNE Group to report information such as the income earned, taxes paid, and business activities carried out in each jurisdiction, and a list of all of its Constituent Entities. Tax authorities use the information provided in the CbCR reports to assess transfer pricing and other BEPS risks. BEPS Action 13 has a different policy to that of Pillar 2. CbCR is a reporting obligation that is designed to promote transparency and improve risk assessment, while Pillar 2 results in the actual imposition of a tax liability. Nevertheless aligning the definitions under CbCR and the GloBE rules can be expected to further reduce compliance and administrative burdens to tax authorities and taxpayers. At the same time, the use of a consolidated accounting standard as a basis for defining the MNE Group allows other design features of the GloBE rules (such as the determination of the tax base) to leverage those same accounting standards.

³ The term “enterprise” is used in definitions of “Group” and “MNE Group” in the CbCR Model Legislation. This term is included in the definition to maintain consistency between GloBE and CbCR definitions. For these purposes, the term “enterprise” is broadly equivalent to the term “business unit” which is used as part of the definition of Constituent Entity.

⁴ See OECD (2015), [Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report](#), OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. p. 39

⁵ See BEPS Action 13 Report (above) p 39.

⁶ See BEPS Action 13 Report (above p 39.

⁷ In brief, and as described further below, the differences between the definitions under CbCR and GloBE are: 1) the reference to “Excluded Group” (subsection (ii)) was eliminated from the definition of “MNE Group” because the GloBE rules deal with the €750 million threshold in a separate rule; 2) the term “business unit” was eliminated from subparagraph (a) from the definition of “Constituent Entity” to clarify the operation of the deemed consolidation test; 3) a last sentence was added to the definition of “Constituent Entity” to make reference to the excluded entities in accordance with the Section 1.2. Minor formatting changes have also been made to align with the overall design of the GloBE rules.

2.2.1. Definition of Group and MNE Group

Definition of Group

8. The definition of “Group” under the GloBE rules is the same as that used in CbCR. A group is defined as a collection of enterprises that are consolidated for financial accounting purposes. This consolidation test is, in turn, based on a control test used for accounting. In general, the effect of this test is that two entities will be treated as part of the same Group where one entity controls the other or both entities controlled by another entity. The definition of “Group” also extends to situations where an entity or arrangement carries on business activities in foreign jurisdictions exclusively through permanent establishments because the assets, liabilities, income, and losses of the permanent establishments are included in the financial statements of the head office as if they were consolidated on a line-by-line basis.⁸

MNE Group

9. The definition of “MNE Group” under the GloBE rules is also consistent with, and has the same outcomes as under, the CbCR rules. The definition of MNE Group incorporates a minor drafting difference from CbCR in that the group revenue threshold, which is incorporated directly into the definition of the MNE Group for CbCR purposes, is excluded from the definition used for GloBE purposes. While the GloBE rules apply the same revenue threshold as CbCR, this requirement is dealt with separately under the GloBE rules. The purpose of the MNE Group definition set out in the box above is to identify the MNE Group and the Constituent Entities that are part of the same group, rather than determine whether an MNE Group is subject to the GloBE rules. As such, the revenue threshold is more appropriately treated as a separate design element of the GloBE rules. See Section 2.4.1.

2.2.2. Definition of Constituent Entity

10. A Constituent Entity consists of a separate business unit that it is (or would have been) included in the consolidated financial statements of the MNE Group. As with CbCR, the GloBE rules apply a “deemed consolidation” test that treats a business unit as part of an MNE Group where that business unit would have been required to be consolidated had any of the equity interests in that MNE Group been traded on a public securities exchange.

11. Any separate business unit that is excluded from the consolidated financial statements, or that would be excluded if the MNE Group prepared such statements, solely on size or materiality grounds is also a Constituent Entity. Lastly, a permanent establishment of a Constituent Entity is treated a separate Constituent Entity. The definition of Constituent Entity does not include those entities specifically identified as “Excluded Entities” in Section 2.3. Further explanation of the separate limbs of the Constituent Entity definition is set out below. A flow chart based on this section is included in the Annex (see Flow Chart set out at Example 2.2.2).⁹

(a) Business units (other than permanent establishments)

12. A business unit means an entity or arrangement such as a company or a partnership and is intended to have the same meaning as is used in the CbCR rules. In order to meet the definition of a Constituent Entity, the business unit must be “included in the consolidated financial statements of the MNE Group”. A business unit will be Constituent Entity of an MNE Group when it is consolidated with the Ultimate

⁸ Revised based on written comments made by the Slovak Republic.

⁹ This sentence and the flow chart in the Annex were included to reflect comments made by Sweden during the WP11 virtual meeting held on July 17, 2020.

Parent Entity under the applicable accounting standard of that parent. These consolidation requirements apply a control test that requires the operations of the Constituent Entity to be consolidated with the rest of the MNE Group on a line-by-line basis. A non-controlled entity is not consolidated on a line-by-line basis in the consolidated financial statements of the MNE Group but rather is separately reported under the equity method. Such an entity is not considered a Constituent Entity under the subparagraph (a) of the definition. A business unit that is subject to special reporting treatment under an applicable accounting standard, for example, on the grounds that the business unit is held for sale, should continue to be treated as a Constituent Entity for tax purposes as long as it otherwise remains sufficiently within the control of the Ultimate Parent Entity to fall within the consolidation requirements of the applicable accounting standard.¹⁰

Joint Operations

13. The phrase “included in the consolidated financial statements of the MNE Group” also refers to situations where an MNE Group has an investment in a joint operation such that a proportionate share of the assets, liabilities, income, and expenditures of that business unit are included in the consolidated financial statements on a line-by-line basis.¹¹ Therefore, a business unit that is treated as a joint operation should be treated as a separate Constituent Entity if the income and expenses of the joint operation are included in the group’s consolidated financial statements in proportion to the group’s ownership interest in the business unit. The Constituent Entity is comprised, however, only of the MNE Group’s share of the joint operation as reflected in the consolidated financial statements.

14. For example, a Constituent Entity may be a member of a partnership that is treated as a joint operation for financial accounting purposes and the MNE Group includes 40% of the income, expenditures, assets, and liabilities of the partnership in its consolidated financial statements. This partnership is treated as a Constituent Entity under the GloBE rules, however its GloBE tax base is determined based on the MNE Group’s share of the partnership’s income, expenditures, assets, and liabilities that are included in the consolidated financial statements and the MNE Group will be treated as controlling that Constituent Entity to the extent of that income.

Resident enterprises

15. A Constituent Entity that is a tax resident will be treated as a Constituent Entity located in its jurisdiction of tax residence. The Constituent Entity’s jurisdiction of tax residence is the jurisdiction where the business unit is liable for covered tax on its income (other than a source-based withholding tax) and where the imposition of the tax is based on its place of management, place of incorporation, or similar criteria. The legal character of the business unit is not determinative of whether it should be treated as a Constituent Entity. For example, if a partnership or trust is considered tax resident in a jurisdiction, it should be considered as a separate Constituent Entity from its owners for the purposes of these rules.

16. Where a jurisdiction does not have a corporate tax system then an entity that is incorporated in that jurisdiction (and is not tax resident in any other jurisdiction) may be treated as located in its jurisdiction of incorporation. Therefore, an entity or arrangement that is incorporated or established in a jurisdiction which does not impose covered taxes may be treated as a Constituent Entity in its jurisdiction of incorporation or establishment, unless it is tax resident under the laws of another jurisdiction (for example, under a place of effective management test).

¹⁰ This paragraph was added based on written comments made by the Slovak Republic.

¹¹ This is in line with the Guidance on the Implementation of Country-by-Country Reporting (December 2019). See *Treatment of an entity owned and/or operated by more than one unrelated MNE Groups* (p.19).

Tax transparent entities or arrangements

17. An entity or arrangement that is treated as tax transparent by all of its owners and in the jurisdiction where it is created will be treated as a Constituent Entity under the GloBE rules if, as set out above, its assets, liabilities, income, and expenses are consolidated on a line-by-line basis in the consolidated financial statements of the MNE Group. This treatment of a fully consolidated tax transparent entity is consistent with the requirements for CbCR. Such a tax transparent entity should be treated as a stateless entity. Under the rules of section 3.6.2., all the income and expenses (and corresponding covered taxes) of that entity may be allocated to other Constituent Entities in the group. These other Constituent Entities could include the owners of the transparent entity or any permanent establishment of that entity (or the owners) The fact that a business unit does not have profit, losses, or covered taxes allocated to it under the GloBE rules does not, however, prevent a tax transparent entity from being treated as a separate Constituent Entity.

Hybrid and reverse-hybrid entities

18. Applying the above criteria, a hybrid entity (i.e. an entity that is treated as a separate entity for tax purposes in its jurisdiction of incorporation or creation, but as transparent by its owners) should be considered a Constituent Entity that is located in the jurisdiction where it is treated as resident.¹² A reverse-hybrid entity (i.e. a business unit that is treated as tax transparent in the jurisdiction where it was created but as a separate entity for tax purposes in the jurisdiction of at least one of its owners), on the other hand, is treated as a Constituent Entity that is not located in any jurisdiction (i.e. a stateless entity).

Dual resident entities

19. There may be cases where a Constituent Entity could be considered a tax resident of more than one jurisdiction. This outcome would be incompatible with the GloBE rules, which determine the ETR and top-up tax liability on a jurisdictional basis. In line with the specific instructions of the CbCR template contained in the Action 13 Final Report, this potential for dual residency should be resolved in accordance with the tax treaty tie breaker rule agreed between the jurisdictions where the entity or arrangement has dual-residence. In case of no applicable tax treaty tie breaker rule, the Constituent Entity is considered to be resident of the jurisdiction where it has its place of effective management.

(b) No exclusion based on size or materiality

20. The GloBE definition of Constituent Entity follows the treatment under CbCR by going beyond financial accounting to capture entities or arrangements that otherwise would be excluded from the consolidated financial statements on the grounds of size or materiality. The purpose of this extension in the CbCR rules was to capture information about business units that were excluded from the consolidated financial accounts because of their low levels of income or profitability. While these entities may not be material from a financial reporting stand point, they may still be considered to raise transfer pricing risks because the business unit may not have been adequately rewarded for the functions performed, assets held, and risks undertaken by that business unit. These entities or arrangements are also considered Constituent Entities of the MNE Group for GloBE purposes for similar reasons. The GloBE rules are applied on a jurisdictional basis and though an entity may be immaterial in the overall MNE Group context, it may be material from the perspective of a particular jurisdiction (for example, under the undertaxed payments rule). Furthermore, including these constituent entities will not unduly increase compliance burdens on MNE Groups as they are already required to gather and submit information for purposes of CbCR.

¹² Under this section, an entity or arrangement is created in a jurisdiction if it was incorporated, organized, or created based on the domestic laws of such jurisdiction.

Subparagraph (b) of the definition also addresses the situation where the MNE Group does not prepare consolidated financial statements because it is not required to consolidate all of its subsidiaries as none of them meet the size or materiality threshold.¹³

(c) Permanent establishments

21. Finally, paragraph (c) of the definition of Constituent Entity treats a permanent establishment as a separate Constituent Entity (that is, separate from the Constituent Entity that owns it) provided that the permanent establishment has separate financial statement for financial reporting, regulatory, tax reporting, or internal management control purposes. The need to distinguish the separate business operations undertaken in the permanent establishment and the head office is particularly relevant for jurisdictional blending. It ensures that the tax rate on income earned through branches in another jurisdiction is not blended with income of the head office in a different jurisdiction. In that sense, it ensures parity in the treatment of foreign subsidiaries and branches of the MNE Group, which is consistent with the policy and design elements of the GloBE.

22. The term “permanent establishment” is not defined in the CbCR rules. For purposes of the GloBE rules, whether a permanent establishment exists is determined in accordance with the applicable tax treaty in force. In case there is no applicable tax treaty in force, then a permanent establishment would be deemed to exist in a jurisdiction only if it has a sufficient business presence in such jurisdiction that the income of the operations are taxed on a net basis. In these cases, a taxable business presence will generally be determined by reference to factors such as whether the Constituent Entity has a place of business in a foreign jurisdiction or whether it is present for a particular period, acting through an agent or any criteria of similar nature. Furthermore, for purposes of the GloBE rules, a permanent establishment is deemed to exist if the residence jurisdiction of the Constituent Entity that owns the branch or similar establishment treats it as a separate taxpayer from its resident taxpayer. For example, a branch would be considered as a permanent establishment and a separate Constituent Entity if its income is subject to a branch exemption in the owner’s residence jurisdiction. In these situations, the permanent establishment is deemed to exist even if the jurisdiction where the branch is located does not exercise any taxing rights.

23. A branch or similar establishment of a Constituent Entity that meets the definition of a permanent establishment is treated as a separate Constituent Entity of the MNE Group in the jurisdiction in which it is located. Whether the permanent establishment is considered to be owned by another Constituent Entity under local law or tax treaties is not relevant for GloBE purposes. For example, when a UPE that is tax transparent maintains a branch in another jurisdiction that qualifies as a permanent establishment, that permanent establishment is treated as a Constituent Entity of the MNE Group for GloBE purposes, even if under local law or tax treaties it is considered a permanent establishment of the owners of the UPE.¹⁴

2.2.3. Definition of the Ultimate Parent Entity

24. The definition of Ultimate Parent Entity (or UPE) is a keystone definition in the sense that is used as a reference point for the application of other GloBE rules. For example, the definition is used to identify all the controlled entities that comprise the MNE group including the identification of Excluded Entities and

¹³ Sentences added based on written comments made by the Slovak Republic.

¹⁴ Paragraph added based on comments made by Germany and Hungary during the WP11 virtual meeting held on July 17, 2020.

the definition is important for the mechanics of the income inclusion rule which are described below in Chapter 5.¹⁵

25. The UPE is the Constituent Entity that directly or indirectly owns a controlling interest in all the other constituent entities that are part of the same MNE group. The UPE is the entity that is or would be required to consolidate the financial accounts of all other constituent entities in the MNE group. Paragraph (b) of the definition of Ultimate Parent Entity¹⁶ clarifies that an entity is not an Ultimate Parent Entity if there is another entity in the group that owns sufficient interest in that entity that it would be required to consolidate the entity's accounts with its own. Generally, this element of the definition means that there is no entity within the MNE Group that owns a controlling interest in the Ultimate Parent Entity. However, it also applies to exclude an entity that owns the controlling interests in the Ultimate Parent Entity but that is not required to consolidate its accounts with those of the Ultimate Parent Entity. For example, investment entities such as funds may be permitted to report their investments, including majority ownership interests, in an MNE Group under the fair value method rather than consolidated accounting. These investment entities would, accordingly, not be treated as the UPE of such MNE groups.

2.2.4. Associates and joint ventures

26. Accounting rules, such as IFRS 10, typically require the Ultimate Parent Entity to fully consolidate on a line-by-line basis, the assets, liabilities, income and expenditures of the entities or arrangements that it controls. This control test is based on *de facto* control and may apply to treat an entity as consolidated even where the parent holds less than a majority stake in the equity interests of the entity or arrangement.

27. Where the Ultimate Parent Entity does not have direct or indirect control over the entity it will not be required to consolidate the operations of an associate entity or joint venture on a line-by-line basis. In this case the profit (or loss) of this entity is required to be reported under the equity method unless the investments is recognised as a non-current financial asset.¹⁷ Entities reported under the equity method will not be considered as Constituent Entities that are members of the MNE Group under the GloBE rules.

Associate entities and arrangements

28. Under IFRS, an associate is an entity or arrangement over which the investor has significant influence. An investor is presumed to have significant influence over an investment when the investor holds at least 20% of the investee's voting power.¹⁸ Associates (entities or arrangements)¹⁹ are typically reported under the equity method and therefore excluded from the definition of a "constituent entity" that entity is not under the control of the ultimate parent entity. Moreover, that same entity could be a subsidiary and fully consolidated on a line-by-line basis in the financial statements of another MNE Group, which would make it a Constituent Entity of that other group. Applying the GloBE rules to an associated entity could therefore lead to significant complications in the applications of the GloBE rules where the same entity

¹⁵ No decision has yet been taken by the Inclusive Framework on the choice between a top-down approach and a bottom-up approach for determining which jurisdiction's GloBE rules have priority of application. This reference to the top-down approach merely serves to highlight the additional significance of the Ultimate Parent Entity in the design of an ordering rule for the IIR.

¹⁶ Revision based on comments by the Slovak Republic.

¹⁷ Typically, where the MNE's stake in a company is less than 20%, it would report its investment in its consolidated financial statements as a non-current financial asset e.g., IFRS 9 – Financial Instruments.

¹⁸ Paragraph 3 of IAS28. IFRS Foundation.

¹⁹ "Associate" is an accounting term which is different to the term "associated enterprise" as used in the context of transfer pricing. – *This footnote is included to reflect comments made by Qatar during the during the WP11 virtual meeting held on July 17, 2020.*

would be subject to the IIR and UTPR applied by different MNE Groups in different jurisdictions. For these reasons, an entity or arrangement should only be a Constituent Entities of the MNE Group that fully consolidates them on a line-by-line basis. Section 4.4.1. discusses the application of a simplified income inclusion rule with respect to low-taxed income of associate entities or arrangements.

Joint ventures

Note for WP11 Delegates

In light of delegate comments at the WP11 meetings on July 17 and 30th, the Secretariat has suggested the following treatment of joint venture interests held by an MNE Group under the GloBE rules:

- (a) Joint Venture Entities would not be treated as Constituent Entities of an MNE Group; and
- (b) Instead, an MNE Group would be required to apply a simplified version of the income inclusion rule to its investments in both joint ventures and associate entities.

This approach avoids departing from the current treatment of joint ventures under CbCR or the need to adopt separate rules to deal with the calculation of an ETR in respect of joint ventures. It also aligns the treatment joint ventures and associate entities which are both accounted under the equity method for financial accounting purposes.

Section 4.4.1 below describes, in further detail, the simplified rule to be applied to joint venture entities

29. A joint venture *is an arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.*²⁰ Joint ventures are excluded from the definition of a “Constituent Entity” because they do not have a single controlling equity interest holder and will generally be reported under the equity method of each MNE Group. The income of joint ventures may be subject to a simplified version of the income inclusion rule in accordance with section 4.4.1 and may be treated as Orphan Entities under 4.4.2.

2.2.5. Use of acceptable accounting standards in defining MNE Group

30. The definitions set out above rely on the accounting principles applied, or that would be applied, by an MNE group in preparing consolidated financial statements for financial reporting purposes. As set out above, a constituent entity is any separate business unit that is included (on a line-by-line basis) in the consolidated financial statements of the MNE Group. Therefore, acceptable accounting standards and, in particular, the consolidation requirements of those standards play an important role in defining the scope of the GloBE rules.

31. The final report on Action 13 does not specify the use of any particular accounting standard for CbCR. Under CbCR, an MNE Group that is not required to prepare consolidated financial statements, may choose between its local general accepted accounting principles (“local GAAP”) or the International Financial Reporting Standards (“IFRS”), except that if the Ultimate Parent Entity has its tax residence in a jurisdiction that requires a specific accounting standard for companies whose shares or interests are traded on a public securities exchange, the MNE Group must use that accounting standard. Jurisdictions with no securities exchange may specify one or more jurisdictions with a securities exchange that would be considered acceptable for these purposes. These rules apply equally to an MNE Group that prepares consolidated financial statements but is not required to do so.

²⁰ Paragraph 16 of IFRS 11. IFRS Foundation.

32. The GloBE rules with respect to the determination of an acceptable accounting standard are set out below in Section 3.3.3. Applying the requirements of an applicable accounting standard in the context of the consolidation test will ensure consistency in the rules for determining the scope of the MNE Group. Moreover these determinations are likely to already be subject to examination by an independent financial accounting auditor. The requirements for determining an acceptable accounting standards are discussed further in Section 3.3.3 below.

2.3. Excluded entities

33. Provided they meet the conditions in the definitions below, certain entities or arrangements at the top of the group ownership chain are excluded from the application of the GloBE rules. These are investment funds, pension funds, sovereign wealth funds, government bodies, international organisations, and non-profit organisations.²¹

34. The entities or arrangements excluded from the scope of the GloBE rules all have a particular purpose and status under the laws of the jurisdiction in which they are created or established. This status is likely to result in that entity not being exposed to domestic income tax in order to preserve a specific intended policy outcome under the laws of that jurisdiction. The domestic tax outcome may, for example, be designed to ensure a single layer of taxation on vehicles used by investors (e.g. funds) or on retirement plans used by employees, or because the entity is carrying out governmental or quasi-governmental functions. The tax policy objectives of the domestic tax exemption for these types of entities are neither inconsistent with the tax policy objectives of the GloBE rules nor create a competitive distortion that would undermine the tax policy objectives of the GloBE proposal. Subjecting the income of such entities to tax under the GloBE rules would undermine the policy objectives that the domestic jurisdiction is seeking to achieve by granting the exemption without furthering the tax policy objectives of the GloBE rules.

35. In many cases, the entities described above would not have the type of structure or be engaged in the type of activities that would bring them within the scope of the GloBE rules. For example, investment and pension funds are likely to be “investment entities” that are not required to consolidate with investments that they control and, therefore, would not meet the definition of a Constituent Entity. These entities will also typically be portfolio investors and are unlikely to have foreign operations and in most cases will not hold controlling interests in foreign subsidiaries. Similarly, the functions performed by governmental entities, international organisations, and non-profit organisations would not generally be expected to be of a nature that would give rise to competitive distortions if they are excluded from the scope of the GloBE rules.

36. The agreement on a list of Excluded Entities under the GloBE rules has been guided by three key principles:

37. Whether the tax policy rationale for the residence jurisdiction providing a nil or low rate of taxation for the sector is consistent with the GloBE tax policy rationale;

38. Whether the exclusion is necessary to avoid the compliance and administration costs that might otherwise arise where such entities derive income that could fall within the scope of the rules;

²¹ At the March WP11 meeting a majority of delegates expressed concerns regarding a proposal to provide shipping with a carve-out from the GloBE rules. However, a question remains for some delegates as to the need to include international shipping in the scope. In particular, as the design of the GloBE rules have further progressed, they continue to query whether the cost and administrative burdens outweigh the benefit of including international shipping, particularly given the practical reality of the application of the UTPR rule and the provisions regarding covered taxes, the carry forward of losses and proposals for a formulaic substance-based carve-out.

39. Whether an exclusion would be contrary to the policy of the GloBE rules by creating material competitive distortions as compared to other internationally operating businesses.

40. The list of Excluded Entities identified in this section is intended to be in line with existing international tax principles and the policy of the GloBE rules, while providing certainty and consistency of treatment of these listed entities. The term “entity or arrangement” is intended to be broad and accommodate the different legal forms that such body may have, including public authorities.

41. The exclusions from the GloBE rules are specific to the entities or arrangements listed and do not extend to the entities that are controlled by the Excluded Entity but do not themselves fall within any of the defined categories set out below. The definition can, however, extend to an entity or arrangement that is established and operated to hold assets or invest funds for the Excluded Entity (i.e. pure holding vehicles). This extension to the definition does not exclude an entity or arrangement that is carrying on or managing a commercial trade or business of the MNE Group. An entity or arrangement would not be treated as carrying on a trade or business if all or substantially all of its income is comprised of interest, rent and capital gains. Thus, for example, if an Excluded Entity such as a Governmental Entity or Non-profit Organisation holds a controlling stake in an MNE Group that otherwise exceeds the consolidated revenue threshold set out in Section 2.3 below, then the GloBE rules will continue to apply to all the members of that MNE Group other than the Excluded Entity.

Excluded Entities - Definitions

Excluded Entities

Investment funds, pension funds, governmental entities (including sovereign wealth funds), international organisations, and non-profit organisations that would otherwise be the Ultimate Parent Entity should not be treated as Constituent Entities of an MNE Group and are excluded from the scope of the GloBE rules.

Investment Fund

Investment Fund means an entity or arrangement that meets all of the following criteria set out in paragraphs (a) to (f) below:

- (a) it is designed to pool assets (which may be financial and non-financial) from an Excluded Entity or a number of investors (at least some of which are not connected);
- (b) it invests in accordance with a defined investment policy and/or to reduce transaction costs and research and analytical costs and/or to spread risk collectively;
- (c) it is primarily designed to generate investment income and/or gains or protection against a particular or general event or outcome;
- (d) investors have a right to return from the assets of the fund, or income earned on those assets, based on the contributions made by those investors;
- (e) the fund, or the management of the fund, is subject to the regulatory regime for collective investments in the jurisdiction in which it is established (including appropriate anti-money laundering and investor protection regulation); and
- (f) it is managed by fund management professionals on behalf of the investors.

The definition also includes any entity or arrangement that is wholly-owned or almost exclusively owned, directly or indirectly, by one or more Investment Funds or other Excluded Entity and that does not carry on a trade or business but is established and operated exclusively or almost exclusively to hold assets or invest funds for the benefit of such Investment Funds or other Excluded Entity.

Pension Fund

Pension Fund means an entity or arrangement that is established by a government (including any political subdivision or local authority) to provide social security, retirement or ancillary and incidental benefits or is established and operated in a jurisdiction exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and that is regulated as such by that jurisdiction or one of its political subdivisions or local authorities.

The definition also includes any entity or arrangement that is wholly-owned, directly or indirectly, by one or more Pension Funds or established by a government (including any political subdivision or local authority)²² and that does not carry on a trade or business but is established and operated exclusively, or almost exclusively, to hold assets or invest funds for the benefit of Pension Funds.

Governmental Entity

Governmental Entity means an entity or arrangement that meets all of the following criteria set out in paragraphs (a) to (d) below:

- (a) it is established by a government (including any political subdivision or local authority thereof);
- (b) it has the principal purpose of:

- i. managing or investing that government's or jurisdiction's assets through the making and holding of investments, asset management, and related investment activities for the government's or jurisdiction's assets; or
 - ii. fulfilment of a government function; and
 - iii. does not carry on a commercial trade or business;
- (c) it is accountable to the government on its overall performance, and provides annual information reporting to the government; and
- (d) its assets vest in such government upon dissolution and to the extent it distributes net earnings, such net earnings are distributed solely to such government with no portion of its net earnings inuring to the benefit of any private person.

The definition also includes any entity or arrangement that is wholly-owned, directly or indirectly, by a Governmental Entity and that does not carry on a trade or business but is established and operated exclusively, or almost exclusively, to hold assets or invest funds for the benefit of that Governmental Entity.

International Organisation

International Organisation means any intergovernmental organisation (including a supranational organisation) or wholly owned agency or instrumentality thereof, that meets all of the following criteria set out in paragraphs (a) to (c) below:

- (a) it is comprised primarily of governments;
- (b) it has in effect a headquarters or substantially similar agreement (for example, arrangements that entitle the organisation's offices or establishments in the jurisdiction (e.g. a subdivision, or a local, or regional office) to privileges and immunities) with the jurisdiction in which it is established; and
- (c) it is prevented by law or its governing documents from inuring its income to the benefit of private persons.

The definition includes any entity or arrangement that is wholly-owned, directly or indirectly, by an International Organisation, and that does not carry on a trade or business but is established and operated exclusively or almost exclusively to hold assets or invest funds for of the benefit of that International Organisation.

Non-profit Organisation

Non-profit Organisation means an entity or arrangement that meets all of the following criteria:

- (a) it is established and operated in its jurisdiction of residence:
 - (i) exclusively for religious, charitable, scientific, artistic, cultural, athletic, or educational purposes; or
 - (ii) as a professional organisation, business league, chamber of commerce, labour organisation, agricultural or horticultural organisation, civic league or an organisation operated exclusively for the promotion of social welfare;
- (b) it is exempt from income tax in its jurisdiction of residence;

²² Change requested by Canada.

- (c) it has no shareholders or members who have a proprietary or beneficial interest in its income or assets;
- (d) the income or assets of the non-profit organisation may not be distributed to, or applied for the benefit of, a private person or non-charitable entity other than:
 - (i) pursuant to the conduct of the entity's charitable activities;
 - (ii) as payment of reasonable compensation for services rendered or for the use of property or capital; or
 - (iii) as payment representing the fair market value of property which the entity has purchased, and
- (e) upon termination, liquidation or dissolution of the entity or arrangements, all of its assets must be distributed or revert to a Non-profit Organisation or to the government or any Governmental Entity of the entity's jurisdiction of residence or any political subdivision thereof;

but does not include any entity or arrangement carrying on a commercial trade or business that is not directly related to the purposes for which it was established.²³

2.3.1. Investment funds

42. The need to preserve the tax neutrality in respect of investment funds is a widely recognised principle that underpins the design of the international tax rules. Under this principle, investment funds may be eligible for a special exemption, deduction, or other preferential treatment under the laws of the jurisdiction where they are established, to put the investors in the same position as if they had invested in the underlying assets of the fund directly, rather than through an investment fund vehicle.

43. The tax treatment of the investment fund is not driven by a need or desire to attract investment from one jurisdiction to another, but rather to allow collective investments to be made through the fund without imposing any additional tax burden on the investment return. This policy goal is relevant across all types of investment funds. There are a range of fund vehicles that may be used to deliver tax neutral outcomes for investors and the operation of the GloBE rules should not distort these choices.

44. The tax neutrality of the fund does not mean that the investment returns earned by the fund go untaxed. The investment return will be subject to tax to the extent that the source country has chosen to impose taxation (e.g. by way of withholding tax on an investment return)²⁴ and a further layer of taxation may be imposed in the hands of the ultimate investor either on distribution or as the investment return accrues. The recent advances in tax transparency, such as through the Standard for Automatic Exchange of Financial Account Information in Tax Matters, have further strengthened the ability of tax administrations to access the information necessary to ensure that fund income is subject to the correct amount of taxation under the laws of the investor's jurisdiction of residence.

45. The fact that the fund itself is not exposed to tax for the above policy reasons does not therefore trigger the concerns that underpin the policy rationale for the GloBE rules. The neutrality of funds is a specific and generally supported tax policy rationale, which would be undermined if the GloBE rules were applied to the income of the fund resulting in an otherwise tax neutral investment vehicle being subject to

²³ Additional language inserted following comment made by the United States at WP11 meeting.

²⁴ Double taxation treaties typically limit the source country's taxing rights over dividends, interest and capital gains derived by a resident of another country. However for procedural reasons, investment funds and / or fund investors cannot always effectively claim the withholding tax relief to which they are entitled under such treaties, leading to over-taxation.

an additional layer of taxation under the laws of another state. Given this approach is already widely adopted in domestic taxation systems, an exclusion for investment funds from the GloBE rules also does not provide a competitive advantage or create economic distortions. It is therefore appropriate to preserve the tax neutrality policy, by ensuring that fund vehicles are not exposed to the GloBE rules.

46. The definition of investment fund draws on the definition of “investment entity” in IFRS 10, European Union Alternative Investment Fund Managers Directive 2011/61/EU (AIFMD), and the IMF definition of collective investment schemes used in the Balance of Payment statistics. As set out in the box above, an investment fund is an entity or arrangement that is designed to pool assets from an unrelated investors (or other excluded entities) and that is managed by professionals on behalf of those investors. The assets of a fund include both financial and non-financial assets including rights to such assets such as options.²⁵ The definition applies only to an entity or arrangement established for the purpose of collective investment which is regulated as such in its jurisdiction, whether directly, or indirectly through a requirement in the jurisdiction of the investment fund that it be managed by a regulated fund manager. The definition does not apply to unregulated investment vehicles such as family held companies.

47. The exclusion does not require that the fund benefit from a special tax status under the laws of the jurisdiction where it is established but requires that the entity or arrangement has the hallmarks of a collective investment vehicle, which include a professional manager investing under a defined investment policy. Fund management professionals may include custodians or brokers that are responsible for implementing the fund’s investment policy and executing transactions on behalf of the fund.²⁶ The definition requires that there be at least two investors in the entity or arrangement but does not otherwise limit the types or number of investors.

48. The final part of the definition recognises that an Investment Fund may use special purpose vehicles to hold assets or to make certain investments. Such entities or arrangements essentially function as part of the infrastructure of the fund itself, and should be treated as part of the Excluded Entity. The exclusion for special purpose vehicles does not extend entities that carry on or otherwise have responsibility for managing a trade or business of the MNE group itself. The definition also provides for cases where the entity or arrangement is held by more than one separate Investment Fund, or by one or more Investment Funds together with another Excluded Entity such as a pension fund. The definition also accommodates cases where, for regulatory or commercial reasons, the fund manager may be required to hold a de minimis shareholding in the entity or arrangement.

2.3.2. Pension funds

49. In many jurisdictions, pension funds are tax exempt in respect of the income they generate for the beneficiaries of the fund. A significant number of jurisdictions use the approach of “exempt – exempt – taxed”, where the contribution to the fund is tax exempt, the income generated by the pension fund is tax exempt, and the return is taxed in the hands of the beneficiary upon distribution. The tax exemption of pension fund may be achieved through a number of mechanisms, for example, by treating the pension fund as a transparent entity for domestic tax purposes, or by granting a specific exemption or preference under domestic tax law.

50. The policy rationale for this treatment is to encourage employees and firms to put in place structures that allow the employee to spread their employment earnings more evenly over their lifetime and to do this in a way that achieves consistency in the tax treatment for the employee. In an economic sense, these vehicles bring taxes on employment income closer to the design of a consumption tax by deferring the imposition of tax until income is actually spent. The “exempt – exempt – taxed” model

²⁵ Change made to reflect comment from Singapore.

²⁶ Change mde to reflect comment form Singapore.

encourages employees to defer a portion of their employment earnings by allowing them to capture, in full, the untaxed value of any investment returns that accrue up to the time of distribution. This tax policy is viewed as increasingly important by a number of Inclusive Framework members that consider such investment vehicles to be an important tool in addressing the need to support ageing populations. In the case of pension plans for government employees, taxation of the pension fund would simply result in an inefficient circular flow of taxation and expenditures as the government would need to increase the contributions to the fund to meet the pension's tax liabilities. A similar logic applies in respect of private pension funds, where there is a public interest in ensuring a stable retirement income to reduce the pressure on the public social security system, and where imposing taxation in the short term would raise revenue from one source to fund another.

51. The exclusions of Pension Funds from the IIR and UTPR preserves the ability of governments to meet their domestic tax policy goals, which have informed the tax treatment of their pension funds. To do otherwise would undermine the policy of maximising the returns earned by the pension fund structure for the beneficiaries. Pension Funds, which effectively operate as a tax preferred personal savings account do not otherwise compete with other internationally operating business. It is therefore appropriate to preserve that policy, by ensuring that Pension Funds are not exposed to the minimum tax.

52. The definition of pension fund follows the definition of “recognised pension fund” used in the OECD Model Tax Convention, Article 3, paragraph (i). The definition has been modified to remove reference to the fund being taxable as a separate person in the jurisdiction of formation, to allow for pension funds formed in a different legal arrangement such as a trust. The definition applies to both public and private Pension Funds provided it is a regulated investment vehicle providing services to individual members of the public (or a defined category thereof). The definition has been modified to accommodate cases where an entity that performs the function in sub-paragraph (b) of holding assets or investing funds for the pension fund is not owned by that pension fund but is established by a government.

2.3.3. Governmental Entities

53. In some cases, a government entity may hold an investment in an MNE group. In most cases, these investments of government entities will be held through a sovereign wealth fund. Sovereign wealth funds are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatisations, fiscal surpluses or receipts resulting from commodity exports.²⁷ The function of a sovereign wealth fund is to invest these amounts for the purpose of managing a country's future fiscal needs, stabilising a country's balance of payments and in order to strike an appropriate balance between domestic consumption and savings.

54. Different approaches to the taxation of sovereign wealth funds are taken around the world. They are generally treated as tax exempt in the jurisdiction where they are established, although in some countries, sovereign wealth funds are not tax exempt and otherwise pay ordinary tax in respect of their income. In the source jurisdiction, the practice is more varied. In some source jurisdictions, the income of a foreign sovereign wealth fund may be entirely exempt from tax or only in respect of certain types of income (such as being limited to non-commercial investment income). This exemption may apply by virtue of domestic tax law or only where such treatment is granted under a double tax treaty. The different approaches to the taxation of sovereign wealth funds reflect different domestic national interests and mutual arrangements between jurisdictions. It also reflects that there is a variety of policy views, such as different concepts of sovereign immunity.

²⁷ See International Working Group of Sovereign Wealth Funds, *Sovereign Wealth Funds — Generally Accepted Principles and Practices — “Santiago Principles”*, October 2008, Annex 1; also replicated in 2017 Model Tax Convention, Commentary on Article 4, paragraph 8.5

55. Where a Governmental Entity such as a sovereign wealth fund has a low ETR under the GloBE this is likely to reflect the specific tax treatment granted to that entity because of the exercise of its government functions. In such a case, it would seem counter-intuitive to require a top-up tax. If it were otherwise, the GloBE rules would have the effect that the government in the residence jurisdiction would need to impose taxation on itself in order to prevent its own revenue being exposed to a top-up tax by other governments.

56. The reference in the definition to “established by government” limits the scope to governmental entities that are public in nature, including where established by specific statute or as a wholly-owned government corporation. To ensure that the exclusion for governmental entities does not result in competitive distortions with respect to internationally operating businesses, the exclusion only applies to entities that have the principal purpose of managing or investing that government or jurisdiction’s assets and / or fulfilment of a government function such as the administration of programmes for the general public with respect to the common welfare. It does not apply if the entity is carrying on or managing a commercial trade or business. For the avoidance of doubt, carrying out the principal purpose of the entity (as described in (b)(i) and b(ii) of the definition above) does not constitute carrying on a commercial trade or business.

2.3.4. International organisations

57. The rationale for excluding international organisations is similar to that which applies to the exclusion for Governmental entities. International organisations such as supranational organisations or development finance organisations are funded by governments. Taxing these organisations on their low tax profit would undo the benefit of the tax exemptions granted to these organisations by agreement under international law. The definition of international organisation follows the definition used in the Standard for Automatic Exchange of Financial Account Information in Tax Matters. The language in paragraph (b) includes an explanation of a “substantially similar agreement” which is taken from Commentary to that Standard.

2.3.5. Non-profit organisations

58. There is a range of non-profit organisations that work for a public purpose, without a view to returning profit to shareholders. Jurisdictions generally provide a tax exemption to such entities, recognising their public purpose, to encourage contributions to such entities, and to maximise the returns available for the intended public good. The provision of these tax exemptions are generally subject to a series of domestic law conditions that must be satisfied, and which are scrutinised by the tax administration.

59. The definition of non-profit organisation follows the definition of “Active NFE” (paragraph (h)) used in the Standard for Automatic Exchange of Financial Account Information in Tax Matters. Where non-profit organisations have been granted a domestic tax exemption, the GloBE rules would not operate to reverse this treatment. Given the non-profit purpose of such entities, the exclusion of these entities from the GloBE rules should not give rise to a risk of competitive distortion between non-profit organisations and internationally operating business.

60. The exclusion does not apply to an MNE that is headed by a non-profit foundation or similar type entity that simply serves as the holding company for an internationally operating commercial business. A non-profit organisation that engages in business activity unrelated to the charitable purpose will also not qualify for this exception from the GloBE rules.

2.3.6. UPEs subject to certain tax neutrality regimes

61. In order to provide a tax neutral outcome for investors, a jurisdiction may treat certain entities or arrangements as transparent for tax purposes or permit that entity or arrangement to make taxable distributions to its investors. Under these tax transparency and taxable distribution regimes, the tax on the

entity's income is effectively paid at the level of the owner, either by taxing that owner directly on its allocable share of the entity's income (in the case of a tax transparent vehicle) or by taxing the owners on a deductible dividend or other distribution paid by the entity (in the case of a taxable distribution regime).

62. The treatment of tax transparent and taxable distribution entities that are Constituent Entities is discussed in Section 3.6.2 and 3.3.4. These rules ensure that any covered tax paid on allocated or distributed income at the shareholder is taken into account under the GloBE rules and is treated as tax paid on such income. However, where the entity subject to these tax transparency or deductible dividend regimes is the ultimate parent entity (UPE), then the owners that pay the tax on the underlying income will not be Constituent Entities of the MNE Group and therefore their tax liability will not be taken into account in computing the entity's ETR under the GloBE rules. Accordingly, special rules are required to address these regimes. The rules set out below allow an entity that is the UPE of the MNE Group to exclude its own income from the GloBE rules where that income qualifies for tax neutral treatment under a tax transparency or taxable distribution regime in the jurisdiction where that entity is established or incorporated. In order for a UPE to benefit from this exclusion, the regime must meet the following criteria:

- a. the owners are subject to tax in that jurisdiction on their share of the entity's income,
- b. the owner's tax liability arises immediately, and
- c. the owners are subject to tax at a rate that equals or exceeds the minimum rate.

These criteria are described in further detail below..

Tax transparency regimes

63. Tax transparency regimes represent the most common approach to single level taxation. Under these regimes, the entity or arrangement is not subject to tax on its income. Instead, the income of the entity is passed through to the owners proportionally and taxed at the owner level. Because the entity is not itself subject to tax, absent special rules, its income would, in many cases, be subject to tax under the GloBE rules because the ETR on that income would generally be zero.

64. The owners of the UPE are not Constituent Entities, and therefore, any taxes paid by the owners would not ordinarily be taken into account in the computation of the ETR under the GloBE rules. Absent a special rule, tax transparency at the level of the UPE would produce a GloBE tax liability because the income of the UPE would be subject to a nil rate of tax. The UPE's income may be subject to tax in the hands of the owners and thus not really subject to low rates of tax overall. However, the GloBE rules generally do not take account of tax paid by owners that are not Constituent Entities for two reasons. First, they are not taxes paid by the MNE Group and the GloBE rules apply to MNE Groups and seek to ensure that they are subject to a minimum level of tax on their income, not that owners of MNE groups are subject to a minimum level of tax on their income. Second, assigning tax paid by non-Constituent Entity owners to Constituent Entities is not feasible, in part, because the UPE does not control its owners and cannot demand that they provide the necessary information. Even if such owners were willing to provide such information, it would be difficult to separate their tax liability on the entities income from their liability with respect to other income unless then jurisdiction applied a schedular regime for the entity's income. Moreover, review of the owner-provided information by tax authorities could have tax administration ramifications with respect to those owners.

65. Nevertheless, there may be circumstances where tax administrations can be confident that the owners of a tax transparent entity are subject to tax above the minimum rate on the entire income of the entity. For example, the United States has an elective tax transparency regime for certain closely-held

domestic corporations, referred to as “S corporations.”²⁸ Under this regime, the S corporation can have no more than 100 shareholders, and all of the shareholders must be natural persons that are U.S. tax residents.²⁹ The annual income of the S corporation is included in the shareholder’s U.S. taxable income in proportion to their ownership of the corporation. Consequently, all income of an S corporation is subject to immediate U.S. tax at rates applicable to U.S. individuals, which can exceed 32%.³⁰

66. An S corporation has three characteristics that indicate its income will be subject to tax in the hands of the shareholders at a rate that exceeds the rates that have been suggested as a minimum rate. The first is that the owners must be tax residents of the U.S., the same jurisdiction in which the corporation is created and in which it would be subject to tax on its own income if not for the election to be treated as an S corporation. The second is that the owners are subject to immediate taxation on their share of the income as if they earned the income directly. The third is that the owners are subject to high rates of tax on their share of the income.

67. These characteristics can serve as a model for determining whether a UPE that is tax transparent should be required to include its income in the GloBE tax base and subject to tax under the GloBE rules.

- a. The first characteristic – the owners are tax resident in the entity’s tax jurisdiction – requires that the owner be subject to tax in the UPE’s jurisdiction on its share of the UPE’s income. For this purpose, a tax transparent entity that is a UPE should be treated as tax resident in the country in which it would be tax resident if it were subject to an income tax based on residency. This would typically result in a tax transparent entity being treated as resident in the jurisdiction in which it is effectively managed. Thus, where all, or substantially all, of the owners are, in fact, tax resident in the UPE’s jurisdiction or are treated as having a PE in that jurisdiction, the first requirement would be satisfied.
- b. The second requirement – immediate taxation on the owner’s share of income – would normally be satisfied under a tax transparency regime.
- c. The third requirement could be treated as satisfied where the nominal tax rates applicable to each owner’s share of the income are expected to exceed a specified threshold. This approach to the last two requirements ignores the fact that an owner’s tax liability may be reduced by losses from non-group activities and other tax reliefs, which would not, in any case, figure into the GloBE tax base. For example, individual shareholders subject to graduated tax rates may be exempt from tax on income below a certain threshold or income earned from certain activities. Nonetheless, if the tax rate applicable to the owners were sufficiently above the minimum rate, there should be some confidence that the UPE’s income is subject to a minimum rate of tax over a period of several years. To the extent that some owners do not meet the requirements, such owners’ share of the income could be included in the ETR computation of either the stateless jurisdiction or the tax residence jurisdiction determined under the special rule for tax transparent UPEs.

The treatment of tax transparent regimes described in this section is limited to the income of the UPE and the treatment is limited to income allocated to owners in the UPE’s jurisdiction. However, where

²⁸ See I.R.C. sections 1361-1379.

²⁹ An S corporation can own another S corporation, referred to as a Qualified Subchapter S subsidiary (QSSS), but a corporation that is not an S corporation cannot be a shareholder of an S corporation. Thus, an S corporation cannot be a subsidiary of an MNE Group that does not have an S corporation as its Ultimate Parent Entity.

³⁰ Income in excess of US\$ 160,000 (single filer) or US\$ 321,000 (married filing jointly) is taxed at rates of 32% or more. In addition, many U.S. states and localities impose income tax on the income of individual residents, including on S corporation income.

the income of a non-resident is taxable in the UPE's jurisdiction at or above the minimum rate (for example by way of withholding) then this income could be excluded from the GloBE rules.

Distribution deduction regimes

68. Jurisdictions may provide tax regimes that are designed to produce a single level of taxation on certain cooperative or pooled activities of taxpayers. Under these regimes, the corporation is generally subject to tax on its income, but is allowed a deduction for certain distributions to owners or participants in the collective enterprise. For example, an agricultural cooperative corporation that buys apples from its members and markets them collectively may be allowed a deduction for distributions of profits from apple sales to each member in proportion to the corporation's purchases of apples from the member. Similarly, a collective investment corporation may be allowed a deduction for distribution of its investment earnings to its own shareholders.

69. The deductions for distributions allowed for tax purposes are not mirrored in the financial accounts. Thus, these entities may have a significant amount of income determined using the financial accounts, but no tax liability, resulting in a low ETR. Consequently, if one of these entities is a Constituent Entity of an MNE Group subject to the GloBE rules, its income could be subject to tax liability under the GloBE rules, unless there are other members of the MNE Group located in the same jurisdiction with relatively high tax rates.

70. Special rules are prescribed in section 3.3.4 for the treatment of dividends distributed by Constituent Entities that are subject to distribution tax regimes and for dividends received by Constituent Entities from corporations subject to distribution tax regimes. Those rules would ensure that the Constituent Entity's income would not be subject to the GloBE rules at the entity level simply due a dividends paid deduction, thus preserving the jurisdiction's single level of tax policy, while simultaneously ensuring that the MNE Group's share of the entity's income remains subject to the GloBE rules.

71. Additional consideration is necessary, however, where the Constituent Entity that is subject to a distribution deduction regime is the Ultimate Parent Entity of the MNE Group.³¹ None of the UPE's shareholders are Constituent Entities, and thus if the UPE is allowed to deduct its distributions from the GloBE tax base, its income will be exempted from the GloBE rules altogether. However, applying the principles set out above, the income of the entity should be exempt from the GloBE rules if the owners are subject to tax in the jurisdiction on their share of the entities income, the owner's tax liability arises immediately, and the owners are subject to tax on the distributions at a rate that equals or exceeds the minimum rate. Typically, to qualify for the distribution deduction, distributions must be made during the entity's tax year or within a brief period after the end of the year. For GloBE purposes, the second criteria is considered met if the distribution occurs within [x] days of the end of the entity's tax year. Under these circumstances, a UPE subject to a distribution deduction regime is permitted to deduct distributions in the same manner as permitted under local in computing its income for GloBE purposes.

72. The principles discussed above have been used to inform the treatment of tax regimes that are intended to preserve tax neutrality. The foregoing discussion broadly describes the types of tax regimes to which the rules apply but does not describe or address all the design features of tax neutrality regimes that may fall within the rules. IF members may wish to undertake a more detailed assessment of specific tax neutrality regimes on a case-by-case basis in the context of the general review of the implementation and application of the GloBE rules in different jurisdictions, and develop further guidance where appropriate.

³¹ Corporations subject to distribution tax regimes that qualify as investment funds under section 3.3.1 will be excluded from the definition of UPE under the exclusion for investment funds. Therefore, where an entity that would otherwise be a UPE of an MNE Group is subject to a distribution deduction regime qualifies as an investment fund, no special rule is needed.

2.3.7. Exclusion for international shipping

Note for Delegates

At the March WP11 meeting a majority of delegates expressed concerns regarding a proposal to provide shipping with a carve-out from the GloBE rules. However, a question remains for some delegates as to whether international shipping should be carved out of the scope of the GloBE rules.

In particular, as the design of the GloBE rules have further progressed, these delegates continue to query whether the cost and administrative burdens of the GloBe rules outweigh the benefit of including international shipping, particularly given the provisions regarding covered taxes, the carry forward of losses and proposals for a formulaic substance-based carve-out.

Delegates at the Steering Group have further made the point that the architecture of the GloBE rules and the way international shipping is organised means that shipping companies may, in practice, be able to structure its operations in a way that they are not subject to any incremental tax under the GloBE rules. This is because the IIR applies only to foreign subsidiaries (not to subsidiaries incorporated in the parent jurisdiction) and because the adjustments under the UTP rule are based on deductible intra-group payments (whereas most of the income from shipping comes from third parties).

Excluding shipping from the scope of the GloBE rules would be consistent with the treatment of International shipping under Article 8 of the OECD Model Tax Convention, and the relevant language and commentary could be readily adapted to the GloBE rules to exclude profits from the operation of ships.

Question for Delegates

Do delegates consider that in light of the architecture and various elements of the GloBE rules, the way international shipping is organised and given the current treatment of shipping under Article 8 of the OECD Model Tax Convention that it international shipping should be carved out from the scope of the GloBE rules.

2.4. Consolidated Revenue Threshold

Excluded MNE Groups

MNE Groups having total consolidated group revenue below €750 million or equivalent in the immediately preceding fiscal year of the group, are excluded from the application of the GloBE rules.

The term “Fiscal Year” means the annual accounting period with respect to which the Ultimate Parent Entity of the MNE Group prepares its financial statements.

73. The GloBE rules will apply to MNE groups that have annual consolidated revenue of €750 million or more in the immediately preceding fiscal year or a near equivalent in domestic currency.³² This is the

³² Although no decision has yet been taken by the Inclusive Framework on whether there will be a revenue threshold for the application of the GloBE rules, or the amount of any such threshold, this Chapter proceeds on the assumption that should the GloBE rules apply only to MNE groups that meet an overall size threshold this threshold will be based on the same design as that used for CbCR..

same threshold that applies under the CbCR rules. [However, jurisdictions are free to introduce an income inclusion rules that apply to MNE Groups that have annual consolidated revenue below the €750 million subject to certain conditions.]³³

2.4.1. Consolidated revenue threshold

74. The general rule set out in the box above limits the application of the GloBE rules to MNE Groups whose consolidated group revenue is at least €750 million. The €750 million threshold has several advantages.

75. **Synergies with the CbCR rules**, which are used for other elements of the GloBE rules, such as the definitions set out above that deal with the composition of the MNE Group. Furthermore MNE's that are not subject to CbCR have no independent financial reporting reason to separately report the income of the branch and head office of the same entity as they are required to under the GloBE rules. The use of the same threshold may also facilitate the use of simplification options.

76. **Use of financial accounts**. A number of design elements of the GloBE rules rely on consolidated financial accounts. Approximately 90% of in-scope MNE groups are publicly accountable (listed) companies that are already required to report consolidated financial information to investors under IFRS or an equivalent standard.³⁴ A lower threshold would pick up more private companies that are not required to prepare consolidated financial accounts (or where they do it may be in local GAAP).

77. **Avoid adverse impacts on SMEs**. The use of the CbCR reporting threshold will exclude small and medium enterprises (SMEs) operating in more than one jurisdiction, where the application of these rules could be a significantly greater burden. A €750m revenue threshold will mean that between 85% and 90% of MNE groups will be outside the scope of the rules. This, in turn, reduces the pressure on IF members to provide carve-outs from the GloBE rules for SMEs that benefit from targeted domestic tax incentives.

78. **It preserves the impact of the GloBe rules**. Under a CbCR threshold, approximately 7,000 – 8,000 MNE groups will be within the scope of the rules. This threshold preserves the impact of GloBE because these in-scope MNE groups earn over 90 percent of global corporate revenues.

³³ A number of IF members have objected to this language (together with that in Section 3.4.2) being included as part of the final report.

³⁴ See section 3.3.1 below on *Profit or loss determined in accordance with financial accounting standard*.

2.4.2. MNE Groups below the consolidated revenue threshold

Note for WP11 Delegates

At the WP11 meetings held in July a number of delegates raised objections to including language in the final report discussing the position of domestic headquartered MNEs that were below the consolidated revenue threshold. Such delegates were of the view that IF members should not be allowed to adapt the design components of the GloBE proposal and apply them to smaller groups below the consolidated revenue threshold.

Questions as to the status of the GloBE rules and the extent to which IF members may choose to apply the same or similar rules to groups that are outside the scope of the GloBE rules are policy issues that should be considered by the Inclusive Framework as a whole rather than the Working Party.

In addition to the policy concerns raised, delegates had a number of other comments on the text of this section that focused on the potential interaction between the GloBE rules and same or similar rules introduced by the jurisdiction. The changes that have been made to this section are intended to clarify these potential interactions. WP11 delegates are not asked to agree this language but are invited to provide technical input on the analysis set out below.

79. [MNE Groups are not subject to the application of the GloBE rules if their total consolidated group revenue in the immediately preceding year was below €750 million. However, once an MNE Group exceeds this consolidated revenue threshold, then it will be subject to the GloBE rules in those jurisdictions where the rules have been introduced in accordance with the overall agreed design of those rules.

80. A jurisdiction which has introduced the undertaxed payment rule cannot apply that rule to a Constituent Entity of an MNE Group if that group does not have consolidated revenues above the threshold. This is because IF members have agreed that GloBE rules described in this report do not apply to MNE Groups with revenues of less than €750 million. Equally, under the agreed rule order, a subsidiary jurisdiction that has implemented the GloBE rules cannot apply the UTPR or an IIR in respect of the low tax profits of another wholly-owned subsidiary within the same group if the Ultimate Parent Entity is located in a jurisdiction that has adopted the GloBE rules, This is because applying the IIR or UTPR in such circumstances would be contrary to overall agreed design and intended operation of the GloBE rules.

81. However, because the GloBE rules do not apply to MNE Groups that are below the €750 million revenue threshold, a jurisdiction remains free to apply rules similar to the IIR (with appropriate modifications) to an MNE Group that is headquartered in that jurisdiction if that group is below the revenue threshold. A jurisdiction may consider that the basic design components of the IIR can be adapted to readily capture pools of offshore low tax income from smaller MNE Groups in a manner that is similar to the rules as described in this Report. Prior to implementing an IIR in respect of smaller MNEs, these jurisdictions should take into account, on the one hand, the expected revenue impact in light of other existing domestic tax rules and the balance between compliance costs and revenue benefits in light of the fact that smaller MNEs are less likely to prepare consolidated financial accounts. On the other hand, the application of the IIR to locally headquartered smaller MNE groups may avoid a cliff-edge effect for MNEs that have revenues close to the consolidated revenue threshold. These rules could also provide jurisdictions with the opportunity to eliminate other more complex base protection measures in favour of a single streamlined, comprehensive measure. The application of the IIR to smaller MNE Groups should not, however, result in those rules being applied in a way that is contrary to the overall agreed design of the GloBE proposal. A jurisdiction could not, for example, continue to apply its modified version of the IIR to a locally headquartered group if that group was acquired by an MNE Group with revenues above the €750 million threshold and was subject to its own IIR.]

2.4.3. Previous fiscal year

82. The €750 million threshold is determined by reference to the total consolidated group revenue of the MNE Group during the immediately preceding fiscal year. This mirrors the rules for determining the MNE Groups to which the CbCR rules apply. Therefore, whether an MNE Group is required to apply the GloBE rules is based on the preceding year's consolidated revenue regardless of whether its consolidated revenue is below or above the threshold in the year for which it is applying the rules.

83. Paragraphs 1 and 2 of the rule set in the Box of this Section make reference to a "fiscal year". Taxable years can vary from one jurisdiction to another. Some jurisdictions use the calendar year as their taxable year, while others use a different period (e.g., some jurisdictions allow taxpayers to choose their taxable year). These differences justify the need to define fiscal year for purposes of the GloBE rules. An MNE Group may have constituent entities in jurisdictions with different required or permitted taxable years. However, the MNE Group will use the same fiscal year for all of its constituent entities in its consolidated financial reports because the GloBE tax base is determined primarily based on the MNE Group's consolidated financial statements. Given that CbCR Model Legislation already has a definition of "Fiscal Year" and the similarities between the CbCR and GloBE rules, paragraph 3 of the rule included in the Box above mirrors the CbCR definition, which is based on the MNE Group's fiscal year for consolidated financial accounting purposes.]

2.4.4. Calculating the consolidated revenue threshold

84. The threshold set above applies based on the consolidated revenue of the MNE group. As explained in section 2.2, the definition of MNE Group under the GloBE rules, like CbCR, relies on the applicable financial accounting standard to determine whether a subsidiary's accounts are consolidated and thus whether it is a constituent entity. The entire revenue of all constituent entities is included in the determination of the threshold irrespective of whether the MNE group owns all of the equity interests in the constituent entity. Stated differently, a deduction for amounts that accrue to minority interest holders in a Constituent Entity are ignored in the determination of the MNE Group's total revenue. However, the revenue of two MNE groups or different standalone entities that are not part of the same consolidated financial statement should not be aggregated even if they are controlled by the same person (e.g. an individual).

85. This situation could arise in case of investment entities that control two different MNE Groups. According to IFRS 10, investment entities are not required to consolidate an investment in a subsidiary, unless the main purposes and activities of the subsidiary is to provide services related to the investment entity's activities. Thus, an investment entity that is the controlling shareholder of two or more MNE Groups would typically not consolidate these groups into its financial statements and would not be considered as the Ultimate Parent Entity of these groups.

86. This is illustrated in Example 2.4.4. of Annex A where an investment fund controls two separate MNE groups with annual consolidated revenue of €500 million each. If the investment entity meets the definition of an investment entity in accordance with IFRS 10 or similar financial accounting standards, the entity will not be required to consolidate the MNE groups. In these cases, each MNE Group would typically have separate consolidated financial statements, and these groups would be considered as separate MNE Groups. As such, they would separately determine whether they meet the threshold described in this section.

87. The approach set in the previous paragraphs is in line with CbCR rules. CbCR rules do not consider investment funds or entities as the ultimate parent entity of an MNE group unless accounting rules instruct them to consolidate with investee companies. The Guidance on the Implementation of CbCR states that investment funds or entities that are investees are not considered as constituent entities or part of a Group or an MNE Group unless they are consolidated by the Group.

88. The entities that are excluded from the GloBE rules are not considered as Constituent Entities of an MNE Group. Therefore, the revenue of these entities is excluded from computation of the threshold even if they are consolidated in a line-by-line basis in the financial statements of an MNE Group. Furthermore, the consolidated revenue of the remaining Constituent Entities of MNE Group may need further adjustments for purposes of the threshold computation. For example, any intragroup payments from the Excluded Entity to the rest of the MNE Group should be reflected for purposes of the revenue threshold because these payments are eliminated in the consolidated financial statements.³⁵ Furthermore, given that these entities would not qualify as the Ultimate Parent Entity of an MNE Group, the subgroups that they control would be accounted as if the excluded entity was not the parent entity for consolidation purposes. This is illustrated in Example 2.4.4A, in which FUND can be an entity excluded in accordance to section on excluded entities. However, the consolidation threshold could be supplemented with anti-avoidance rules to avoid the fragmentation of a single MNE Group into different subgroups. For example, if two subgroups are controlled by the same Excluded Entity then they would be accounted together for purposes of the revenue threshold if they were previously part of the same MNE Group before they were acquired by the Excluded Entity.³⁶

³⁵ Sentences added to reflect the comments made by Japan and New Zealand during the WP11 virtual meeting held on July 17, 2020.

³⁶ Sentences added to reflect the comments made by Finland and Spain during the WP11 virtual meeting held on July 17, 2020.

3 Calculating the top-up tax under the GloBE rules

3.1. Overview

89. To determine an MNE's effective tax rate (ETR) under the GloBE rules, the MNE first determines its income for GloBE purposes and the covered taxes on that income. The ETR is the amount of such covered taxes divided by the amount of income as determined under the GloBE rules. In the event that an MNE's ETR is below the agreed minimum rate then the MNE will be liable for an incremental amount of GloBE tax that is sufficient to bring the total amount of tax on that income up to the minimum rate. The minimum ETR under the GloBE therefore operates both as a trigger for the imposition of a GloBE tax liability and as a measure of the amount of top-up tax imposed under the GloBE rules.

90. To ensure transparency and a level playing field, the GloBE tax base is uniform across jurisdictions. As described in greater detail below, the determination of the tax base under the GloBE rules will start with the financial accounts that are prepared under the same accounting standard that is used by the parent of the MNE to prepare its consolidated financial statements. The financial accounting standard used by the parent to compute the GloBE tax base must be IFRS or another acceptable accounting standard.

91. In addition, certain adjustments will be made to the financial accounts to eliminate specific items of income from the tax base, such as intra-group dividends, and to incorporate certain expenses, such as tax deductible stock-based compensation. Transactions between Constituent Entities of the MNE group in different jurisdictions will be taken into account in determining the GloBE tax base of each jurisdiction and must be recorded based on the arm's length principle.

92. As set out further below, the jurisdictional ETR is computed by dividing the aggregate of covered taxes on income earned by constituent entities by the aggregate of the profit (or loss) before tax on that income.³⁷ The jurisdictional ETR computation requires assignment of the income and taxes among the jurisdictions in which the MNE operates and to which it pays taxes. Generally, the income of the MNE is assigned to the jurisdiction of the Constituent Entity that earned the income with each permanent establishment being treated as a separate Constituent Entity. The corresponding covered taxes on that income are then assigned to the jurisdiction that has been allocated the income. Special rules address the treatment of entities that are tax transparent and that do not have any tax jurisdiction of residence.

³⁷ Although no decision has yet been taken by the Inclusive Framework on blending, this Chapter proceeds on the assumption that the rules for determining the ETR are to be applied on a jurisdictional basis. As explained in Section 3.6 below, the basic design of the rules for global and jurisdictional blending are broadly similar. Given that the design of jurisdictional blending rules are necessarily more complex and the significant level of support amongst IF members for a jurisdictional blending approach, this Chapter focusses on how the GloBE rules could be applied on a jurisdictional basis.

93. Temporary differences in the time for reporting income for financial accounting purposes and local tax purposes could potentially give rise to liability under the GloBE rules that would need to be reversed-out in a subsequent period. To address this concern the GloBE rules include a carry-forward and tax credit mechanisms to address the effects of temporary or timing differences on the computation of the ETR under a jurisdictional blending model.

94. Finally, Section 3.10 below explores potential simplification options for determining whether a jurisdiction will be subject to a top-up tax with respect to its Constituent Entities in a particular jurisdiction, including simplifications based on the data provided in Country-by-Country (CbC) reports and the use of deferred tax accounting.

3.2. Covered taxes

Definition of covered taxes

Covered taxes means any tax on an entity's income or profits (including a tax on distributed profits), and includes any taxes imposed in lieu of a generally applicable income tax. Covered taxes also includes taxes on retained earnings and corporate equity.³⁸

A tax is a compulsory unrequited payment to general government.

95. The definition of covered taxes aligns the numerator (i.e. the measure of covered taxes) and the denominator (i.e. the measure of net income) in the GloBE's ETR calculation so that the taxes imposed on income included in the GloBE tax base are treated as a covered tax for the purposes of determining the GloBE ETR. The definition of covered taxes is developed solely for the purposes of the GloBE rules and has no direct interaction with Article 2 (Taxes Covered) of the OECD Model Tax Convention, which is developed for the distinct purpose of eliminating double taxation. Taxes that do not qualify for the definition of covered taxes under the GloBE, such as excise taxes and payroll taxes, will be treated as deductible in the computation of the GloBE tax base (i.e. as reductions to the denominator in the GloBE's ETR calculation).

96. The definition of covered taxes applies not only to taxes imposed on income at the time such income is derived but also on taxes that are imposed on a subsequent distribution of profits.³⁹ The definition further applies to any tax that is imposed in lieu of a generally applicable income tax. The definition of covered taxes also includes taxes on retained earnings and corporate equity. In determining whether a tax is a covered tax, the focus is on the underlying character of the tax. The name that is given to a tax or the mechanism used to collect it (such as through a withholding mechanism) is not determinative of its character. Whether a tax charge is levied under a jurisdiction's corporate income tax rules or under a separate regime or statute does not have any bearing on its underlying character. Whether a tax is deductible is not relevant to determining whether it is a covered tax.⁴⁰

97. The definition of tax is based on the OECD's longstanding definition of taxes used for statistical purposes, with the same definition equally used by many international organisations (IMF, World Bank,

³⁸ This has been amended to reflect comments by US and New Zealand.

³⁹ This has been amended to reflect comments by US and New Zealand.

⁴⁰ Sentence moved from paragraph above.

United Nations, European Union),⁴¹ and which defines taxes as any compulsory unrequited payment to general government. General government is a defined term in the UN-OECD National Accounts that includes the central administration, agencies whose operations are under its effective control, state and local governments and their administrations⁴². Taxes are unrequited in the sense that any benefits provided by government to the taxpayer are not in proportion to their payments. Thus, fees and payments for privileges, services, property, or other benefits provided by government do not qualify as taxes. Similarly, taxes do not include fines and penalties nor do they include interest or similar charges with respect to payments of tax liabilities after the applicable due date.

3.2.1. Design principles

98. The agreement on a definition of covered taxes under the GloBE rules has been guided by a number of principles:

99. **Align with the GloBE tax base and avoid double taxation.** Because the GloBE tax base covers a wide range of income and gains, it is imperative that the GloBE ETR calculation similarly adopts an expansive definition of covered taxes in order to accommodate the present and future design of tax systems and to avoid the risk of double taxation.

100. **Provide for clear and consistent outcomes.** To enhance compliance and administration, and to ensure a level playing field, the GloBE demands a definition of covered taxes that is transparent and clear in its application, and produces consistent and predictable outcomes.

101. **Avoid the need for a legalistic analysis of the specific technical design features of taxes in various jurisdictions.** The definition of covered taxes focuses on the underlying character of the tax and avoids the need to engage in a legalistic analysis of the technical nuances of particular taxes imposed by each jurisdiction to determine whether those taxes qualify as a covered tax.

102. **Accommodate differences in the timing of the imposition of tax under local law.** The definition of covered taxes is designed to take account of the effects of temporary differences so that the GloBE does not result in incremental taxation in respect of temporary mismatches between the recognition of income and the imposition of tax on that income.

103. The principles set out above underpin the definition of covered taxes that has been developed for the purposes of the GloBE, and which is further elaborated in the commentary below. The commentary explains how this definition is applied to certain common design features of taxes in many IF jurisdictions. The commentary does not describe or address every design feature of all the taxes that may fall within the definition. IF members may wish to undertake a more detailed assessment of specific taxes on a case-by-case basis and develop further guidance where appropriate.⁴³

3.2.2. Taxes on income

104. While there is no internationally agreed definition of an income tax, income taxes are generally levied on a flow of money or money's worth that accrue to a taxpayer during a period of time. Income taxes take into account related expenses of producing the flow of money to measure the taxpayer's net increase in wealth for the period. A definition of covered taxes that applies to income calculated on a net (rather than gross) basis is in line with the definition of income tax used for financial accounting purposes and

⁴¹ See, e.g., Revenue Statistics 1965-2017 Interpretative Guide, Annex A, ¶1 (OECD 2018), available at: <https://www.oecd.org/tax/tax-policy/oecd-classification-taxes-interpretative-guide.pdf>.

⁴² The System of National Accounts 2008. See also Revenue Statistics 1965-2017 Interpretative Guide, Annex A, ¶3 (OECD 2018), available at: <https://www.oecd.org/tax/tax-policy/oecd-classification-taxes-interpretative-guide.pdf>.

⁴³ See Chapter 6 below. [This sentence and footnote has been added to reflect comments by Australia.]

therefore it is expected that a tax recognised as an income tax for financial accounting purposes should generally qualify as a covered tax under the GloBE rules.

105. It is clear, however, that a tax need not determine the taxpayer's precise change in wealth to qualify as an income tax. A definition of covered taxes that required taxpayers and administrators to undertake further technical analysis of the precise terms of each type of tax in order to determine whether a particular tax took into account an appropriate amount of relevant expenses incurred in the generation of that income would be cumbersome to apply and lead to uncertainty in the determination of the ETR. Accordingly, the definition of covered taxes includes taxes that allow for a simplified estimate of net profit. For example, a tax that allows deductions for some but not all expenses of earning the relevant income, would be considered an income tax provided the deductible expenses can reasonably be considered to have been incurred in connection with deriving that income. Similarly, a tax on income that allows a standardized deduction in place of actual expenses is generally considered an income tax if such standardised deduction is based on a reasonable method for estimating such expenses. A tax imposed on gross income or revenue without any deductions (i.e. a tax on turnover) would not be considered an income tax. The design and substantive character of such turnover taxes generally have more similarities to consumption or sales taxes. The definition of covered taxes therefore does not apply to a tax on a gross amount unless such a tax is in lieu of an income tax (see next Section 3.2.3).

106. Taxes or surcharges imposed on the net income from specific activities, such as banking or the exploration and production of oil and gas, irrespective of whether or not they apply in addition to a generally applicable income tax, would also fall within the general definition of a covered tax.⁴⁴ That would include a separate resource levy that is imposed on the net income or profits from the extraction activity (or a component of a multi-component levy that is imposed on net income or profits). However, resource levies closely linked to extractions, for example, those that are imposed on a fixed basis or on the quantity, volume or value of the resources extracted rather than on net income or profits, would not be treated as covered taxes.⁴⁵

107. A supplementary tax which applies a top-up tax to the net income of domestic entities would also fall within the definition of a covered tax. Supplementary taxes that apply on an alternative basis - that is other than net income - would not, however, fall within the general definition of a covered tax as they are not taxes imposed on net income. As set out above, taxes on net income imposed at state and local government level are covered taxes, even where they are deductible for the purposes of income taxes imposed at national government level. Tax paid on net income allocated to a jurisdiction under Pillar One would also be treated as a covered tax under the GloBE.⁴⁶

108. Under an imputation credit regime, the tax that is imposed by a jurisdiction on a corporation's income gives rise to a credit, which can be attached to a subsequent distribution and used by a resident shareholder to shelter or reduce the tax payable under the laws of the same jurisdiction on that distribution. An imputation system is designed to ensure a single level of tax on corporate income whereby a portion of the tax paid by the corporation is creditable against the shareholder's tax liability arising from dividend distributions. Thus, in a sense, part of the tax paid by the corporation can be thought of as the pre-payment of the shareholder's tax liability. However, the fact that a shareholder may subsequently be entitled to an indirect credit for the tax paid by the corporation on the underlying income, does not prevent the corporation tax from being treated as a covered tax. Imputation regimes that protect resident shareholders from the imposition of economic double taxation under the laws of the same jurisdiction on the same income are equivalent, in this sense, to other mechanisms, such as foreign tax credits, exemptions and preferential

⁴⁴ This has been amended to reflect comments by Australia.

⁴⁵ These sentences have been added to reflect comments by Canada.

⁴⁶ See Section 3.3.4. on 'Adjustment for Pillar One Outcomes' for discussion of adjustments to the GloBE tax base.

rates, designed to protect domestic shareholders from economic double taxation on distributions of previously taxed income. Corporation tax paid under an imputation system that seeks to prevent economic double taxation at the resident shareholder level (and does not provide credits or refunds to non-residents) is properly treated as a covered tax.⁴⁷ Where, however, the imputation regime allows for a refund of taxes to be paid in respect of distributions made to a non-resident shareholder who is not subject to tax under domestic law, the regime has gone beyond relieving economic double taxation of the same income under the laws of the same jurisdiction, rather it is providing a refund of covered taxes paid in prior years. Accordingly, a distribution paid to a non-resident that gives rise to a refund of covered taxes (either to the company or to the shareholder) should be treated as a refund or reduction in covered taxes in the year such distribution is made.

3.2.3. Taxes in lieu of a generally applicable income tax

109. The definition of covered taxes includes taxes in lieu of a generally applicable corporate income tax. A generally applicable corporate income tax could be one that applies to all resident corporations or one that typically applies to those resident corporations that are members of a large multinational group. A generally applicable corporate income tax would also include an income tax imposed on a corporation but which also applies to other taxable persons such as individuals. The “in lieu of” test includes taxes that are not covered under the generally applicable income tax definition but which operate as substitutes for such taxes. This test, which will be familiar to some tax administrations in the context of their foreign tax credit rules, would generally include withholding taxes on interest, royalties and other categories of gross payments, provided such taxes are imposed in substitution for a generally applicable income tax. Some jurisdictions consider that such source-based withholding taxes, which apply to payments to non-residents, are technically not substitutes for an income tax that would have been imposed in the jurisdiction of the payee where the non-resident does not have a permanent establishment in the payee jurisdiction. However, these jurisdictions also recognise that it is general practice that such withholding taxes are creditable in the payer jurisdiction on a limited basis (e.g. only for interest and royalties, but not for other types of income like sales) and so they should be considered covered taxes under the GloBE.

110. The “in lieu of” concept also covers taxes that are imposed on an alternative basis, such as taxes based on number of units produced or commercial surface area, and which are used as substitutes for a generally applicable income tax under the laws of the jurisdiction. Where, for example, a jurisdiction imposes a simplified methodology for calculating the income on a particular category of business or investment and this tax is imposed in substitution for a generally applicable income tax then that tax should be treated as falling within the definition of a covered tax. This includes a tax on deemed return for investments in foreign equity. It also includes taxes such as tonnage taxes that use income earning capacity as a proxy for income and are designed to act as a substitute for corporation tax. Generally when a taxpayer elects into a tonnage tax regime, the taxpayer opts out of the normal corporate income tax rules. A tax imposed on an alternative basis (i.e. other than net income) levied at state or local government level, which is creditable against a generally applicable income tax levied at national government level, would also qualify as a covered tax under the “in lieu of” test to the extent that it is credited against income tax in the same jurisdiction. Such local taxes can be considered as being in substitution (partially or fully) for a generally applicable income tax and an administratively efficient way of transferring resources from national to local government within the same jurisdiction.⁴⁸ A tax that is imposed on an alternative basis that applies in addition to, and not as substitute for, a generally applicable income tax under the laws of the jurisdiction would not fall under the “in lieu of” test for covered taxes.

⁴⁷ This sentence has been added to reflect comments by Australia.

⁴⁸ These sentences have been added to reflect comments by Colombia.

3.2.4. Taxes on retained earnings and corporate equity

111. Some jurisdictions impose taxes on the net equity of a corporation in addition to corporate income tax. The equity or capital of a corporation is composed of its retained earnings and the contributions made by shareholders. Taxes on corporate equity may be inherently interlinked with the design of the corporate income tax systems. For example, it may be possible under the laws of a jurisdiction to credit corporate income tax against a corporate equity tax so that a company is allowed to reduce the corporate equity tax up to the amount of corporate income tax that it pays in that jurisdiction. Taxes on corporate equity may also act as a supplement to corporate income tax as part of a jurisdiction's overall approach to the taxation of a corporation's activities in that jurisdiction. For example, some taxes on corporate equity may incorporate a minimum tax element to their design. Such taxes on corporate equity are therefore an integral part of the overall system of corporate taxation in those jurisdictions. From an economic perspective, a tax on net equity can be seen as an ex ante income tax on the company. For these reasons, these type of taxes based on corporate equity should be treated as covered taxes under the GloBE rules.⁴⁹

3.2.5. Taxes based on multiple components

112. Some jurisdictions impose taxes that have multiple components to the base. Where all the components of the tax base fall within the definition of income or profit covered by the GloBE rules then the tax should as a whole, be included within the definition of covered taxes. Other taxes may be levied in respect of a corporation's activities in a jurisdiction, and are administratively and conceptually part of the system of corporate taxation in these jurisdictions but may include both an income and a non-income element. Where such taxes are predominately a tax on an entity's income and it would be administratively burdensome to split the tax into separate income and non-income components then such taxes should be treated as fully covered under the GloBE rules. This approach would minimise the complexity of the GloBE rules and avoid the additional administrative and compliance burden of requiring the different components of such taxes to be split out for the purposes of the ETR calculation. Furthermore, it is consistent with the general principle that the definition of covered taxes should focus on the underlying character of the tax and avoid the need for a legalistic analysis of the technical nuances of particular taxes imposed by each jurisdiction.

113. An example of a covered tax with multiple components is the corporate Zakat levied by the Kingdom of Saudi Arabia, which is described in Example 3.2.5.A. As described in that example, the Zakat operates as a tax on income or equity or both and is therefore properly considered a covered tax for the purposes of the GloBE rules.

3.2.6. Taxes on distributed profits

114. In line with the principle to address temporary differences, the timing of a levy does not have any bearing on the definition of covered taxes. Accordingly, taxes imposed on the income of a distributing corporation at the time it distributes the income are covered taxes, irrespective of whether the income distribution is attributable to current or previously accumulated retained earnings.

3.2.7. Taxes paid under CFC rules

115. Taxes paid in accordance with Controlled Foreign Corporation (CFC) rules are considered covered taxes for the purposes of the GloBE provided that they are imposed on the income of the CFC that is attributed to shareholders in the parent jurisdiction. Such CFC taxes should be assigned, where possible,

⁴⁹ This subsection has been drafted to reflect comments by US, New Zealand, Luxembourg and Switzerland and replaces the previous subsections on taxes on retained earnings and corporate equity.

to the jurisdiction in which the underlying income arises (i.e. to the jurisdiction of the CFC) and should be excluded from the ETR computation if the underlying income is excluded.⁵⁰

3.2.8. Non-covered taxes

Consumption and sales taxes

116. Consumption taxes, such as sales taxes and value-added taxes (VATs), are not covered taxes under the GloBE rules. Such taxes are calculated by reference to the consideration for a defined supply and are not taxes on the net income of a taxpayer.

Excise taxes

117. Excise and other taxes on inputs are not covered taxes under the GloBE rules. Such taxes arise in relation to a specific input which do not represent an accretion of income.

Digital services taxes

118. Digital services taxes (DSTs), as currently contemplated by a number of Members of the Inclusive Framework, are generally designed to apply to the gross revenues from the provision of certain digital services and so would not be considered an income tax. DSTs are generally designed to apply in addition to, and not as substitutes for, a generally applicable income tax under the laws of a jurisdiction, and so would not fall under the “in lieu of” test for covered taxes either.

Stamp and other transfer taxes

119. Stamp duty, ad valorem taxes and other taxes that are imposed on a particular transaction are not taxes on income or taxes in lieu of an income tax. They are therefore outside the scope of the covered tax definition.

Payroll taxes and social security contributions

120. Payroll taxes and other employment based taxes, as well as social security contributions, are not covered taxes under the GloBE rules. Payroll taxes and social security contributions are not imposed on the employer in respect of its income. This follows the well-established view of payroll taxes and social security contributions as being levied on labour income (i.e. wages and in some cases personal income) as opposed to business profits. Rather, payroll taxes and social security contributions are typically deductible from business profits in the same way that wages are deducted from business profits. Payroll taxes and social security contributions will also be included in the payroll component of the proposed formulaic substance-based carve-out from the GloBE (Section 3.5).

Property taxes

121. Taxes based on ownership of specified items or categories of property are distinguishable from taxes based on a corporation’s equity and should not be covered taxes under the GloBE rules. Taxes on corporate equity are generally levied on a broader range of assets than property taxes. Property taxes are based on the assessed value of the property, often without regard to whether the property is subject to a

⁵⁰ See Section 3.6.2 on *Assignment of income and taxes of entity to each jurisdiction* for the approach for the treatment of CFC income and related taxes in the ETR calculation under the GloBE.

liability. They are not based on income, retained earnings, or corporate equity. Neither are they taxes imposed in lieu of a generally applicable income tax.

122. Furthermore, including property taxes in covered taxes would give a preference to owned assets over leased assets. In many cases, ownership versus lease of assets are business structure or finance decisions. In other cases, the treatment of a financing arrangement as a purchase or lease depends on accounting rules that do not implicate the policy of the GloBE. There is no apparent reason to favour ownership of assets over leasing of assets under the GloBE.

123. A property tax that reduced the assessed value of taxable property based on liabilities associated with the property might be considered similar to corporate equity taxes because corporate equity is the difference between the value of an entity's assets and its liabilities. However, equity taxes are not generally based on the specific assets held by a company, although the equity tax base could be reduced by certain categories of assets. Moreover, corporate equity is determined by taking into account all liabilities of the corporation, not just liabilities associated with specific assets. Conceptually, a corporate equity tax is⁵¹ closer to an income tax than a property tax as the return on equity capital is a proxy for income. Adjustments to the assessed value of property for liabilities against the property is more akin to a valuation method under a property tax than a tax that is predominantly on previous income. Accordingly, property taxes are not included in the definition of covered taxes under the GloBE rules.

3.3. Tax base

GloBE tax base calculated by reference to consolidated financial accounts

Profit or loss determined in accordance with financial accounting standard

The starting point for determining the GloBE tax base is the profit (or loss) before income tax as determined using the relevant financial accounting standard, which may include items previously included in other comprehensive income. Certain items of income are removed from and certain items of expense are added back to arrive at the GloBE tax base.

Financial accounting standard

The relevant financial accounting standard for calculating the GloBE tax base is the financial accounting standard used by the parent in the preparation of its consolidated financial statements.

Acceptable accounting standards

The acceptable financial accounting standards are IFRS and any equivalent financial accounting standard. Equivalent financial accounting standards include the generally accepted accounting principles of Canada, Japan, the People's Republic of China, the Republic of India, the Republic of Korea, and the United States.

In addition, an MNE should be permitted to use any generally acceptable accounting standard permitted by the body with legal authority in the ultimate parent entity's tax jurisdiction to prescribe, establish, or accept accounting standards for financial reporting purposes, provided the use of that standard will not result in material competitive distortions in the application of the GloBE rules.

Determining profit (or loss) before tax of each entity

⁵¹ This has been amended to reflect comments by Switzerland.

Entity-level financial information that is used in preparing the parent's consolidated financial accounts can be used, even if such financial information is not prepared in strict accordance with the parent's financial accounting standard where (a) it is reasonable to do so, (b) the information is reliable, and (c) the use of such information does not result in material permanent differences from the accounting standard of the parent.

Determining income of permanent establishment and head office

Profit (or loss) before tax of a permanent establishment is determined based on the income and expenses that are treated as arising for tax purposes in the jurisdiction where the permanent establishment is located. Transactions between the permanent establishment and the head office that are taken into account in determining the taxable income of the permanent establishment are taken into account in determining the profit (or loss) before tax of the permanent establishment and the head office under the GloBE rules.

Intercompany items

Income, gains, expenses, and losses attributable to transactions between members of the GloBE tax group should be recorded in the entity level financial accounts in accordance with the arm's length principle. Intercompany items can be excluded, however, to the extent the transaction is between group members in the same jurisdiction.

Items held in consolidation

Purchase accounting adjustments held in consolidation should not be pushed down or otherwise allocated to specific entities. Other items maintained at the consolidated level should only be taken into account in the GloBE tax base of a constituent entity where those items can be reliably and consistently traced to that entity.

Dividends and equity method profit (or loss)

The GloBE tax base excludes all dividends received from a corporate entity, including intra-group dividends and portfolio dividends, except portfolio dividends received by constituent entities that are engaged in a financial services business, such as a bank, insurance company, or securities dealer, and securities traders. The GloBE tax base of a Constituent Entity that is not engaged in a financial services business excludes any profit (or loss) attributable to an entity accounted for using the equity method of accounting.

Dispositions of stock

The GloBE tax base generally excludes gain (or loss) arising from dispositions of stock, including mergers. The acquired entity is required to use the historical carrying value of its underlying assets to compute its GloBE tax base after the acquisition. An exception to these rules applies to stock transactions between parties tax resident in the same jurisdiction that are treated as taxable asset sales in that jurisdiction.

Covered taxes

Covered taxes, including taxes that are not treated as income taxes for financial accounting purposes, are not deductible in the computation of the GloBE tax base.

Stock-based compensation expense

Stock-based compensation expense is only allowed as a deduction in the GloBE tax base computation for a jurisdiction to the extent it is allowed as a deduction in the local tax base of the jurisdiction of the entity that employed or contracted with the party receiving the stock-based compensation. However, MNEs may reduce the GloBE tax base by stock-based compensation expense as recognised for

financial accounting purposes (rather than local tax purposes), in those jurisdictions that do not have a corporate income tax system.

Bribes, kickbacks and other illegal payments

Bribes, kickbacks (and other illegal payments) are not allowed as a deduction to the GloBE tax base.

Fines and penalties

A fine or penalty imposed by government on an entity is not allowed as a deduction to the GloBE tax base of a jurisdiction if the fine or penalty, including a periodic penalty, incurred by the entity in the jurisdiction equals or exceeds €50,000.

Adjustment for Pillar One Outcomes

Pillar One applies before Pillar Two. Depending upon the final design of Pillar One, an adjustment may be required to the GloBE tax base to properly reflect Pillar One outcomes.

3.3.1. Profit or loss determined in accordance with financial accounting standard

124. As directed in the Programme of Work, the Inclusive Framework first considered the possibility of calculating the GloBE tax base using the parent jurisdiction's rules for computing domestic taxable income or the income of controlled foreign companies (CFC). Leveraging the existing tax base calculation rules that a country uses for CFC purposes might initially seem to have the advantage of facilitating a tax administrations implementation and administration of the rules. However, CFC rules typically do not apply to all the subsidiaries in an MNE group and, when they do apply, they usually only capture certain types of low-tax passive income. In contrast, the GloBE rules will apply to all the subsidiaries in the group and all types of income. Therefore, Members of the Inclusive Framework considered that using the tax base calculation rules in the Parent's jurisdiction of residence would entail significant compliance costs due to the need for each foreign subsidiary to re-calculate all of its income in accordance with the tax base of another jurisdiction. These re-calculations could lead to situations where technical and structural differences between the calculation of the tax base in the parent and subsidiary jurisdiction could result in an otherwise highly-taxed subsidiary being treated as having a low ETR for reasons unrelated to the policy underlying the GloBE rules. For example, differences between jurisdictions in the treatment of carry-forward losses and in the timing of the recognition of income and expenses could impact the calculation of the ETR in different jurisdictions. Such differences could result in the application of the rule in cases that do not give rise to the policy concerns that are intended to be addressed by the GloBE rules.

125. Structural differences in the calculation of the tax base between jurisdictions could also complicate the application of the GloBE rules and undermine its policy objectives, including the policy of ensuring transparent outcomes. For example, two jurisdictions may apply the same minimum tax rate to the income of entities pursuant to their income inclusion rules. However, if one jurisdiction has a different tax base from the other, this could result in significantly different outcomes for similarly situated entities, undermining the policy intent of creating a transparent and level playing field already reflected in the agreement on a minimum ETR equal to a fixed percentage. Finally, from the perspective of the application of the undertaxed payments rule it would be impossible to design an effective tax rate test that required a group entity making a related party payment to re-compute the recipient's income according to the tax base rules in the paying entity's tax jurisdiction. This could result in requiring taxpayers to re-compute the income many times over, possibly hundreds of times for larger groups.

126. In order to improve compliance and administration and to neutralise the impact of structural differences in the calculation of the tax base, the Programme of Work called for the exploration of simplifications to help address the issues arising from the use of the tax base in the parent jurisdiction. One simplification identified in the Programme of Work was to start with the relevant financial accounting

rules. The net income calculated for financial accounting purposes could then be subject to any necessary and agreed adjustments to arrive at the GloBE tax base.

127. Use of financial accounts as a starting point for determining the tax base under the GloBE rules offers numerous advantages. From a compliance and administration perspective, it facilitates the coordination of the GloBE rules operating in different jurisdictions and eliminates the need to re-calculate the taxable income of each foreign subsidiary under the rules of the jurisdiction applying the GloBE rules. It also improves the transparency of outcomes under the GloBE rules and reduces distortions among jurisdictions based on differences in the tax base.

128. Importantly, the use of financial accounts to determine the GloBE tax base builds on existing internationally agreed standards. Although there are variations in financial accounting standards among jurisdictions, International Financial Reporting Standards (IFRS) and the generally accepted accounting principles (GAAP) of many Inclusive Framework jurisdictions have far more commonalities than differences. Moreover, there are no other uniform international standard methods of measuring the income of an entity, and it is not feasible to create, from the ground up, a new international accounting standard for computing profit (or loss) before tax under the GloBE rules.

129. The financial accounts of the entity are used to determine the entity's profit (or loss) before tax. Profit (or loss) before tax is the preferred profit measure under the GloBE rules for several reasons. First, it takes into account the actual costs of doing business, including all operating and non-operating expenses. Second, it is the most comparable financial accounting measure to taxable income, but, critically, it is computed without regard to special local tax exclusions, deductions and tax accounting conventions that would undermine the policy objectives of the GloBE rules. Therefore, using profit (or loss) before tax as a measure of profit for computing the GloBE tax base should limit the risk of the GloBE tax base diverging significantly from the tax base of the MNE group under local corporate income tax rules, where such a divergence would be inconsistent with the policy objectives of the GloBE rules.

130. Most commonly used accounting standards, including IFRS, do not strictly define profit (or loss) before tax. Profit measures other than net income, such as profit (or loss) before tax, are typically referred to as non-GAAP measures, and MNE groups have some flexibility in how to calculate them.

131. For the purposes of the GloBE rules, it will be necessary to establish a consistent way for MNE groups to determine profit (or loss) before tax using their separate entity financial accounts. One option would be to adopt an additive approach, which would define the various income and expense items that should be included. Alternatively, a deductive approach would assume that all items included in the computation of net income for purposes of the group's consolidated financial accounting statements should be included in the computation of profit (or loss) before tax, but would identify specific items that should be excluded for specific policy reasons. IF members have agreed that the latter approach is the preferred one as it is likely to be simpler for MNE groups to apply given that it merely requires exclusion of a limited number of items.

Other comprehensive income

132. Generally, financial accounting profit (or loss) does not include other comprehensive income (OCI). However, some items of income or loss reported in OCI are "recycled" through the profit and loss statement. OCI is reported on a company's balance sheet, under the equity section. The items included in OCI may include gains and losses on certain debt and equity investments, foreign currency exchange gains and losses, and changes in liabilities under pension plans. Certain revenue, expenses, gains, and losses appear in OCI before a third-party transaction has been completed. For example, if a company has invested in an interest-bearing bond and the value of that bond changes due to changes in market interest rates, then the company might be required to recognise that change in value as a gain (or loss) in OCI. Once the company sells or redeems the bond, it will then realise the transactional gain (or loss) associated with the bonds, and the realised gain (or loss) will be reported in the income statement and impact profit

(or loss) before tax. Some items that are included in OCI may also be subject to tax in the local jurisdiction. In most cases, however, this will only be expected to give rise to a temporary or timing difference between local tax base and the GloBE tax base.⁵²

133. In other cases, the corresponding gain (or loss) can generally be expected to be excluded from the GloBE tax base. The GloBE rules do not directly recognise items of OCI as includible in the GloBE tax base. However, such items will be included in the GloBE tax base if and when they are recognised as profit (or loss) for financial accounting purposes, provided they are not otherwise excluded from the calculation of the GloBE tax base under another rule. In this regard, an adjustment may be necessary to ensure that all of the gain (or loss) is included in the GloBE tax base in cases where only the current portion of the total gain (or loss) on disposition is included in the profit (or loss) for financial accounting purposes. This situation could arise where an asset is disposed and previous increases or decreases in fair value in respect of that asset have already been reflected in the OCI. These corresponding carrying value adjustments should be taken into account in determining the gain or loss in the year of disposition.

3.3.2. Use of parent entity's consolidated financial accounting standard

134. The starting point for the GloBE tax base is the financial accounts of each constituent entity of the MNE group prepared in accordance with the financial accounting standard used by the parent entity of the group in the preparation of its consolidated financial statements.

135. There are two advantages to using the parent entity's accounting standard. First, the use of a single standard helps minimise mismatches in the treatment of transactions between constituent entities that may arise due to the use of different accounting standards in different jurisdictions. Second, the standards used to prepare financial accounts for constituent entities will, in many cases and particularly for those MNE groups that are listed, follow the standard used in the parent jurisdiction. This is because, in many cases, maintaining financial accounts for all constituent entities using a single standard facilitates the preparation of consolidated financial statements and quarterly reporting for those groups. In those cases where a constituent entity's accounts are not regularly maintained in accordance with the accounting standard of the parent entity there will typically be mechanisms in place that allow those accounts to be converted into the parent entity's standard as part of the consolidation process.

3.3.3. Acceptable financial accounting standards

136. The use of any accounting standard, including the standard used by the parent entity in preparing its consolidated financial statements, is always subject to the caveat that the standard, itself, must be a reliable and acceptable financial accounting standard.

IFRS and equivalents

137. The rule accepts IFRS as adopted by the parent jurisdiction. IFRS is the most commonly used and accepted financial accounting standard worldwide. IFRS were established by the International Accounting Standards Board (IASB) in order to create a common accounting language, so that financial statements can be consistent and reliable from company to company and country to country. Jurisdictions adopt IFRS by conforming their local generally accepted accounting principles (GAAP) to IFRS. However, some jurisdictions have adopted IFRS with minor modifications, including different effective dates for the application of specific IFRS rules.

⁵² See below Section 4.7 on *Mechanisms to address temporary differences*.

138. In addition, the GloBE rule accepts any financial accounting standard that is equivalent to IFRS. Equivalency with IFRS can be assessed based on the work of the IASB as well as the work of securities regulators that allow other accounting standards in financial reports of publicly accountable companies.

139. The IASB works with accounting standard authorities of different jurisdictions in an effort to converge these different accounting standards. The IASB provides information on the status of IFRS adoption and convergence projects in many jurisdictions on its website. For example, the IASB notes on its website that the accounting standards used for publicly listed entities in the People’s Republic of China, the Republic of India, the Republic of Korea, and Singapore are substantially converged with IFRS standards. Similarly, the IASB notes that Australia, Hong Kong (China), and New Zealand have adopted IFRS “nearly word for word as their national accounting standards”.⁵³ IFRS as adopted by all of these jurisdictions are considered IFRS for purposes of the GloBE proposal. However, the IASB generally does not undertake an evaluation of the overall comparability of each jurisdiction’s local financial accounting standards with IFRS. Thus, assessments of equivalency to IFRS for purposes of the GloBE rules cannot be based solely on the work of the IASB.

140. Securities regulators in Inclusive Framework jurisdictions may issue guidance authorising foreign issuers of securities to use financial statements that are prepared under an accounting standard different from the accounting standards generally applicable to domestic issuers. Each regulator has its own process for authorising the use of an alternative accounting standard and the basis on which this authorisation is made may not be publicly disclosed. However, in general, the regulator will consider whether the alternative accounting standard provides investors with substantially similar financial information about the issuer such that an investor acting on such information is likely to make the same decisions about the acquisition or disposal of the issuer’s securities. For example, European Union securities regulators have recognised that the GAAP of Canada, Japan, the People’s Republic of China, the Republic of India, the Republic of Korea, and the United States are generally equivalent to IFRS. Determinations by securities regulators for a significant number of jurisdictions that use IFRS as the primary reporting standard to allow foreign issuers to use financial statements prepared under an alternative financial accounting standard provides a strong indication that the alternative financial accounting standard is equivalent to IFRS.

141. The assessments made by the IASB and the reciprocal recognition of accounting standards by different regulators provide a strong indication that any differences between IFRS and the GAAP of Canada, Japan, the People’s Republic of China, the Republic of India, the Republic of Korea, and the United States would not provide a material competitive advantage or disadvantage to an MNE group using any of these standards vis-à-vis an MNE group using IFRS. Furthermore, Inclusive Framework members are not aware of any differences between IFRS and these standards that would create material competitive distortions in the GloBE tax base, nor did the December Public Consultation bring to light any material distortions in response to this specific point. Accordingly, these accounting standards are considered equivalent to IFRS.

Other generally accepted financial accounting standards

142. As a result of the €750 million consolidated revenue threshold described above in Section 2.4,⁵⁴ a significant majority of MNEs subject to the GloBE rules are expected to be listed companies that prepare consolidated financial statements under IFRS or an equivalent standard. There will, however, be some MNE groups that are listed but prepare consolidated financial reports based on standards other than IFRS

⁵³ <https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/#analysis>

⁵⁴ It is recognised that no decision has yet been taken by the Inclusive Framework on the threshold (including the level of that threshold) this current draft, for the sake of analysis, uses a threshold that corresponds with that used for Country-by-Country reporting (CbCR) rules.

or an equivalent and MNE Groups that are not listed. Non-listed MNE groups may be headquartered in a jurisdiction that requires IFRS for listed companies, but they may prepare their financial statements using the local accounting standard. It is not proportionate or reasonable to require such MNE groups to prepare financial accounts under a different accounting standard solely for purposes of complying with the GloBE rules if their existing accounting standard is recognised by an appropriate authority and it does not result in material competitive distortions under the GloBE rules. Thus, the rule would permit an MNE group to use any generally acceptable accounting standard permitted by the body with legal authority in the tax jurisdiction of its ultimate parent entity to prescribe, establish, or accept accounting standards for financial reporting purposes, provided the use of that standard would not result in a material competitive distortion in the application of the GloBE rules.⁵⁵

3.3.4. Adjustments for permanent differences

143. Section 3.3.1 above sets out a basic approach for computing profit (or loss) before tax for each Constituent Entity under the accounting standard of the parent entity as the starting point for the GloBE tax base. This section sets out the adjustments to net income that are required in order to more closely align the GloBE tax base with the computation of taxable income under the rules of the jurisdiction where the MNE operates. Adjustments may be required where differences between tax and financial accounting could have a disproportionate impact on the outcomes under the GloBE rules.

144. Differences between the relevant financial accounting standard and tax accounting rules generally can be categorized as giving rise either to permanent differences that will not reverse in a future period or temporary (i.e., timing) differences that will reverse in a future period. This chapter is focused on permanent differences. Temporary differences are addressed below in section 3.7.

Evaluating permanent differences

145. Each Inclusive Framework jurisdiction has its own unique combination of additions to and exclusions from financial accounting income to arrive at taxable income. It is therefore implicit in the decision to use financial accounts as the starting point for determining the GloBE tax base that certain permanent differences will arise between that local tax base and the GloBE tax base. If there is agreement on a common tax base for the GloBE rules it follows that such permanent differences are to be expected and it would not be possible or desirable, from either a policy or a design perspective, to develop a comprehensive set of adjustments that will bring the GloBE tax base fully into line with the tax base calculation rules of all Inclusive Framework members. Nevertheless, some adjustments to financial accounts are appropriate based on the policies of the GloBE rules and tax policy more generally.

146. In order to justify adopting or rejecting potential adjustments to the financial accounts to arrive at the GloBE tax base, it is necessary to evaluate permanent differences using an agreed set of principles. The pertinent principles for evaluating permanent differences are materiality and commonality. Specifically, in order to avoid disproportionate outcomes that are out of line with the intended outcomes under GloBE, a constituent entity's profit (or loss) before tax, as determined under the applicable financial accounting standard, should only be adjusted to exclude material items that are commonly excluded from the tax base of Inclusive Framework jurisdictions. Furthermore any adjustments should be kept to a minimum in order to minimise complexity. Set forth below is an exclusive list of adjustments to financial accounts that have been agreed by the Inclusive Framework as being necessary and appropriate for calculating the GloBE tax base. In keeping with the desire to minimise both the number and complexity of required adjustments,

⁵⁵ The Chapter on implementation will describe a process for evaluating and providing guidance on material competitive distortions.

the adjustments described in this section that exclude income do not require a correlative exclusion of expenses, other than some covered taxes, attributable to that income.

Dividends and equity method accounting

147. The GloBE rules generally require the GloBE tax base and covered taxes of Constituent Entities to be determined on a separate entity basis. Dividends received from other Constituent Entities would ordinarily be included in the separate entity computation of profit (or loss) before tax and thus would be included in the starting point of the GloBE tax base. Similarly dividends received from a corporate entity in which the shareholder holds a minority interest, commonly referred to as “portfolio dividends”, will also be included in the profit (or loss) before tax of the subsidiary receiving the dividend. In many jurisdictions, dividends are wholly or partially excluded, from the taxable income of a corporate shareholder. This permanent difference between the financial accounting treatment and the rules for taxing dividends under local law could give rise to a GloBE tax liability in respect of dividends unless the GloBE rules permit the taxpayer to make a corresponding adjustment for the purposes of calculating the GloBE tax base.

Intra-group dividends

148. The income of a Constituent Entity is subject to the GloBE rules irrespective of whether the controlling ownership of the entity is held entirely by a single Constituent Entity, or collectively by multiple Constituent Entities of the MNE Group. Dividends distributed from one Constituent Entity of an MNE Group to another Constituent Entity of the same MNE Group must be excluded from the GloBE tax base because they represent income that has already been included in the GloBE tax base. Failure to exclude such dividends from the recipient’s GloBE tax base could result in double taxation of the same income, which would be inconsistent with the policies of the GloBE rules.

Portfolio dividends

Note for WP11 Delegates – Treatment of Dividends and Gains on Portfolio Stock

Background

During the 25 June Working Party 11 videoconference, the Secretariat presented the document [CTPA/CFA/WP11/NOE\(2020\)13/REV1](#), the revised draft of this chapter (sections 4-7). The document covered, among other things, the treatment of dividends for purposes of the GloBE tax base. In particular, the proposed rules excluded all dividends received by a constituent entity (“CE”) from a corporate entity from the GloBE tax base, including:

- A dividend received by a CE from another CE (i.e., an intra-group dividend);
- Net income of a non-CE reported by a CE under the equity method of accounting, which generally applies to ownership interests representing between 20% and 50% of the equity interests in the entity; and
- A dividend received by a CE from a less than 20% owned equity investment (i.e., a portfolio dividend).

This broad exclusion for dividends was designed to reflect that many IF jurisdictions either have broad participation exemption systems that exclude most dividends received from both foreign and domestic corporations from the local tax base or otherwise provide an indirect credit for taxes paid. Dividend exemptions or indirect credits are usually granted to corporate shareholders under local law in recognition of the fact that dividends are generally paid out of retained earnings that have already been subject to tax in the hands of the distributing company.

However, the proposed rule contained in the previous draft of this chapter turned-off the exemption for portfolio dividends and income that was included under the equity accounting method for CEs engaged in a financial services business. Therefore, equity method net income and portfolio dividends received by a CE engaged in a financial services business were included in its GloBE tax base. The previous draft of this chapter also excepted financial services businesses from the exclusion for gains and losses on securities accounted for using the fair value accounting method.

The reason for these exceptions to the general rule was that portfolio dividend income and gains or losses on investment or trading securities represent core operating income for financial services businesses; income which is typically included in the local corporate tax base, if any. Furthermore, the exception recognised that, unlike non-financial businesses, financial services firms typically incur material expenses in generating this type of income which would need to be commensurately excluded from the GloBE tax base computation. Identifying the relevant expenses would likely lead to significant complexity. For example, it may be difficult for a financial services business to reliably allocate its labour costs between portfolio dividend income and interest income. It should also be noted that requiring financial service businesses to exclude portfolio dividends is not necessarily more favourable for them, from a GloBE perspective, because such income is often highly taxed.

During the 25 June meeting of WP11, some delegates argued for removal of the exception for equity method net income, fair value gains and losses, and portfolio dividends received by a CE engaged in a financial services business. These delegates generally preferred excluding such income for all CEs. These delegates noted that regardless of whether the recipient of the dividend is engaged in a financial services business, the underlying income that funded the dividend has likely already been subject to tax – possibly even an IIR tax – and, therefore, including the dividend in the GloBE tax base would potentially lead to double tax. These delegates were also concerned that a special rule for financial

services businesses would inevitably lead to a difficult line drawing exercise of defining a financial services business. Other delegates, however, voiced support for the financial services business exceptions.

These comments suggest a need for an alternative approach that could balance the preference of some delegates to ensure financial services businesses are subject to the GloBE rules on their core business income, namely portfolio dividends and gains from trading equity securities, while at the same time addressing the concerns raised by other delegates, including double tax and definitional issues.

Alternative approach

Under the alternative approach, all dividends received, equity method income or loss, fair value gains and losses, and gains or losses on the disposition of stock would be excluded from the GloBE tax base of the shareholder if the MNE owned at least 10% of the equity interests (by vote or value) in the investee entity and held that interest for at least 12 months (i.e., any period of 12 consecutive months that includes the date of the dividend or relevant income item). Such income attributable to stock that did not meet these criteria would be included in the GloBE tax base of the shareholder.

This rule would be designed to exclude all dividends and investment income other than those stemming from minority, short-term equity investments (referred to as “trading investments”). The criteria are intended to distinguish between short-term investments and long-term equity stakes in a company. The securities routinely bought and sold by banks, insurance companies, and traders would generally not meet the criteria. Nor would temporary cash surpluses of other businesses parked in mutual funds or other equity investments for short periods. Delegates may view this alternative approach as an improvement because it achieves substantially similar results for financial services businesses, without the definitional challenges, and does not distort temporary or short-term investment decisions of businesses generally.

This alternative approach would also require a corresponding change to the treatment of gains or losses on the disposition of stock held for less than 12 months and to the taxation of equity interests that are accounted for under the fair value method.

This result would also achieve parity with the tax outcomes in those IF jurisdictions that do not provide an exemption or tax credit in respect of portfolio dividends. In these jurisdictions, where a shareholder does not own a sufficient stake in the corporation for the two to be considered in any sense one and the same taxpayer, dividends received by the shareholder are seen in the same way as earnings of any other non-participatory investment that produces similar income, such as interest, rents, and royalties. Taxes paid by the shareholder on the dividend or other investment income would, of course, be taken into account in the ETR computation.

For those instances in which a CE engaged in a financial services business owns more than 10% of the investee for more than 12 months consideration would need to be given to the treatment of expenses relating to the income excluded under the rule. Because the income is being excluded, it may be appropriate to commensurately exclude related expenses. However, most expenses (including labour costs) incurred by a financial services business in connection with equity investments are related to trading investments, rather than large, long-term equity investments. Therefore, it does not appear necessary to exclude expenses related to portfolio dividends or equity method income received by a CE engaged in a financial services business from non-trading investments.

This alternative approach does not eliminate the potential for double tax on portfolio dividends. If the income that funded the dividend was subject to tax in the hands of the distributing corporation, then including the dividend in the GloBE tax base of the shareholder may result in an additional layer of corporate tax on the same underlying income. This is particularly the case where the issuer of the

shares is subject to the GloBE rules. Potentially, this could be dealt with by excluding those dividends paid by corporations where the ultimate parent entity is located in a jurisdiction that applies an IIR in accordance with the GloBE rules.

Questions for WP11 delegates

1. Do delegates prefer an approach that
 - a. excludes all dividends and gains and losses from stock, but with a special rule for financial services businesses (i.e., Option A set out below), or
 - b. the alternative approach that excludes dividends and gains and losses from stock based on a minimum fixed percentage of ownership, such as 10%, or ownership term, such as 12 months (i.e. Option B below)?
2. Do delegates agree that Option B it is unnecessary to exclude expenses related to portfolio dividends or equity method income of a CE engaged in a financial services business from non-trading investments?

149. In many Inclusive Framework jurisdictions, dividends are excluded, in whole or in part, from the taxable income of a corporate shareholder. These dividend exclusion rules are often referred to as participation exemptions. In some jurisdictions, the exemption is conditioned on certain ownership or control threshold and holding period requirements. In other jurisdictions, dividends are excluded from taxable income without restrictions.

150. Recognising the broad nature of the participation exemptions of many Inclusive Framework members, the GloBE tax base should exclude all dividends received from any corporation. This exclusion from the GloBE tax base applies to both intra-group dividends and portfolio dividends received from both domestic and foreign corporations. Consistent with the principles for evaluating permanent differences, this rule recognises that dividends are both material and commonly excluded from the tax base of many Inclusive Framework members or otherwise benefit from tax relief (such as an indirect credit for taxes paid). Dividend exemptions, exclusions, or credits are usually granted under local law in recognition of the fact that the dividend is generally paid out of retained earnings that have already been subject to tax in the hands of the distributing company. Taxing these dividends under the GloBE rules would therefore give rise to the risk of over taxation.

151. **[OPTION A:** The adjustment does not apply, however, to portfolio dividends received by constituent entities that are engaged in a financial services business, such as a bank, insurance company, or securities dealer. Consistent with the tax rules in a number of countries, portfolio shares held by banks, insurance companies, and dealers form part of the trading stock of these entities and the dividends paid on these shares are properly considered part of that entities business income. If a portfolio dividend received by constituent entities engaged in a financial services business is subject to covered taxes in another jurisdiction, then those covered taxes should be treated as taxes paid on the portfolio dividend in the jurisdiction of the recipient of the dividend.

152. **OPTION B:** The adjustment only applies, however, to portfolio dividends received from entities in which the MNE Group owns at least 10% of the equity interests (by vote or value) and has held that interest for at least 12 months (i.e., any period of 12 consecutive months that includes the date of the dividend or relevant income item). If a portfolio dividend is subject to covered taxes in another jurisdiction such as withholding taxes, then those covered taxes should be treated as taxes paid on the portfolio dividend in the jurisdiction of the recipient of the dividend.]

Use of equity method

153. As explained in Chapter 2, associate entities and joint ventures are not Constituent Entities. Ownership interests in associate entities and joint ventures are generally accounted for using the equity method. Under the equity method, the owner includes in income its proportionate share of the entity's after-tax income or loss and increases or decreases the carrying cost of the investment by the same amount. The income included by the owner under the equity method is thus equal to the amount of dividends the owner would have received if the entity had distributed its annual income. Actual distributions reduce the carrying cost of the investment but are not included in the owner's financial accounting profit (or loss).

154. For tax purposes, a shareholder with a significant interest in a foreign corporation will not ordinarily be required to include the income of that entity in the shareholder's taxable income until distribution, absent a CFC or similar rule. The equity method, however, includes the owner's proportionate share of the entity's after-tax income or loss in the year earned by the associate entity of joint venture. Nonetheless, the equity method income is more like dividend income than consolidated income because the amount included is the net income of the entire investment on an aggregate basis.

155. Accordingly, the rule excludes both income and loss attributable to an interest in an entity that is accounted for by the MNE Group under the equity method from the income of the shareholder in order to equate the treatment of the income from these investments with the treatment of income from portfolio investments. Section 4.2.4 sets out special rules for the treatment of investments in associate entities under a simplified income inclusion rule.

156. The determination of whether an entity is an associate or joint venture is based on the ownership of that entity held by the MNE Group. Thus, if twenty Constituent Entities of the same MNE Group each own 5% of the same entity, that entity is a Constituent Entity of the MNE Group, not an associate entity of each Constituent Entity shareholder.

Distribution deduction regimes

157. As explained in section 2.3.6, some jurisdictions provide tax regimes for certain collective enterprises or investment vehicles that are designed to produce a single level of taxation by providing a deduction for distributions to certain owners. Constituent Entities of an MNE Group may own stock in entities subject to these regimes or could be subject to these regimes, themselves.

158. The rationale for excluding intra-group dividends from the GloBE tax base is that the underlying income was already subject to the GloBE rules in the hands of the Constituent Entity that earned that income. The rationale for excluding dividends and equity method income of other entities similarly is based on the idea that the distributing corporation was already subject to tax on that income. In the case of a distributing corporation subject to a distribution deduction regime, however, these rationales do not apply. If the distributing corporation and the shareholder are Constituent Entities of the same MNE Group and the shareholder excluded the dividend, that income would effectively be exempted from the GloBE tax base. Accordingly, dividends received from such corporations should be included in the GloBE tax base.

159. A special rule is also needed for situations where the corporation subject to the distribution deduction regime is a Constituent Entity. The distribution deductions allowed for tax purposes are not mirrored in the financial accounts. Thus, the distributing entity may have a significant amount of income determined using the financial accounts, but no tax liability, resulting in a low ETR. In addition, under the rule described above, the Constituent Entity shareholders will include the distributions in their income. To prevent double counting of the income and distortions in the ETR computations, a Constituent Entity that is eligible for a distribution deduction for tax purposes is permitted to deduct distributions in the same manner as allowed under local tax law as a permanent adjustment to the GloBE tax base.

160. These rules ensure that income of a Constituent Entity subject to a distribution deduction regime is not considered low-taxed income under the GloBE rules at the entity level simply due a dividends paid deduction, thus preserving the jurisdiction's single level of tax policy, while simultaneously ensuring that the MNE Group's share of the entity's income remains subject to the GloBE rules.

Gain (or loss) from the disposition of stock

161. In many Inclusive Framework jurisdictions, gains arising from the disposition of stock are exempt from tax. The rationale for excluding such gains from taxation is similar (but not identical) to the rationale for excluding tax on dividends. To the extent the gain on the stock represents retained earnings, these amounts may have already been subject to tax in the issuer's jurisdiction. Similarly, to the extent the gain on the stock represents unrealised gains in assets held by the company it may be subject to tax in the issuer's jurisdiction in the future. Gain or loss on the disposition of stock that is included in the financial accounting income of the seller but excluded from the seller's taxable income would represent a permanent difference. If the difference is not adjusted for under the GloBE rules, gains on disposition will result in a lower GloBE ETR for the seller (and potential tax liability under the GloBE rules) and losses will result in a higher GloBE ETR.

162. The rule eliminates this permanent difference by excluding from the seller's GloBE tax base all gains (or losses) arising in connection with dispositions of stock, including mergers, of wholly owned entities.

163. **[OPTION A:** However, constituent entities engaged in a financial services business cannot use the exception to exclude gains and losses from dispositions of equity interests they own in entities that are not Constituent Entities. The exception for financial services businesses is necessary to align the treatment of their gains and losses from dispositions of equity interests with their treatment of portfolio dividends.

164. **OPTION B:** However, the exclusion does not apply to where the MNE Group owns less than 10% of the equity interests (by vote or value) and has held that interest for less than 12 months (i.e., any period of 12 consecutive months that includes the date of the dividend or relevant income item).] .

165. The gain (or loss) on the disposition of stock is defined as the gain (or loss) recognized by the seller for financial accounting purposes. Consistent with the principles for evaluating permanent differences, this rule recognises that gains (or losses) arising in connection with stock dispositions and fair value accounting are both material and commonly excluded from the tax base of many Inclusive Framework members and that the recognition of such amounts for the purposes of the GloBE rules could give rise to over-taxation.

166. For example, Corp A (resident in jurisdiction A) wholly owns Target Corp B (resident in jurisdiction B). Target Corp B owns a single asset with a fair market value of €200 and has no liabilities. Corp A has €50 of basis for tax purposes in the shares of Target Corp B (outside basis). Target Corp B has €50 of basis for tax purposes in its single underlying asset (inside basis). An unrelated party, Corp C (resident in jurisdiction C) acquires 100% of the stock of Target Corp B from Corp A for €200. Jurisdiction A excludes Corp A's €150 gain from taxable income. For financial accounting purposes, however, Corp A recognises €150 of gain. Under the rule, this gain would be excluded from Corp A's GloBE tax base which would more closely align Corp A's GloBE tax base with its local tax base. Consistent with the treatment of dividends and the tax rules in a number of Inclusive Framework jurisdictions, gains on the disposal of shares held by banks, insurance companies and dealers form part of the trading stock of these entities are properly considered part of that entity's business income and should be treated as part of the GloBE tax base.

167. In a stock acquisition, the purchaser acquires the target entity's stock from the selling shareholders. After the acquisition, the underlying assets of the target entity are neither "stepped-up" nor reduced to fair value for tax purposes. Instead, the target entity accounts for its underlying assets using their historical carrying value. However, for financial accounting purposes, the purchaser recognises the

acquired assets at fair value. If the target entity prepares separate financial statements, a question arises as to whether the historical carrying value of the target entity's underlying assets or the stepped-up carrying value should be reflected in the target entity's separate financial statements. Pushdown accounting refers to the latter. Pushdown accounting is not permitted under IFRS, but other accounting standards, including US GAAP, allow pushdown accounting in certain circumstances.

168. Pushdown accounting results in the carrying values of some of the target entity's underlying assets being stepped-up to fair value for financial accounting purposes, which usually results in higher depreciation and amortization expense, which, in turn, leads to lower financial accounting income for the acquired entity. Because financial accounting income is the starting point for the GloBE tax base, the target entity's profit will generally be lower if pushdown accounting is permitted, which will increase the target entity's ETR, perhaps above the minimum rate.

169. For example, assume the same facts as described in the example above. After the acquisition, Corp C will account for Target B's underlying assets at their stepped-up carrying value (i.e., €200) for purposes of preparing its consolidated financial accounts. In the case that Corp C pushes down the purchase accounting adjustments to Target B, Target B's stand-alone financial accounts will be based on the stepped-up carrying value of its underlying assets (i.e., €200). However, for local tax purposes, Target B will compute its taxable income based on the historical carrying value of its underlying assets (i.e., €50). This difference will result in more depreciation and amortization expense for financial accounting purposes than for tax purposes, which will result in a smaller GloBE tax base and a higher GloBE ETR for Target B.

170. The rule neutralises this effect by requiring the target entity to use the historical carrying value of its underlying assets to compute its GloBE tax base after the acquisition. The justification for this rule is that the purchase price of the target entity is equal to the present value of the estimated future income of its underlying assets. If the target entity was not sold then all the income generated by its underlying assets would be included in its GloBE tax base. On the other hand, if the target entity is sold, and a stepped-up carrying value is permitted, then the target entity's GloBE income will be reduced by higher depreciation and amortization expense, which would result in a portion of the income generated by its underlying assets being excluded from the GloBE tax base. The rule ensures that all the income generated by the target entity's underlying assets is included in the GloBE tax base. Furthermore, the rule eliminates a potentially material difference between different accounting standards (i.e., those that permit push-down accounting and those that do not).

171. However, if the seller and purchaser of a target entity and the entity itself are tax resident in the same jurisdiction and that jurisdiction treats the disposition of stock as a deemed asset sale for tax purposes in the target entity's jurisdiction (for both the seller and the purchaser) and imposes tax on the deemed asset sale above the minimum rate, then the target entity can use the stepped-up carrying value of its assets for purposes of computing its GloBE tax base. The justification for this exception is the gain (or loss) from the deemed asset sale has been subject to tax above the minimum rate.

Equity interests accounted for under the fair value accounting method

172. Some equity interests, usually interests below a 20% threshold, are accounted for using the fair value method. The fair value method re-values the equity interest periodically and changes in value are reported as gain or loss, either in the profit and loss statement or in the other comprehensive income section of the balance sheet. To match the treatment of gains and losses from actual sales of stock, these gains and losses should also be excluded from the GloBE tax base.. \

173. **[OPTION A;** However, constituent entities engaged in a financial services business cannot use the exception to exclude fair value gains and losses of equity interests they own in entities that are not Constituent Entities. The exception for financial services businesses is necessary to align the treatment of their fair value accounting income with their treatment of portfolio dividends.

174. **OPTION B:** However, the exclusion does not apply to where the MNE Group owns less than 10% of the equity interests (by vote or value) and has held that interest for less than 12 months (i.e., any period of 12 consecutive months that includes the date of the dividend or relevant income item).]

175.

Covered taxes

176. As noted above in Section 3.3.1, the GloBE tax base will be determined by starting with net income of the relevant entities and removing certain items of income and adding back certain expenses to arrive at a profit (or loss) before tax. Covered taxes are the most obvious expense that needs to be added back to net income to determine profit (or loss) before tax. Moreover, because covered taxes are included in the numerator of the ETR fraction, it would be inconsistent with the policy of GloBE to also allow them as a deduction in the computation of the denominator of the fraction. Accordingly, covered taxes are not treated as an expense in the computation of the GloBE tax base.

177. Financial accounting distinguishes between income taxes and other taxes. Income taxes, as defined for financial accounting purposes, are typically separately reported in the profit and loss statement. Taxes that are not considered income taxes are treated like operating expenses and may not be separately identified in the income statement. The definition of covered taxes under the GloBE rules is broader than the definition of income taxes for financial accounting purposes, and therefore, both covered taxes identified as income taxes in the financial accounts and other covered taxes must be added back to the net income to determine profit (or loss) before tax.

Stock-based compensation

178. Generally, for tax purposes, a corporation is entitled to deduct the value of stock-based compensation based on the ultimate market value of the stock. For example, a corporation may be able to deduct the present value of the stock option at the time of issuance or over the term of the option and then the difference between the present value at the time of issuance and the ultimate market value when the option is exercised by the holder. For financial accounting purposes, companies generally account for stock based compensation based on the present value of the stock option at the time of issuance and amortize that amount over the vesting period. In this case, if the market value of the stock increases over the life of the option, the corporation will deduct an amount for tax purposes that is higher than the amount expensed for financial accounting purposes, which is a permanent difference. This difference between financial accounting income and the local tax base will generally result in a lower GloBE ETR, perhaps below the minimum tax rate.

179. There is a different policy behind the treatment of stock-based compensation for financial accounting and tax purposes. Financial accounting rules focus on the economic position of the reporting entity, where changes to the ownership of the entity are reflected in adjustments in respect of earnings per share. Tax policy tends to treat the issue of stock-based compensation as an expense of the company and as income of the option holder, similar to other compensation for services rendered to the company. The tax policy justification for allowing the corporation to deduct the ultimate market value of the stock option is that the option holder will include the same amount in its taxable income.

180. The rule eliminates the permanent difference by allowing stock-based compensation as a deduction in the GloBE tax base computation to the extent it is allowed and at the same time applied as a deduction in the local tax base computation. In other words, the rule conforms the treatment of stock-based compensation to the local tax treatment. In principle, the rule applies to stock-based compensation for employees and non-employees. However, if the local tax base applies different rules for employees and non-employees, the GloBE tax base would conform to those rules. This rule is consistent with the principles for evaluating permanent differences. In particular, stock-based compensation can be material and some

form of deduction is commonly allowed by Inclusive Framework jurisdictions. Furthermore, the deduction is consistent with ensuring a single level of taxation in respect of these instruments.

181. However it is recognised that allowing stock-based compensation to reduce the GloBE tax base only to the extent it is deductible for local tax purposes means that stock-based compensation would never be deductible from the GloBE tax base for jurisdictions that do not impose a corporate income tax, even if the compensation income is subject to tax in the local jurisdiction. As a result, MNEs are allowed to reduce the GloBE tax base by stock-based compensation expense as recognised for financial accounting purposes (rather than local tax purposes), in those jurisdictions that do not have a corporate income tax system. This special rule is subject to the condition described in section 3.6.1 below that the item of expense must be able to be reliably and consistently traced to the entity in the relevant jurisdiction.

Bribes

182. Bribes are treated as expenses under financial accounting rules but are not deductible for tax purposes in most Inclusive Framework jurisdictions. A tax deduction for this item is disallowed for public policy reasons. Bribery hinders competition, distorts trade and harms consumers and taxpayers. It can also undermine public support for government. Denying a tax deduction serves as a strong symbol of a common international commitment to combat bribery. Therefore, members of the Inclusive Framework consider that a bribe should not be deductible under the GloBE rules.

183. To the extent a bribe reduces financial accounting income but is disallowed for tax purposes it represents a permanent difference. This difference between financial accounting income and the tax base will result in a higher GloBE ETR. The rule eliminates this permanent difference by disallowing a deduction for bribes in the GloBE tax base.

184. Bribes may be relatively easy to identify as they are commonly disallowed for local tax purposes. Furthermore, adjusting for this item is not expected to result in any significant added complexity and compliance costs because bribes are generally rare and non-recurring items.

185. As a practical matter, bribes may not be identified as such by local tax authorities until several years after the payment is actually made. The rules applicable to post-filing adjustments to local tax liability would apply when the bribe is discovered and disallowed for local tax purposes.⁵⁶

186. Consistent with the principles for evaluating permanent differences, this rule recognises that bribes, while rare, can be material and a deduction for this expense is commonly disallowed in Inclusive Framework jurisdictions.

Fines and penalties

187. Similar to bribes, fines and penalties imposed by a government are commonly disallowed for tax purposes. However, the policy rationale is slightly different. The policy rationale for denying a deduction for bribes is primarily to show a common international commitment to combat bribery and therefore under no circumstance should a bribe be deductible, for any purpose, and in any amount. Whereas the policy rationale for denying a deduction for fines and penalties is to limit the economic cost to only the person that committed the act; which would be diluted if the taxpayer were allowed to share the burden of the penalty with all taxpayers (by way of tax deduction for it).

188. However, fines and penalties, particularly those for minor offenses such as traffic tickets, are more frequent than bribes and vary widely in amount. They can range from a €50 traffic ticket incurred by a trucking company to a multi-million euro fine for securities law violations incurred by a large bank. Recognising the de minimis nature of many fines and penalties, the GloBE tax base excludes deduction

⁵⁶ Rules for addressing post-filing adjustments to local tax liability are discussed in section 3.7.5.

of only fines and penalties of €50,000 or more. The exclusion therefore applies only to large fines (€50,000 or more in equivalent currency) but it includes fines that may be levied in respect of the same activity on a periodic basis (e.g. daily fines) that in the aggregate equal or exceed €50,000. A periodic fine or penalty includes a fine or penalty that is assessed periodically until corrective action is taken, but does not include separate fines that are for the same type of offense committed upon multiple occasions, such as traffic tickets. The purpose of the threshold is to continue to allow deductions for smaller fines that may not be specifically recorded as separate items in the accounts of the Constituent Entity. This approach avoids the complexity of tracking small fines and penalties for GloBE purposes while at the same time preventing MNEs from escaping a top-up tax because of a few large, non-deductible, fines or penalties. It is also in line with the public policy considerations supporting an adjustment for bribes and consistent with the principles for evaluating permanent differences, including materiality. Interest charges for late payment of tax or other liabilities to a governmental unit are not considered fines or penalties for this purpose.

Gains and losses on restructuring

Note for WP11 Delegates

Gains and losses in connection with reorganisations and restructurings

The document [CTPA/CFA/WP11/NOE\(2020\)13/REV1](#) included a box that discussed the possible exclusion of gains and losses from the sale of land and immovable property from the GloBE tax base. The exclusion received very little support at the meeting. However, some delegates observed that transfers of land and other assets among Constituent Entities in connection with a restructuring or reorganisation of the MNE Group commonly benefit from a tax deferral provision. Generally, the gains and losses on transfers of assets in connection with a reorganisation are deferred by requiring the acquiring entity to take the same carrying cost in the asset as the transferor of the asset. This preserves the built-in gain or loss on the asset at the time of the reorganisation and will be realised through use of the asset in the production of income or upon sale or other disposition outside the group. Under the GloBE rules, however, gains and losses on transactions between Constituent Entities will generally be recognised. The difference between the local tax deferral rules and the GloBE rules would tend to lower the ETR in jurisdictions from which the assets are transferred, possibly creating GloBE tax liability.

Given the commonality of local tax rules that allow for gain and loss deferral in connection with reorganisations as well as the materiality of the differences between these local tax rules and the GloBE rules, it seems appropriate to provide a mechanism for taxpayers to conform the treatment of these transactions under the GloBE rules with the treatment under the local tax rules.

Under these rules an MNE Group would be required to exclude the gain or loss on a transfer of property, including intangible property, between two Constituent Entities and reduce (increase) the basis of the property in the hands of the acquiring Constituent Entity by the amount of the excluded gain (loss) if the transfer was made in connection with a reorganisation. A reorganisation should be defined as a transfer of substantially all of the assets, including intangible assets, to another Constituent Entity.

Questions for delegates

1. Do WP11 delegates agree with the approach described above for addressing gains and losses arising in connection with a reorganisation?

Covered taxes on excluded income

189. Intra-group dividends may be subject to a net basis tax in the shareholder's jurisdiction or subject to a withholding tax in the jurisdiction of the distributing constituent entity. Although the dividend is excluded

from the GloBE tax base, such taxes represent new or additional taxes on the income of the distributing constituent entity that has been included in the GloBE tax base. Thus, such taxes are properly taken into account in computing the ETR of the constituent entity that earned the underlying income.

190. In some cases, a constituent entity of an MNE group may be liable for covered taxes on income from an ownership interest in an entity that is not a Constituent Entity. For example, a Constituent Entity may be subject to a withholding tax on portfolio dividends received from an investment in a corporation or subject to tax under a CFC regime on a minority ownership interest in a CFC.

191. Similarly, a constituent entity that owns a minority interest in a partnership or other tax transparent entity or arrangement that is accounted for using the equity method for financial accounting purposes may be subject to net basis tax on its share of a partnership's, entity's, or arrangement's net income. Because income the interest is accounted for using the equity method of accounting, however, it is generally excluded from the Constituent Entity owner's GloBE tax base.

192. Any tax paid in connection with excluded income must be excluded from the numerator of the GloBE ETR computation for the jurisdiction of the owner. The rationale for this exclusion is that these items of income are permanently excluded from the GloBE tax base and hence the denominator of the GloBE ETR calculation. Therefore, it is appropriate to correspondingly exclude any taxes on these items of income from the numerator of the GloBE ETR calculation. The key distinction between taxes imposed on intra-group dividends and taxes imposed on portfolio dividends and equity method income is that the underlying income that funded the intra-group dividend was previously included in the MNE group's GloBE tax base when earned, whereas the income that funded portfolio dividends and equity method income is excluded from the GloBE tax base.

193. Like taxes on dividends, taxes on stock gains may arise in connection with sales of stock in a constituent entity or a non-constituent entity. Because of the rule that excludes gains (or losses) from the seller's GloBE tax base arising in connection with the disposition of stock, any corporate taxes imposed on the seller's gain generally should be excluded from the numerator of the GloBE ETR calculation in the seller's jurisdiction. However, part or all of the gain on the sale of stock may be attributable to the undistributed earnings of the target entity. If the target entity were a constituent entity and those earnings had been distributed as a dividend prior to the stock sale, any taxes on such dividends would have been treated as covered taxes because they represent additional taxes on income that was previously subject to the GloBE rules. Similarly, to the extent a gain from the sale of stock of a constituent entity is attributable undistributed earnings previously included in the GloBE tax base, any taxes attributable to that portion of the gain represent additional taxes imposed on that undistributed income and may be included in the numerator of the ETR computation in the same manner as taxes on dividends from such constituent entities. This same approach applies to taxes on stock gains taxed under a fair value or mark-to-market accounting method.

*Adjustment for Pillar One Outcomes***Note for WP11 Delegates**

Following the release of the Pillar One Blueprint it is now anticipated that further analytical work can be done to explain the potential interaction between Pillar One and Two and mechanisms to address the risk of double taxation. Further text on this point will be added by the Secretariat in the next draft of the Report.

194. Pillar One applies before Pillar Two. Depending upon the final design of Pillar One, an adjustment may be required to the GloBE tax base to properly reflect Pillar One outcomes.⁵⁷

3.4. Treatment of government grants and tax credits**Note to WP11 delegates****Background**

This text has been drafted on the basis of the paper [CTPA/CFA/WP11/NOE\(2020\)19](#), which was discussed by WP11 at its meeting on 23 June, and responds to the feedback from delegates at that meeting and in subsequent written comments [insert link to compilation of comments].

The Secretariat paper [CTPA/CFA/WP11/NOE\(2020\)19](#) set out 4 design options for the treatment of credits or grants:

- Option 1 - Treat all government grants and tax credits as a reduction in tax liability;
- Option 2 - Distinguish between government subsidies provided inside or outside the tax system;
- Option 3 - Follow the accounting treatment for grants and tax credits with certain conditions attached to the treatment of refundable tax credits to address risk areas; and
- Option 4 - Distinguish based on whether the grant or credit is eligible to be offset against a covered tax liability under local law.

Most delegates expressed significant concerns about the approaches set out under Options 1 and 2 and there was limited support for the approach set out under Option 4. Option 3 received the most support from delegates and in the Secretariat's assessment seems to be the most likely approach on which consensus can be reached. The approach set out in Option 3 was viewed by most delegates as the most balanced approach that is most closely aligned with the financial accounting treatment and economic substance. Most delegates considered that imposing conditions on "qualified refundable tax credits", together with the possibility for reviewing specific cases, provide safeguards against the risk of distortions arising.

195. This section addresses how government cash grants and tax credits should be taken into account in the ETR calculation under the GloBE rules (IIR and UTPR). Specifically, an approach is set out for

⁵⁷ See Section 3.2.2. for discussion on covered taxes. Tax paid on net income allocated to a jurisdiction under Pillar One would be treated as a covered tax under the GloBE.

determining whether, and under what circumstances, the grant or credit should be treated as part of the recipient's income or as a reduction in a covered tax liability.

3.4.1. Accounting treatment of government grants and tax credits

196. Consistent with the general approach for determining the GloBE tax base, the starting point for determining whether the grant or tax credit should be recognised as income or a reduction to tax liability is to look to existing financial accounting rules.

197. Under IFRS the accounting treatment for government grants and other forms of government assistance is prescribed by IAS 20. That accounting standard provides that government grants should be recognised as income on a systematic basis over the periods in which the entity recognises expenses for the related costs for which the grants are intended to compensate.

198. Government grants are defined broadly under IAS 20 as assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. Government is understood broadly in IAS 20 and includes central and local government bodies as well as all sorts of government agencies and similar bodies, including at the international level. Grants are usually provided as an incentive for an entity to engage in an activity that would not be commercially justified without those grants. This includes, for example, a forgivable loan when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan (IAS 20.10). The benefit of a government loan at a below-market rate of interest is also treated as a government grant (IAS 20.10A). IAS 20 also covers other forms of government assistance whereby the action by government is designed to provide an economic benefit that is specific to an entity or range of entities qualifying under certain criteria. Excluded from the scope of IAS 20 are transactions with government which cannot be distinguished from the normal trading transactions of the entity (e.g. government procurement policy that is responsible for part of an entity's sales) and those forms of government assistance which cannot reasonably have a value placed on them, such as free technical or marketing advice and the provision of guarantees (IAS 20.35).⁵⁸ Other forms of government assistance affecting only general conditions, such as the provision of transportation or communication infrastructure available on an ongoing basis to the general public or the imposition of trading constraints on competitors, are also out of scope of IAS 20.

199. The accounting treatment of expenditure based tax credits, commonly referred to as investment tax credits (ITCs), is significantly less clear. In fact the accounting treatment of ITCs is specifically scoped out of IAS 20 (Government Grants) and IAS 12 (Income Taxes). In practice, this means that MNEs commonly account for ITCs by analogy with the requirements of IAS 20 or IAS 12. ITCs are provided by many jurisdictions to incentivise a range of business investments. ITCs can take different forms and be subject to different conditions and entitlement to receive the ITC can be determined in a variety of ways. Some ITCs may relate to direct investment in property, plant and equipment. Other entities may receive ITCs relating to R&D or other activities. Some credits are not restricted to being realised as a reduction in current CIT. For example, where a credit exceeds the current year CIT liability, the unused credit may be carried forward to reduce future CIT or may be carried back. For some credits, the remaining portion of the credit can be used to offset other non-CIT liabilities, such as VAT or payroll taxes. Other credits may be settled directly in cash if the entity does not have sufficient taxes payable to access the credit within a certain period.

200. It is a matter of judgement to determine the most appropriate accounting treatment for an ITC based on a qualitative analysis of the legal requirements that must be met in order to generate the credit rather than a quantitative assessment of the economic outcomes for how a particular ITC is realised in practice. An ITC that is determined or limited by reference to an entity's income tax liability or provided in

⁵⁸ Disclosure of these benefits is required under IAS 20.39(b)

the form of an income tax deduction is likely to be accounted for under IAS 12 (Income Taxes) and recorded in the financial accounts as a reduction in current tax expense. If the realisation of the ITC is not dependent on the amount of taxable profit or on any past or future income tax liability generated by an entity, then it is likely to be accounted for under IAS 20 (Government Grants) and recorded in the financial accounts as other income.

201. Therefore, it is expected that generally under IFRS and equivalent accounting standards any “refundable” ITCs would be treated as income, whereas any non-refundable ITCs would be treated as a reduction in a tax liability. The term “refundable” is understood in a broad sense and covers ITCs that may become payable as cash or available as cash equivalents, including being available to be used to discharge liabilities other than a covered tax liability. The rationale, from an accounting perspective, for treating refundable tax credits in the same way as grants is that, similar to grants, the taxpayer’s entitlement to a refundable tax credit is not tied to its income or tax liability, and so in terms of economic substance grants and refundable tax credits are equivalent.

202. IFRS may treat a credit as “refundable” even if it is eligible to be refunded only after a number of years or where the taxpayer has the option to offset the credit against a non-CIT liability, such as a payroll tax or VAT liability. Most importantly, IFRS generally takes an “all-in” approach to refundability by which if a credit has some feature of potential refundability (e.g. the credit is required to be carried forward and only the unused / excess portion of the credit is refundable after a certain number of years), the entire amount of the credit is treated as income even if in practice credit is used to offset a CIT liability, and, thus, may never actually be refunded.

203. The lack of clear guidance in IFRS, and thus the judgement involved in accounting for ITCs, will inevitably lead to varying interpretations across MNEs and jurisdictions, which could result in non-transparent outcomes under the GloBE if the rules were simply to follow the accounting treatment. Furthermore, the sharp difference in outcomes under the GloBE for ITCs that are considered either refundable or non-refundable, combined with the qualitative and “all-in” nature of the determination, could lead to a loss of transparency and potential distortions in the design of countries’ tax systems. For example, rather than lowering its tax rate to attract new investment, a jurisdiction could offer what is legally structured as a “refundable tax credit” in order to provide for a more favourable outcome under the GloBE rules. While existing refundable tax credit regimes have not been designed with this intention, jurisdictions could be incentivised to develop such regimes in order to increase their competitiveness in a post-GloBE environment.

3.4.2. Treatment under the GloBE based on the financial accounting rules with safeguards for refundable tax credits to address risk areas

Treatment of government grants and tax credits under the GloBE

General rule [Option 3]

The treatment of government grants and tax credits will be based on the financial accounting rules with safeguards for refundable tax credits to address risk areas:

- (a) Where a refundable tax credit meets certain conditions, i.e. a “qualified refundable tax credit”, the entire amount of the credit is treated as income (in line with the financial accounting treatment for refundable tax credits).
- (b) Where a refundable tax credit does not meet the conditions, i.e. a “non-qualified refundable tax credit”, the entire amount of the credit is treated as reducing covered tax liability.

(c) For non-refundable tax credits, the entire amount of the credit is treated as reducing covered tax liability (in line with the financial accounting treatment for non-refundable tax credits).

(d) For all government grants, the entire amount of the grant is treated as income (in line with the financial accounting treatment for government grants).

Primary condition for a “qualified refundable tax credit”:

The tax credit must become refundable within [4] years. Where part of the credit has been used to offset a covered tax liability, the full amount of the unused credit (i.e. the excess over the covered tax liability) must become refundable within this time period.

Review process:

(a) Specific: As part of the review process for testing financial accounting standards for “material competitive distortions”, if an IF member identifies a risk associated with a certain jurisdiction’s refundable tax credit, it can be brought to WP11 for review on a case-by-case basis. This specific review process would seek to identify whether the tax credit has been designed in a way that made it unlikely, at the time such credit is introduced into law, that there will be significant refunds paid to taxpayers.

(b) General: As part of a general review of the operation of the GloBE rules after a certain number of years of their application, if IF members identify risks associated with the treatment of refundable tax credits that lead to unintended outcomes, WP11 will be asked to consider designing further conditions for a “qualified refundable tax credit” or alternative rules for the treatment of tax credits and government grants (e.g. Option 4).

Emergency government assistance

The ETR calculation under the GloBE rules excludes emergency government assistance provided directly by way of cash grant or tax credit where the benefit is provided by a government for limited duration to provide financial support in response to an external shock to a certain category of taxpayers or industry that are materially affected by that shock.

204. The approach to the treatment of government credits and grants would treat all government grants as income, and would also treat refundable tax credits as income where they meet certain conditions (referred to as “qualified refundable tax credits”). The conditions are intended to reduce the particular risk areas identified specifically in relation to refundable tax credits. Refundable tax credits that do not meet the conditions (referred to as “non-qualified refundable tax credits”) and all other tax credits would be treated as a reduction in a covered tax liability. This approach is based on the principle underpinning the approach to the design of the GloBE rules to start with the relevant financial accounting rules subject to any agreed adjustments as necessary.⁵⁹

205. The proposed approach would generally align with the financial accounting treatment for government grants and non-refundable tax credits, and, therefore, would not require many adjustments for these under the GloBE rules. It would also follow the accounting treatment for refundable tax credits where the terms of the credit satisfied the conditions of a qualified refundable tax credit, and only depart from the financial accounting treatment for non-qualified refundable tax credits.⁶⁰

⁵⁹ See para 71 of the PoW

⁶⁰ In practice, some adjustments will still be required in the GloBE ETR calculation for refundable tax credits to avoid “double-counting” their impact in both the numerator and denominator. For qualified refundable tax credits, which are treated as income (denominator), an adjustment may be required to ensure that the credit does not also get treated

Conditions for a “qualified refundable tax credit”

206. Refundable tax credits are typically used by governments to incentivise activities, such as R&D, where there is significant uncertainty as to whether the expenditure will ultimately result in a net return for the investor. By making these credits refundable, the government reduces the risk associated with these type of investments and puts large and small taxpayers on an equal footing, by ensuring the subsidy is available regardless of whether the person undertaking the activity is paying taxes.

207. The conditions that a refundable tax credit would need to satisfy to be treated as a qualified refundable tax credit are intended to reduce the risk that tax credits could be used as a mechanism for distorting the GloBE ETR calculation by being legally constructed as “refundable” but with terms that make it unlikely, in practice, that the credit will actually be refunded. In particular, this risk can be specifically identified when a tax credit regime is designed in a way so that a credit is only refundable after a long period of time. The conditions are intended to be bright-line tests that should be easy to apply in order to provide certainty to taxpayers and tax administrations.

208. The primary condition to safeguard against this particular risk is to stipulate that, in order to be treated as a “qualified refundable tax credit” under the GloBE, the tax credit regime is designed in a way so that the credit must become refundable within a reasonable period of time. The time period that has been suggested is [4] years from when the tax credit is first provided. Where a credit can be partly used to offset a covered tax liability, the full amount of the unused credit (i.e. the excess over the covered tax liability) must become refundable within this time period. Refundable means either payable as cash or cash equivalents, including being available to be used to discharge liabilities other than a covered tax liability.

Review process

209. A multilateral review process may be established to address any residual risk that refundable tax credits could be designed to circumvent the condition set out above to manipulate the GloBE ETR outcomes. This review process would be designed to identify risks associated with the design of a jurisdiction’s refundable tax credit regime, in particular where the terms of the tax credit are designed in a way that makes it unlikely, at the time such credit is introduced into law, that there will be significant refunds paid to taxpayers. The review process could identify hallmarks for those features of a tax credit regime that indicated there were risks under the GloBE rules, such as where the tax credit is targeted at a particular taxpayer or small group of taxpayers.

210. A specific review process focused on refundable tax credits could be incorporated into the same review process that would allow IF members to consider whether a financial accounting standard “results in material competitive distortions in the application of the GloBE rules”.⁶¹ It would be possible to include the review of refundable tax credits in this process and agreed framework. That is, if an IF member identifies a risk associated with a certain country’s refundable tax credit regime, it is brought to WP11 for review on a case-by-case basis. The logic of dealing with the review of refundable tax credits as part of the same process is that the core concern is the financial accounting treatment of those refundable tax credits.

211. In addition to a specific review process as set out above, as part of a general review of the operation of the GloBE rules after a certain number of years of their operation⁶², if IF members identify

as a reduction in the covered tax liability (numerator) under the GloBE. For non-qualified refundable tax credits, which are treated as a reduction in the covered tax liability (numerator), an adjustment may be required to ensure that the credit does not also get treated as income (denominator) under the GloBE.

⁶¹ See the discussion on ‘*Other generally accepted financial accounting standards*’ in section 3.3.3.

⁶² See the discussion on ‘*Multilateral review process*’ in section 6.5.2.

risks associated with the treatment of refundable tax credits that lead to unintended outcomes, WP11 could be asked to consider designing further conditions for a “qualified refundable tax credit” or alternative rules for the treatment of tax credits and government grants (for example, consider developing the approach set out under Option 4 of the previous paper).

212. The specified conditions for qualified refundable tax credits combined with the review process should provide sufficient disincentives to neutralise potential distortive behaviour.

3.4.3. *Emergency government assistance*

213. The provision of emergency government assistance (e.g. government grants and tax credits designed to mitigate the impact of Covid19) may lead to a lower GloBE ETR calculation that could trigger a top-up tax under the GloBE rules. To avoid businesses being taxed on emergency government assistance, the ETR calculation under the GloBE rules excludes emergency government assistance provided directly by way of cash grant or tax credit where the benefit is:

- a. provided by a government;
- b. limited in duration;
- c. intended to provide financial support in response to an external shock; and
- d. provided to a certain category of taxpayers or industry materially affected by such an external shock.

214. Where the conditions are met an adjustment would be made to exclude the impact of the emergency government assistance from the GloBE ETR calculation (e.g. removing from the measure of income in the denominator or adding back to the measure of tax expense in the numerator).

3.5. Formulaic substance-based carve-out

Note for WP11 delegates

Overview

The topic of carve-outs have been discussed at a number of WP11 meetings, including most recently in March and July. These discussions have shown strong support for a formulaic substance-based carve-out based on payroll and tangible assets. However, some delegates have suggested alternative carve-out designs, including a carve-out for FHTP compliant regimes and a facts and circumstances based carve-outs. Delegates have asked whether the GloBE rules should include formulaic carve-out focused on R&D expenditures, or a gateway test followed by an assessment of facts and circumstances. Other suggestions have included an exclusion of domestic profits of the parent jurisdiction, a carve-out based on regulatory capital, and a carve-out of all government grants. These alternative designs did not receive wide support in WP11. Furthermore a significant number of delegates indicated that they were opposed to any type of carve-out but were prepared to consider the design of a formulaic substance-based carve-out based on payroll and tangible assets as a basis for a compromise.

Therefore, the Secretariat has prioritised its work on developing the design of a formulaic substance-based carve-out based on payroll and tangible assets as the basis for a consensus solution.

A key discussion point of the formulaic substance-based carve-out based on payroll and tangible assets was the question of whether tangible assets should be measured using carrying value or depreciation. Both approaches received support in WP11, with strongest support for the depreciation-based

approach, which, when combined with payroll, would generally align with a cost-plus transfer pricing method.

Given the mixed views on this question this draft chapter includes a complete rule set for both approaches with the intention of including in the October final report the option that receives the strongest support and around which a consensus solution looks most likely. Specifically, this draft chapter includes a rule set for two carve-out options:

- Combined carve-out based on payroll and depreciation of tangible assets (**Option 1**); or
- Combined carve-out based on payroll and carrying value of tangible assets (**Option 2**).

Delegates will find that the language used for the depreciation approach and the carrying value approach are very similar. This reflects a simple fact, which has previously been pointed out by several delegates: depreciation and carrying value are directly related. Specifically, carrying value is the difference between the original cost of the asset and the accumulated depreciation taken in respect of the asset. Some differences do exist, however, related to the mechanics of the carve-outs. For example, a carrying value approach requires a measuring date which is irrelevant for the depreciation approach.

There have also been extensive discussions in WP11 regarding the types of tangible assets to include in the carve-out base, including leases, land and natural resources. There was strong support in WP11 for including a lessee's right-of-use asset in its tangible asset carve-out base. However, delegates took different views on whether land and natural resources should be included in the base. The rules contained in this draft chapter assumes leased assets, land and natural resources are in fact included in the tangible asset carve-out base. This inclusive approach recognises that all such assets are indicative of substantive activities.

Secretariat assessment

As summarised in detail in the July WP11 note [[CTPA/CFA/WP11/NOE\(2020\)14](#)], the Secretariat's assessment is that the better option is Option 1. Conceptually combining payroll and depreciation creates an approach that generally aligns with a cost-plus transfer pricing approach. Furthermore, several delegates have pointed out that depreciation better represents the substance involved in generating income in the jurisdiction in the relevant year. Whereas, the carrying value of an asset represents the portion of the asset that has not been consumed and is closer to the measure of invested equity. It is also true that the carrying value approach creates a larger carve-out for tangible assets with longer lives, which has no obvious connection to the intensity of substantive activities. There is also a concern that a carrying value approach exacerbates the incentive MNEs already have to overestimate the useful life of tangible assets.

With that said, the Secretariat considers Option 2 an acceptable approach, albeit inferior to Option 1 for the reasons noted above and described in detail in the July WP11 note. It should be noted that the July WP11 note concluded that carrying value may be more complicated to determine than depreciation because it requires a measuring date. However, the discussions in WP11 showed that the complexity of a measuring date is not substantial and can be overcome using an average of beginning and ending carrying value, for example. The Secretariat's current view is that determining the depreciation and carrying value of tangible assets involve a similar amount of complexity. The key difference between the two approaches therefore is the policy and design consistency between combining payroll (an expenditure item) with depreciation (another expenditure item) or with the carrying value of assets (a measure of investment)

Fixed percentage mark-up & economic impact assessment

The rules contained in this draft chapter indicate the fixed percentage mark-up with an "[x]". This reflects the fact that the IF has not yet taken a decision on the quantum of the fixed percentage mark-up. The

July WP11 note [CTPA/CFA/WP11/NOE(2020)14] contained a discussion of two approaches that may be helpful in determining the appropriate fixed percentage mark-up: a generic transfer pricing analysis, and a profitability distribution analysis. It was noted that neither approach is expected to provide a definitive answer as to the appropriate fixed percentage mark-up, but they can be used as reference points to inform discussions. During the July WP11 meeting, several delegates expressed the view that the determination of the fixed percentage mark-up would ultimately be a high-level decision that should be considered alongside the other design parameters of the GloBE, in particular the minimum rate, guided by an economic impact assessment.

The Secretariat does not expect the October final report to contain a technical discussion of how the fixed percentage mark-up was determined. Instead the report could simply replace the “[x]” with the agreed fixed percentage mark-up, assuming it can be agreed by October.

To help guide the decision of the fixed percentage mark-up, the Secretariat prepared an economic analysis and impact assessment of various potential fixed percentage mark-ups, as summarised in the table below. This analysis was contained in a note distributed to WP2 [CTPA/CFA/WP2/NOE2(2020)9], however, the final column was added to align with the carve-out options presented in this draft chapter.

As shown in the table below, the effect of a formulaic substance-based carve-out on GloBE revenue gains is relatively small. It also shows that a higher mark-up is required for an Option 1 approach (payroll and depreciation-based) to generate an equivalent overall economic impact as Option 2 (payroll and carrying value). For example, as illustrated in the table below a 20% return on payroll and depreciation has approximately the same overall economic impact as a 10% return on payroll and the carrying value of tangible assets.⁶³

Carve-out design		No carve-out	Combined carve-out based on a percentage of payroll plus depreciation expenses on tangible assets			Combined carve-out based on a percentage of payroll plus carrying value on tangible assets		
			10%	15%	20%	10%	15%	20%
Fixed % mark-up		n/a	10%	15%	20%	10%	15%	20%
Global low-taxed profit subject to Pillar 2 (USD bn)		604	574	560	548	529	507	491
Global Pillar 2 revenue gains (Scenario 1)	In USD bn	28-34	27-33	27-33	26-32	26-32	25-31	25-30
	In % of CIT revenues	1.3%-1.6%	1.2%-1.5%	1.2%-1.5%	1.2%-1.5%	1.2%-1.4%	1.1%-1.4%	1.1%-1.4%

⁶³ The estimates in this table assume a 12.5% minimum tax rate and focus on a ‘static’ scenario without behavioural reactions. More scenarios are presented in [CTPA/CFA/WP2/NOE2(2020)9]. Consistent with the assumption that GILTI would coexist with Pillar 2, the estimates exclude low-taxed profit from MNEs with an ultimate parent in the United States and the associated revenue gains. Uncertainty ranges take into account data uncertainty and, in the last row, uncertainty relative to the existence and scale of pockets of low-taxed profit in higher-tax jurisdictions. For more details on the data and methodology, see [CTPA/CFA/WP2/NOE2(2020)9].

	In % of CIT revenues, taking into account uncertainty on pockets of low-taxed profit	1.3%- 2.3%	1.2%- 2.1%	1.2%- 2.0%	1.2%- 1.9%	1.2%- 1.9%	1.1%- 1.7%	1.1%- 1.6%
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Source: OECD Secretariat calculations.

Questions for delegates

- Do delegates prefer to adopt Option 1 (i.e., combined carve-out based on payroll and depreciation of tangible assets) or Option 2 (i.e., combined carve-out based on payroll and carrying value of tangible assets) into the final GloBE rule set?
- Would delegates consider Option 1 acceptable if adopted in the October final report?
- Do delegates agree that it is appropriate to include a lessee’s right-of-use assets, land and natural resources in the tangible asset carve-out base in recognition of the fact that all such assets are indicative of substantive activities? Would delegates consider it acceptable if all such assets were included in the carve-out base for purposes of the October final report?
- Do delegates have any specific suggested changes to the language in this draft chapter?
- Do delegates have any views on mark-up percentages, either specific percentages or ranges?

Formulaic substance-based carve-out

The GloBE tax base is reduced by the carve-out amount, but only for purposes of the computation of the top-up tax for each Constituent Entity. The carve-out amount is equal to the sum of the payroll component and the tangible asset component

Payroll component

The payroll component is equal to [x]% of the eligible payroll costs of eligible employees.

Eligible employees includes all employees of the MNE, including part-time employees. Eligible employees would also include independent contractors participating in the ordinary operating activities of the MNE.

The payroll component of the carve-out is computed on a jurisdictional basis focused on where the actual activity is performed. The CbC reporting rules, which are based on the residence jurisdiction of the Constituent Entity paying the employee's salary (i.e. the employer), can be used for determining this but where this differs from the jurisdiction where the employee's activities or services are performed, the residence of the employee should be used.

Eligible payroll costs would be determined based on a general test of whether the expenditure of the employer gives rise to a direct and separate personal benefit to the employee. Eligible payroll costs include expenditures for salaries and wages as well as for other employee benefits or remuneration such as medical insurance, payments to a pension fund or other retirement benefits, bonuses and allowances payable to eligible employees. Eligible payroll costs also includes payroll taxes (or other employee expense-related taxes such as fringe benefits taxes), as well as employer social security contributions.

[Tangible asset component [depreciation approach – Option 1]

The tangible asset component is equal to the sum of:

- [x]% of the depreciation of property, plant and equipment;
- [x]% of the deemed depreciation of land;
- [x]% of the depletion of natural resources; and
- [x]% of the depreciation of a lessee's right-of-use tangible asset.

Buildings and land that are held to earn rental income or for capital appreciation (or both) outside the ordinary course of business, i.e., investment properties, are excluded from the carve-out. Assets held for sale, rather than use, are also excluded from the carve-out.

The calculation of depreciation of property, plant and equipment, depletion of natural resources and depreciation of right-of-use assets, must conform with the calculation used for the same asset for financial accounting purposes, specifically the financial accounts used to compute the GloBE tax base for the relevant Constituent Entity. However, any incremental increase in depreciation or depletion resulting from revaluation increases, or related party asset sales are disregarded. And, to avoid double-counting, the labour costs and depreciation included in the carrying cost of a self-constructed asset are disregarded.

Depreciation and depletion charges that are accounted for as product costs are included in the carve-out base in the year it is incurred regardless of when the related product is sold.

For purposes of calculating the deemed depreciation of land, the depreciable base is equal to the original acquisition cost of the land, i.e., without regard to revaluation increases/decreases. The useful life is deemed to be 25 years. The depreciation method is deemed to be straight-line.

Impairment charges on depreciable property, plant and equipment, land, natural resources and right-of-use tangible assets, are disregarded.

A lessor is not allowed a carve-out in respect of the depreciation of leased assets.

The tangible asset component is computed on a jurisdictional basis.

Tangible asset component [carrying value approach – Option 2]

The tangible asset component is equal to the sum of:

- [x]% of the carrying value of depreciable property, plant and equipment;
- [x]% of the carrying value of land;
- [x]% of the carrying value of natural resources; and
- [x]% of the carrying value of a lessee's right-of-use tangible asset.

Buildings and land that are held to earn rental income or for capital appreciation (or both) outside the ordinary course of business, i.e., investment properties, are excluded from the carve-out. Assets held for sale, rather than use, are also excluded from the carve-out.

The carrying value of depreciable property, plant and equipment, natural resources and a lessee's right-of-use tangible asset is equal to the initial costs of the asset less any accumulated depreciation/depletion and is calculated without regard to impairment losses. Both elements of the calculation of carrying value, i.e., initial costs and accumulated depreciation/depletion, are required to conform with the calculations used for the same asset for financial accounting purposes, specifically the financial accounts used to compute the GloBE tax base for the relevant Constituent Entity. However, any incremental increase/decrease in carrying value resulting from revaluation increases/decreases, or related party asset sales are disregarded. And, to avoid double-counting, the labour costs and depreciation included in the carrying value of a self-constructed asset are disregarded.

The carrying value of land is equal to the original acquisition cost of the land less accumulated deemed depreciation, and is calculated without regard to impairment losses. Deemed depreciation is calculated based on an assumed 25 year useful life and straight-line depreciation. Any incremental increase/decrease in the carrying value of land resulting from revaluation increases/decreases are disregarded.

The carrying value of depreciable property, plant and equipment, land, natural resources and a lessee's right-of-use tangible asset is measured based on the average of the beginning and ending carrying value of the relevant asset for the relevant year. For assets acquired during the year, the beginning of the year carrying value is the acquisition cost for the assets. For assets disposed of during the year, the end of year carrying value is the carrying value that would have been determined at year end if not for the disposal. However, an asset that is both acquired and disposed of within the same year is disregarded.

A lessor of an asset is not allowed a carve-out in respect of the carrying value of that asset.

The tangible asset component is computed on a jurisdictional basis.]

215. The policy rationale behind a formulaic carve-out based on expenditures for payroll and tangible assets is to exclude a fixed return for substantive activities within a jurisdiction from the scope of the GloBE rules. The use of payroll and tangible assets as indicators of substantive activities is justified because these factors are generally expected to be less mobile and less likely to lead to tax induced distortions. Conceptually, excluding a fixed return from substantive activities focuses GloBE on “excess income”, such as intangible-related income, which is most susceptible to BEPS risks. Furthermore, a carve-out based on expenditures for payroll and tangible assets should help to shield low-margin businesses from what would otherwise be disproportionately negative outcomes under the GloBE as a result of expenditure based tax credits and other forms of government subsidy based on expenditure, such as government grants.

216. The carve-out will only benefit those MNEs with operations in jurisdictions that are taxed at below the minimum rate.⁶⁴ However, provided the amount of the carve-out is limited to a modest return (sometimes referred to as a “routine return”) on expenditures for payroll and tangible assets, then the MNE will not generally be able to use the carve-out to shelter other low-tax returns in a particular jurisdiction. An MNE can increase the amount of the carve-out by shifting more payroll and tangible assets into the jurisdiction, but, all other things being equal, increasing investment in these production factors would result in a corresponding real increase in the routine returns attributable to those factors and will not allow the carve-out to shelter excess returns or returns attributable to other factors such as intangible assets.

217. By acknowledging the contributions of both employees and tangible assets, a combined carve-out for payroll and tangible assets provides for a more level playing field by allowing a meaningful carve-out for MNEs with varying substance profiles, including labour-intensive and asset-intensive businesses. Whereas a carve-out based on a single factor, either payroll or tangible assets, would end up favouring one set of industries over another. Therefore, a combined carve-out provides greater neutrality between different industries. However, including both elements inevitably adds complexity, and leads to additional compliance and administrative burdens.

218. The sections below set out more detail on the operation of the carve-out, starting with the payroll component and then turning to the tangible asset component.

3.5.1. Payroll component

219. The payroll component of the combined carve-out would remove from the GloBE tax base a fixed return on activities performed in that jurisdiction calculated by reference to the taxpayer’s employment costs. Such a carve-out design would recognise a Constituent Entity’s payroll expense as an appropriate proxy for substantive activities carried out by employees of the taxpayer in the relevant jurisdiction. In applying such a carve-out it is necessary to identify relevant employees (eligible employees), the situs of those employees as relevant for jurisdictional blending, and the relevant payroll expenses of those eligible employees (eligible payroll costs).

Eligible employees

220. For the purposes of the payroll component of the carve-out, eligible employees would include all employees of the MNE, including part-time employees. Eligible employees would also include independent contractors participating in the ordinary operating activities of the MNE, which is both consistent with

⁶⁴ The carve-out would still need to be applied in cases when an MNE’s operations in a given jurisdiction are taxed above the minimum rate for purposes of tracking carry-forward attributes.

country-by-country (CbC) reporting and avoids what would otherwise be a difficult line-drawing exercise of distinguishing an employee from an independent contractor.⁶⁵

221. The payroll component of the carve-out is computed on a jurisdictional basis focused on where the actual activity is performed. The CbC reporting rules, which are based on the residence jurisdiction of the Constituent Entity paying the salary, could be used for determining this in most cases. However, where the residence jurisdiction of the Constituent Entity paying the employee's salary (i.e. the employer) differs from the jurisdiction where the employee's activities or services are performed, the residence of the employee should be used. The ordinary or normal residence of its employees should be information that an MNE can easily access and so this should not constitute a significant additional compliance burden. A day count test could be used to address employees that do not spend all of their time in a single jurisdiction, such as employees in a transportation business or those that undertake specialised activities in a number of jurisdictions. For example, if an employee spends more than 183 days in a jurisdiction in a given tax year, then the employee would normally be considered a resident in that jurisdiction. The approach for determining where eligible employees' activities or services are performed should be applied consistently across the MNE group and from year to year.

Eligible payroll costs

222. A broad approach for determining eligible payroll costs is used for the payroll component of the carve-out based on a general test of whether the expenditure of the employer gives rise to a direct and separate personal benefit to the employee. Eligible payroll costs include expenditures for salaries and wages as well as for other employee benefits or remuneration such as medical insurance, payments to a pension fund or other retirement benefits, bonuses and allowances payable to eligible employees. Eligible payroll costs also includes payroll taxes (or other employee expense-related taxes such as fringe benefits taxes), as well as employer social security contributions.

223. Consistent with the broad approach for determining eligible payroll costs, the payroll component of the carve-out would be based on the total amount of the payroll expenditures in the current year, rather than the amount treated as an expense in the income statement as per financial accounting rules. This also avoids the additional administrative burden of taxpayers sorting payroll costs based on whether it was currently expensed or capitalised for financial accounting purposes.⁶⁶ It is also consistent with BEPS Action 5 approach to computing qualified R&D expenditures for the purposes of the modified nexus ratio.

3.5.2. [Tangible asset component [depreciation approach – Option 1]

224. The tangible asset component of the carve-out is equal to the sum of:

- a. [x]% of the depreciation of property, plant and equipment;

⁶⁵ See page 34 of Action 13 Report: "In the tenth column of the template, the Reporting MNE should report the total number of employees on a full-time equivalent (FTE) basis of all the Constituent Entities resident for tax purposes in the relevant tax jurisdiction. The number of employees may be reported as of the year-end, on the basis of average employment levels for the year, or on any other basis consistently applied across tax jurisdictions and from year to year. For this purpose, independent contractors participating in the ordinary operating activities of the Constituent Entity may be reported as employees. Reasonable rounding or approximation of the number of employees is permissible, providing that such rounding or approximation does not materially distort the relative distribution of employees across the various tax jurisdictions. Consistent approaches should be applied from year to year and across entities."

⁶⁶ For example, the direct labour costs of manufacturing related employees are capitalised into work-in-process inventory, then finished goods inventory and subsequently recognised as part of cost of goods sold, which may not be until a year or more after the payroll expenditure was initially incurred.

- b. [x]% of the deemed depreciation of land;
- c. [x]% of the depletion of natural resources; and
- d. [x]% of the depreciation of a lessee's right-of-use tangible asset.

225. The tangible asset carve-out base includes the annual cost of using depreciable property, plant and equipment, land, natural resources, and a lessee's right-of-use assets that are used in the production of income. Including a broad range of tangible assets in the carve-out base recognises that all such assets are indicative of substantive activities. Moreover, it helps to level the playing field across industries that use varying types of tangible assets in their business. Including leased tangible assets neutralises the difference between owning and leasing assets and recognises that the business decision to own or lease typically has no bearing on the intensity of substantive activities.

226. While the carve-out generally seeks to recognise a broad range of tangible assets, an MNE should not be allowed to generate a larger carve-out by purchasing investment property in a jurisdiction. This risk is particularly relevant as it relates to buildings and land, which are commonly held as investments. To neutralise this risk, buildings and land that are held to earn rental income or for capital appreciation (or both) outside the ordinary course of business, are excluded from the carve-out. This rule is not expected to materially increase complexity or compliance costs because many accounting standards already require that such assets be separately identified and accounted for. For example, in the case of IFRS, investment properties are separately accounted for under IAS 40 – Investment Property.⁶⁷

227. Similarly, an MNE should not be allowed to generate a larger carve-out via tangible assets whose carrying amount, i.e., cost, will be recovered principally through a sale transaction instead of through continuing use in the business. Since such assets are held for sale, not use, they are a poor proxy for substantive activities. Consequently, assets held for sale are excluded from the carve-out. This rule is also not expected to materially increase complexity or compliance costs because many accounting standards already require that such assets be separately identified and accounted for. For example, in the case of IFRS, assets held for sale are separately accounted for under IFRS 5 – Non-current Assets Held for Sale and Discounting Operations.

228. The sections below provide additional rules on the individual elements of the tangible asset carve-out, starting with property, plant and equipment.

Property, plant and equipment

229. Property, plant and equipment are tangible items that are held for use in the production or supply of goods or services or for administrative purposes and are expected to be used during more than one period. Assets in this category include: buildings, machinery, computers and other office equipment, motor vehicles, furniture and fixtures, and land improvements with a limited useful life. Land is also technically part of property, plant and equipment. However, because land is non-depreciable it is excluded from the definition of property, plant and equipment, for purposes of the carve-out, and considered separately.

230. Property, plant and equipment is initially recognised on the balance sheet at its costs, including its purchase price and any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. After initial recognition as an asset, an item of property, plant and equipment is carried at its cost less any accumulated depreciation and any accumulated impairment losses (referred to as the “cost model”). Depreciation refers

⁶⁷ IAS 40 applies to buildings and land held to earn rentals or for capital appreciation (or both); not owner-occupied; not used in production or supply of goods and services, or for administration; and not held for sale in the ordinary course of business.

to the systematic allocation of the cost of an asset, less its residual or “salvage” value, over its useful life. An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.⁶⁸

231. Therefore, calculating depreciation of property, plant and equipment requires three factors be established: (i) the depreciable base of the asset, which is the cost of the asset less its residual value, (ii) the useful life of the asset, and (iii) the depreciation method, such as straight-line, diminishing balance and units of production. For purposes of the carve-out, all three factors are required to conform with those used for the same asset for financial accounting purposes, specifically the financial accounts used to compute the GloBE tax base for the relevant Constituent Entity (referred to as the “conformity rule”). For example, if the parent prepares its consolidated financial accounts in accordance with IFRS, then the factors used to compute depreciation, for purposes of the carve-out, must follow IAS 16 – Property, Plant and Equipment.

232. However, there are three exceptions to the conformity rule. The first relates to the revaluation model, which is permitted by some financial accounting standards as an alternative to the cost model. The second relates to asset sales between GloBE group members. The third relates to self-constructed assets.

- a. *Revaluation model.* Under some financial accounting standards, including IFRS, an entity can elect either the cost model or the revaluation model as its accounting policy. Under the revaluation model, an asset is carried at a revalued amount, which is its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluation increases are generally recognised in OCI, rather than profit or loss. Revaluation decreases, on the other hand, are generally recognised in profit or loss. Absent a corrective measure the revaluation model would impact the quantum of the carve-out because depreciation expense is determined based on the revalued amount. This result is not appropriate because revaluation increases/decreases have no connection to substantive activities. Therefore, to eliminate the effect of the revaluation model for purposes of the carve-out, any subsequent incremental increase in depreciation resulting from revaluation increases are disregarded. And, any revaluation loss is treated as additional depreciation in the year of the loss, and the subsequent decreased financial accounting depreciation is included in the carve-out base annually. In both cases, i.e., revaluation increases and decreases, the result of this rule is that the total depreciation charge included in the carve-out base over the life of the asset is the same as what it would have been without the revaluation. Such a result recognises that revaluation increases/decreases have no connection to substantive activities. It also eliminates a key difference across accounting standards: those that allow the revaluation model and those that do not.
- b. *Intercompany transaction.* Under the GloBE rules, transactions between Constituent Entities in different jurisdictions are not eliminated as they would be in the MNE’s consolidated financial statements. Thus, when an asset is sold between Constituent Entities, the buyer may recognise the asset for purposes of the GloBE rules based on the purchase price of the asset, rather than the carrying value of the asset that is in the consolidated financial accounts. This creates the risk of MNEs engaging in intra-group asset sales designed to “refresh” the carrying value of assets and generate a larger carve-out. In such a case, the stepped-up carrying value has no connection to substantive activities. To prevent this type of planning, any incremental depreciation resulting from an asset acquired in a related party transaction is not allowed in the carve-out base. This rule also applies to assets sold to third parties as part of a structured back-to-back transaction.
- c. *Self-constructed assets.* The cost of a self-constructed asset include the labour costs, i.e., payroll, of the employees that constructed it. Absent a corrective measure, the labour-related costs of a self-constructed asset would be counted once in the payroll component of the carve-out and again

⁶⁸ IAS 16 – Property, Plant and Equipment

in the tangible asset component. To eliminate such double-counting, the labour-related costs included in the carrying cost of a self-constructed asset are disregarded for purposes of computing the assets depreciation. To avoid a further instance of double counting, the carrying costs of a self-constructed asset excludes the depreciation of assets used in its construction.

233. The depreciation charge of property, plant and equipment is recognised in financial profit or loss, and, by extension, the GloBE tax base, unless it is included in the carrying amount of another asset. For example, depreciation on manufacturing equipment is included in inventory. Eventually, when the product is sold, the depreciation charge becomes part of cost of goods sold. For purposes of the carve-out, depreciation includes both depreciation charges that are recognised in profit and loss in the period it is incurred (often referred to as “period costs”), and depreciation charges recognised in profit and loss in the period when the related product is sold (often referred to as “products costs”). Depreciation that is a product cost is included in the carve-out base in the year it is incurred regardless of when the related product is sold. This rule recognises that the timing of the recognition of the depreciation charge in the income statement has no bearing on substantive activities.

234. Most financial accounting standards, including IFRS, require firms to test property, plant and equipment for impairment when events or changes in circumstances indicate book value may not be recoverable. When an asset is in fact impaired, an impairment loss is recognised in profit in loss and the carrying value of the relevant asset is reduced. The post-impairment carrying value then serves as the revised basis for subsequent depreciation. Consequently, absent a corrective measure, impairments would reduce the quantum of the carve-out amount. This result is not appropriate because impairments are typically caused by deteriorating market conditions, poor management, new competition or technological innovations, and are generally not indicative of a reduction in substantive activities. There are broadly two approaches to eliminate the effect of impairments on the carve-out amount. First, impairment losses could be treated as equivalent to depreciation for purposes of the carve-out, thus included in the carve-out base in the year of impairment, and the subsequent decrease in depreciation for financial accounting purposes would be regarded. This approach is considered relatively simple to apply. It is also consistent with the treatment of re-valuation losses, which are closely related to impairments. However, impairments are often associated with losses. In the case the MNE was in fact in a loss, treating the impairment as equivalent to depreciation in the year of impairment would be unfavourable to the MNE because it would simply increase its loss, with no ability to carry-forward the excess carve-out amount to future years. The second approach would require the MNE to compute its subsequent depreciation as if the impairment did not happen. This approach would entail additional complexity because it would require tracking multiple depreciable assets bases, i.e., with and without the effect of the impairment. The benefit of this approach is that it avoids accelerating the carve-out amount to years with potential losses.

235. For purposes of computing the carve-out on a jurisdictional basis, depreciation of property, plant and equipment is treated as having nexus in the jurisdiction of the Constituent Entity (which includes a permanent establishment) that uses the asset. As explained in the right-of-use asset section below, a lessor is not allowed to include assets that it has leased to customers in its tangible asset carve-out base.

Land

236. Land is technically part of property, plant and equipment, however, unlike other property, plant and equipment, land is non-depreciable. As a non-depreciable tangible asset, land does not naturally “fit” in a depreciation-based tangible asset carve-out. Nonetheless, land is considered an indication of substantive activities and a significant non-mobile factor of production, and, on that basis, is included in the tangible asset carve-out base. The mechanic for doing so is a deemed depreciation charge for land, which requires establishing the same three depreciation factors as are required for depreciable property, plant and equipment, that is: (i) the depreciable base (ii) the useful life, and (iii) the depreciation method.

237. For purposes of calculating the deemed depreciation of land, as relevant to the carve-out, the depreciable base is equal to the original acquisition cost of the land, i.e., without regard to revaluation increases/decreases and with an assumed residual value of nil. The useful life is deemed to be 25 years. The depreciation method is deemed to be straight-line. Taken together, this implies that each year the deemed depreciation amount will be 4% of the original acquisition cost of the land.

238. As previously provided, land that is an investment property is not included in the carve-out base. All other land is included, including land on which a building rests and land used in an agricultural business. The acquisition cost of land should be computed separately from the building and agriculture produce. Separating the value of land from a building or agriculture produce is not expected to materially increase complexity or compliance costs because many financial accounting standards already account for these assets separately. For example, IAS 16 – Property, Plant and Equipment, provides that land and buildings are separable assets and are accounted for separately. Similarly, IAS 41 – Agriculture Assets, scopes out the land related to agriculture activity, and requires the land be separately accounted for under IAS 16 and IAS 40 – Investment Property.

239. Like property, plant and equipment, land is tested for impairment. In the case of land, an impairment could arise when, for example, the area where the land is located experiences a natural disaster such as flooding, an earthquake or a tornado. If the land is in fact impaired, an impairment loss is recognised and the carrying value of the land is reduced. Consistent with the impairment rule for property, plant and equipment, impairment losses on land should be disregarded.

240. For purposes of computing the carve-out on a jurisdictional basis, land is treated as having nexus in the jurisdiction in which the land is located.

Natural resources

241. Natural resources include oil and gas deposits, timber tracts and mineral deposits. These assets are accounted for similarly to depreciable property, plant and equipment. That is, natural resources are initially recognised at cost, including acquisition and exploration-related costs. After initial recognition, the asset is carried at its cost less any accumulated depletion and any accumulated impairment losses, i.e., the cost model.⁶⁹ Depletion is the allocation of the cost of natural resources, and has a number of similarities to depreciation accounting. Because the usefulness of a natural resources is generally directly related to the amount of resources extracted, the units of production method is widely used to calculate depletion. Service life is therefore the estimated amount of mineral resources to be extracted, e.g., tons of minerals or barrels of oil.

242. For purposes of the carve-out, the assumptions used to compute depletion are required to conform with those used for the same asset for financial accounting purposes, specifically the financial accounts used to compute the GloBE tax base for the relevant Constituent Entity. For example, if the parent prepares its consolidated financial accounts in accordance with IFRS, then the factors used to compute depletion must follow IFRS 6 – Exploration for and Evaluation of Mineral Resources. However, as with property, plant and equipment, an exception applies with respect to the revaluation model. In particular, any incremental increase in depletion resulting from revaluation increases are disregarded. And, any revaluation loss is treated as additional depletion in the year of the loss, and the decreased financial accounting depletion determined after the revaluation is included in the carve-out base annually.

⁶⁹ Under some financial accounting standards timber tracts are accounted for the same as other natural resources, i.e., cost model. However, under IFRS, specifically IAS 41 – Agriculture, “biological assets”, which includes timber tracts, are valued at their fair value less estimated costs to sell, with changes in fair value included in profit or loss. For purposes of the carve-out, a deemed depletion charge for timber tracts must be derived using the cost model.

243. Depletion, being a product cost, is included in the cost of inventory, just as the depreciation on manufacturing equipment is included in inventory. The depletion charge is recognised as cost of goods sold in the income statement when the inventory is eventually sold. Consistent with the rule provided for property, plant and equipment, depletion is included in the carve-out base in the year it is incurred regardless of when the inventory is sold. This rule recognises that the timing of the recognition of the depletion charge in the income statement has no bearing on substantive activities.

244. Natural resources are tested for impairment under financial accounting rules. In the case of a natural resource, an impairment could arise when, for example, exploration for and evaluation of mineral resources in the specific area have not led to the discovery of commercially viable quantities of mineral resources.⁷⁰ If the asset is in fact impaired, an impairment loss is recognised in profit in loss and the carrying value of the relevant asset is reduced. The post-impairment carrying value then serves as the revised basis for subsequent depletion. Consistent with the impairment rule for property, plant and equipment and land, impairment losses on natural resources should be disregarded.

245. For purposes of computing the carve-out on a jurisdictional basis, depletion is treated as having nexus in the jurisdiction in which the natural resource is located.

Right-of-use tangible assets

246. A carve-out based on the ownership of tangible assets would lead to a difference between owning and leasing assets. In order to avoid this distortion, the carve-out treats an appropriate portion of the expense of leasing a tangible asset, including buildings and land, in the same way as depreciation of property, plant and equipment.

247. In a lease arrangement a lessee recognises a “right-of-use” asset on its balance sheet representing its right to use the underlying asset and a lease liability representing its obligation to make lease payments. A lessee accounts for right-of-use assets similarly to an owner of property, plant and equipment. Specifically, a lessee initially recognises right-of-use assets based on the present value of the lease payments, and subsequently recognises depreciation and impairment losses i.e., the cost model.⁷¹ The depreciation method is typically straight-line and the useful life is generally the earlier of the end of the useful life of the asset or the end of the lease term. The lessee also recognises interest expense on the lease liability.

248. For purposes of the carve-out, the assumptions used to compute depreciation of a lessee’s right-of-use asset must conform with the assumptions used for the same asset for financial accounting purposes, specifically the financial accounts used to compute the GloBE tax base for the relevant Constituent Entity. For example, if the parent prepares its consolidated financial accounts in accordance with IFRS, then the assumptions used to compute the depreciation of the lessee’s right-of-use asset must follow IFRS 16 – Leases. MNEs applying a non-IFRS financial accounting standard are required to account for a lessee’s right-of-use assets using the single lessee accounting model used in IFRS.

249. As with property, plant and equipment, land, and natural resources, a lessee must test the underlying asset for impairment for financial accounting purposes. A leased asset could be impaired for the same reasons property, plant and equipment is impaired: deteriorating market conditions, poor management, new competition, technological innovations, etc. If a right-of-use asset is in fact impaired, an impairment loss is recognised and the carrying value of the relevant asset is reduced. The post-impairment carrying value then serves as the revised basis for subsequent depreciation. Consistent with the

⁷⁰ IFRS 6 – Exploration for and Evaluation of Mineral Resources.

⁷¹ Some financial accounting standards require lessee’s to distinguish between “operating leases” and “finance leases”. Other standards, including IFRS, have a single lessee accounting model which requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value.

impairment rule for property, plant and equipment, land, and natural resources, impairment losses on right-of-use assets should be disregarded.

250. The lessor of an asset is not allowed a carve-out in respect of the depreciation on that asset. This rule reflects the fact that the lessor is not actively using the underlying asset to earn income. It is therefore not a reliable measure of substantive activities of the lessor.

251. For purposes of computing the carve-out on a jurisdictional basis, a lessee's depreciation of a right-of-use asset is treated as having nexus in the jurisdiction of the Constituent Entity lessee that uses the property in its business.

3.5.3. Tangible asset component [carrying value approach – Option 2]

Note for WP11 delegates

In the July WP11 note, a carve-out based on the carrying value of tangible assets was framed as a standalone option, i.e., without payroll. However, during the July meeting several delegates objected to this and considered that a fixed return on the carrying value of tangible assets could in fact be combined with a fixed return on payroll, even if such a combination was not entirely consistent with existing transfer pricing principles.⁷²

As a result of these discussions, and bearing in mind that the carve-out should not be constrained by a strict application of existing transfer pricing principles, Option 2 would in fact combine a return on the carrying value of tangible assets with payroll. The rule set out below is relevant for the tangible asset component of Option 2. The payroll component was already covered in the sections above.

As previously noted, delegates will find that the language used to describe the carrying value approach is very similar to the language used in the depreciation approach. This reflects a simple fact, which has previously been pointed out by several delegates: depreciation and carrying value are directly related. Some differences do exist, however, related to the mechanics of the carve-outs. For example, a carrying value approach requires a measurement date which is irrelevant for a depreciation approach.

252. The tangible asset component of the carve-out is equal to the sum of:

- a. [x]% of the carrying value of depreciable property, plant and equipment;
- b. [x]% of the carrying value of land;
- c. [x]% of the carrying value of natural resources; and
- d. [x]% of the carrying value of a lessee's right-of-use tangible assets.

253. Including a broad range of tangible assets in the carve-out base, including, depreciable property, plant and equipment, land, natural resources, and a lessee's right-of-use tangible assets, recognises that all such assets are indicative of substantive activities. Moreover, it helps to level the playing field across industries that use varying types of tangible assets in their business. Including leased tangible assets neutralises the difference between owning and leasing assets and recognises that the business decision to own or lease typically has no bearing on the intensity of substantive activities.

254. While the carve-out generally seeks to recognise a broad range of tangible assets an MNE should not be allowed to generate a larger carve-out by purchasing investment property in a jurisdiction. This risk

⁷² Under existing transfer pricing principles, an entity is typically compensated via a return on expenses (e.g., payroll, depreciation and other costs), or a return on the carrying value of its assets, but not both.

is particularly relevant as it relates to buildings and land, which are commonly held as investments. To neutralise this risk, buildings and land that are held to earn rental income or for capital appreciation (or both) outside the ordinary course of business, are excluded from the carve-out. This rule is not expected to materially increase complexity or compliance costs because many accounting standards already require that such assets be separately identified and accounted for. For example, in the case of IFRS, investment properties are separately accounted for under IAS 40 – Investment Property.⁷³

255. Similarly, an MNE should not be allowed to generate a larger carve-out via tangible assets whose carrying amount, i.e., cost, will be recovered principally through a sale transaction instead of through continuing use in the business. Since such assets are held for sale, not use, they are a poor proxy for substantive activities. Consequently, assets held for sale are excluded from the carve-out. This rule is also not expected to materially increase complexity or compliance costs because many accounting standards already require that such assets be separately identified and accounted for. For example, in the case of IFRS, assets held for sale are separately accounted for under IFRS 5 – Non-current Assets Held for Sale and Discounting Operations.

256. The sections below provide additional rules on the individual elements of the tangible asset carve-out, starting with depreciable property, plant and equipment.

Depreciable property, plant and equipment

257. Depreciable property, plant and equipment are tangible items that are held for use in the production or supply of goods or services or for administrative purposes and are expected to be used during more than one period. Assets in this category include: buildings, machinery, computers and other office equipment, motor vehicles, furniture and fixtures, and land improvements with a limited useful life.

258. Depreciable property, plant and equipment is initially recognised on the balance sheet at its costs, including its purchase price and any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. After initial recognition as an asset, an item of depreciable property, plant and equipment is carried at its cost less any accumulated depreciation and any accumulated impairment losses (referred to as the “cost model”). Depreciation refers to the systematic allocation of the cost of an asset, less its residual or “salvage” value, over its useful life. An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.⁷⁴

259. Impairment losses are typically caused by deteriorating market conditions, poor management, new competition or technological innovations, and is generally not indicative of a reduction in substantive activities. Keeping with the policy objective of the carve-out to exclude a return on substantive activities, impairment losses are disregarded for purposes of the carve-out.

260. Therefore, for purposes of the carve-out, the carrying value of depreciable property, plant and equipment is equal to the initial costs of the asset less any accumulated depreciation and is calculated without regard to impairment losses. Both elements of the calculation of carrying value, i.e., initial costs and accumulated depreciation, are required to conform with the calculations used for the same asset for financial accounting purposes, specifically the financial accounts used to compute the GloBE tax base for the relevant Constituent Entity (referred to as the “conformity rule”). For example, if the parent prepares its

⁷³ IAS 40 applies to buildings and land held to earn rentals or for capital appreciation (or both); not owner-occupied; not used in production or supply of goods and services, or for administration; and not held for sale in the ordinary course of business.

⁷⁴ IAS 16 – Property, Plant and Equipment

consolidated financial accounts in accordance with IFRS, then the calculation of initial costs and accumulated depreciation must follow IAS 16 – Property, Plant and Equipment.

261. However, there are three exceptions to the conformity rule. The first relates to the revaluation model, which is permitted by some financial accounting standards as an alternative to the cost model. The second relates to asset sales between GloBE group members. The third relates to self-constructed assets.

- a. *Revaluation model.* Under some financial accounting standards, including IFRS, an entity can elect either the cost model or the revaluation model as its accounting policy. Under the revaluation model, an asset is carried at a revalued amount, which is its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluation increases are generally recognised in OCI, rather than profit or loss. Revaluation decreases, on the other hand, are generally recognised in profit or loss. Absent a corrective measure the revaluation model would impact the quantum of the carve-out because the carrying value of the asset is determined based on the revalued amount. This result is not appropriate because revaluation increases/decreases have no connection to substantive activities. Therefore, to eliminate the effect of the revaluation model for purposes of the carve-out, any incremental increase/decrease in carrying value resulting from revaluation increases/decreases are disregarded.
- b. *Intercompany transaction.* Under the GloBE rules, transactions between Constituent Entities in different jurisdictions are not eliminated as they would be in the MNE's consolidated financial statements. Thus, when an asset is sold between Constituent Entities, the buyer may recognise the asset for purposes of the GloBE rules based on the purchase price of the asset, rather than the carrying value of the asset that is in the consolidated financial accounts. This creates the risk of MNEs engaging in intra-group asset sales designed to "refresh" the carrying value of assets and generate a larger carve-out. In such a case, the stepped-up carrying value has no connection to substantive activities. To prevent this type of planning, any incremental increase in carrying value resulting from an asset acquired in a related party transaction is not allowed in the carve-out base. This rule also applies to assets sold to third parties as part of a structured back-to-back transaction.
- c. *Self-constructed assets.* The cost of a self-constructed asset include the labour costs i.e., payroll, of the employees that constructed it. Absent a corrective measure, the labour-related costs of a self-constructed asset would be counted once in the payroll component of the carve-out and again in the tangible asset component. To eliminate such double-counting, the labour-related costs included in the carrying value of a self-constructed asset are disregarded. To avoid a further instance of double counting, the carrying value of a self-constructed asset excludes the depreciation of assets used in its construction.

262. Because carrying value changes over time, the carrying value has to be determined at a specific point in time, i.e., a measuring date. For purposes of the carve-out, the carrying value of depreciable property, plant and equipment is measured based on the average of the beginning and ending carrying value of the relevant asset for the relevant year. For example, if an asset has a carrying value of 1,000 at the beginning of the year and a carrying value of 800 at the end of the year, with the difference being depreciation, then the carrying value, for purposes of the carve-out, is 900 $((1,000 + 800) / 2)$.

263. Under a strict application of the above measuring date rule, an asset acquired during the year would have a carrying value of nil at the beginning of the year. Similarly, an asset disposed of during the year would have a carrying value of nil at the end of the year. To eliminate this distortive result, the beginning of the year carrying value is the acquisition cost for assets acquired during the year and the end of year carrying value is the carrying value that would have been determined at year end if not for the disposal. However, an asset that is both acquired and disposed of within the same year is wholly disregarded.

264. For purposes of computing the carve-out on a jurisdictional basis, depreciable property, plant and equipment is treated as having nexus in the jurisdiction of the Constituent Entity (which includes a permanent establishment) that uses the asset. As explained in the right-of-use asset section below, a lessor is not allowed to include assets that it has leased to customers in its tangible asset carve-out base.

Land

265. Land is initially recognised on the balance sheet at its costs, including its purchase price and any other costs necessary to bring the land to its intended use, such as title transfer fees, surveying costs, and zoning fees. After initial recognition, land is carried at its cost less accumulated impairment losses. Since land is assumed to have an unlimited life it is not depreciated. Therefore, the carrying value of land, for financial accounting purposes, is equal to the original acquisition costs of the land less accumulated impairment losses.

266. Absent an adjustment land would generate a larger carve-out than depreciable property, plant and equipment, for the same dollar amount of investment. This is due to the fact that the carrying value of land is not depreciated. Such a result is inconsistent with the objective of the carve-out because land is no more an indication of substantive activity than depreciable property, plant and equipment. To eliminate this distortion, the carrying value of land, for purposes of the carve-out, is equal to the original acquisition cost of the land less accumulated deemed depreciation. Deemed depreciation is calculated based on an assumed 25 year useful life and a straight-line depreciation method. Similar to depreciable property, plant and equipment, the carrying value of land, for purposes of the carve-out, is calculated without regard to impairment losses and revaluation increases/decreases.

267. Under the approach outlined above, the carrying value of land will change over time, thus a measuring date is required. Consistent with the rule for depreciable property, plant, and equipment, the carrying value of land is measured based on the average of the beginning and ending carrying values for the relevant year. To address situations where land is acquired or disposed of during the rule, the same rule that was discussed in the context of depreciable property, plant and equipment applies to land. Specifically, the beginning of the year carrying value is the acquisition cost for land acquired during the year and the end of year carrying value is the carrying value that would have been determined at year end if not for the disposal. Land that is both acquired and disposed of in the same year is wholly disregarded.

268. As previously provided, land that is an investment property is not included in the carve-out base. All other land is included, including land on which a building rests and land used in an agricultural business. The acquisition cost of land should be computed separately from the building and agriculture produce. Separating the carrying value of land from a building or agriculture produce is not expected to materially increase complexity or compliance costs because many financial accounting standards already account for these assets separately. For example, IAS 16 – Property, Plant and Equipment, provides that land and buildings are separable assets and are accounted for separately. Similarly, IAS 41 – Agriculture Assets, scopes out the land related to agriculture activity, and requires the land be separately accounted for under IAS 16 and IAS 40 – Investment Property.

269. For purposes of computing the carve-out on a jurisdictional basis, land is treated as having nexus in the jurisdiction in which the land is located.

Natural resources

270. Natural resources include oil and gas deposits, timber tracts and mineral deposits. These assets are accounted for similarly to depreciable property, plant and equipment. That is, natural resources are initially recognised at cost, including acquisition and exploration-related costs. After initial recognition, the asset is carried at its cost less any accumulated depletion and any accumulated impairment losses i.e.,

the cost model.⁷⁵ Depletion is the allocation of the cost of natural resources, and has a number of similarities to depreciation accounting. Because the usefulness of a natural resources is generally directly related to the amount of resources extracted, the units of production method is widely used to calculate depletion. Service life is therefore the estimated amount of mineral resources to be extracted, e.g., tons of minerals or barrels of oil.

271. For purposes of the carve-out, and consistent with the rule for depreciable property, plant and equipment, the carrying value of natural resources is equal to the initial costs of the asset less any accumulated depletion and is calculated without regard to impairment losses. Both elements of the calculation of carrying value, i.e., initial costs and accumulated depletion, are required to conform with the calculations used for the same asset for financial accounting purposes, specifically the financial accounts used to compute the GloBE tax base for the relevant Constituent Entity. For example, if the parent prepares its consolidated financial accounts in accordance with IFRS, then the calculation of carrying value must follow IFRS 6 – Exploration for and Evaluation of Mineral Resources. However, as with depreciable property, plant and equipment and land, any incremental increase/decrease in carrying value resulting from revaluation increases/decreases are disregarded.

272. Because the carrying value of natural resources changes over time a measuring date is required. Consistent with the rule for depreciable property, plant and equipment, and land, the carrying value is measured based on the average of the beginning and ending carrying value of the relevant asset for the relevant year.

273. For purposes of computing the carve-out on a jurisdictional basis, a natural resource asset is treated as having nexus in the jurisdiction in which it is located.

Right-of-use tangible assets

274. A carve-out based on the ownership of tangible assets would lead to a difference between owning and leasing assets. In order to avoid this distortion, the tangible asset carve-out base includes the carrying value of a lessee's "right-of-use" tangible assets, including leased buildings and land.

275. In a lease arrangement a lessee recognises a "right-of-use" asset on its balance sheet representing its right to use the underlying asset and a lease liability representing its obligation to make lease payments. A lessee accounts for right-of-use assets similarly to an owner of depreciable property, plant and equipment. Specifically, a lessee initially recognises right-of-use assets based on the present value of the lease payments, and subsequently recognises depreciation and impairment losses, i.e., the cost model.⁷⁶ The depreciation method is typically straight-line and the useful life is generally the earlier of the end of the useful life of the asset or the end of the lease term. The lessee also recognises interest expense on the lease liability.

276. For purposes of the carve-out, the carrying value of right-of-use tangible assets is equal to the initial costs of the right-of-use tangible asset, including the present value of the lease payments, less any accumulated depreciation and is calculated without regard to impairment losses. Both elements of the calculation of carrying value, i.e., initial costs and accumulated depreciation are required to conform with the calculations used for the same right-of-use asset for financial accounting purposes, specifically the

⁷⁵ Under some financial accounting standards timber tracts are accounted for the same as other natural resources, i.e., cost model. However, under IFRS, specifically IAS 41 – Agriculture, "biological assets", which includes timber tracts, are valued at their fair value less estimated costs to sell, with changes in fair value included in profit or loss. For purposes of the carve-out, carrying value for timber tracts must be derived using the cost model.

⁷⁶ Some financial accounting standards require lessee's to distinguish between "operating leases" and "finance leases". Other standards, including IFRS, have a single lessee accounting model which requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value.

financial accounts used to compute the GloBE tax base for the relevant Constituent Entity. For example, if the parent prepares its consolidated financial accounts in accordance with IFRS, then the assumptions used to compute the carrying value of the right-of-use asset must follow IFRS 16 – Leases. MNEs applying non-IFRS financial accounting standards are required to account for a lessee’s right-of-use assets using the single lessee accounting model used in IFRS. As with depreciable property, plant and equipment, land, and natural resources, any incremental increase/decrease in carrying value resulting from revaluation increases/decreases are disregarded.

277. Because the carrying value of right-of-use assets changes over time a measuring date is required. Consistent with the rule for depreciable property, plant and equipment, land and natural resources, the carrying value is measured based on the average of the beginning and ending carrying value of the relevant asset for the relevant year.

278. As regards to the lessor, it is not allowed a carve-out in respect of the carrying value of that asset. This rule reflects the fact that the lessor is not actively using the underlying asset to earn income. It is therefore not a reliable measure of substantive activities of the lessor.

279. For purposes of computing the carve-out on a jurisdictional basis, a lessee’s right-of-use asset is treated as having nexus in the jurisdiction of the Constituent Entity lessee that uses the property in its business.]

3.5.4. Low margin businesses

280. The impact of expenditure based tax credits on a taxpayer’s ETR is more significant for low margin businesses. This is due to the fact that low margin businesses have more credits as a proportion of their total income. However, the formulaic substance-based carve-out based on payroll and tangible assets is designed, in part, to accommodate to some extent the provision of tax credits and other incentives for low margin businesses. Low margin businesses have more expenses as a percentage of their income and thus would secure a relatively larger carve-out. The carve-out will therefore limit the impact of GloBE rules on low margin businesses that are entitled to tax credits for local expenditures.

3.5.5. Alternative carve-out designs

281. As provided above, the IF adopted a formulaic substance-based carve-out using payroll and tangible assets. Consistent with the Programme of Work, Working Party 11 also explored the possible use and effect of several alternative carve-outs designs, including:⁷⁷

- a. Regimes compliant with the standards of BEPS Action 5 on harmful tax practices, and other substance based carve-outs, noting however such carve-outs would undermine the policy intent and effectiveness of the proposal, and
- b. Controlled corporations with related party transactions below a certain threshold.

282. These alternative approaches were thoroughly considered, but ultimately not adopted for the reasons summarised in the sections below.

⁷⁷ OECD (2019), Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, OECD/G20 Inclusive Framework on BEPS, OECD, Paris, www.oecd.org/tax/beps/programme-of-work-to-develop-aconsensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm, see page 29 and 31.

Carve-out for FHTP compliant regimes

283. The Programme of Work calls upon WP11 to explore the possible use and effect of carve-outs, including for regimes compliant with the standards of BEPS Action 5 on harmful tax practices (FHTP compliant regimes), and other substance based carve-outs, noting however that such carve-outs would undermine the policy intent and effectiveness of GloBE. Also, the Programme of Work notes that there could be an inclusion at the full rate rather at a minimum rate for those cases where income benefits from a harmful preferential regime and is taxed at an effective rate below the minimum rate.

284. Allowing a carve-out for income derived from regimes compliant with the standards of BEPS Action 5 on harmful tax practices (FHTP compliant regimes) would give credit to IF members for their significant efforts to comply with the FHTP requirements. While there may be a concern that the lack of recognition for FHTP would undermine the progress that has been made within the context of FHTP, it is also true that the top-up of design was chosen, at least in part, to recognise the FHTP's work.

285. Moreover, a coherent integration of an FHTP carve-out within the framework of GloBE would prove challenging for several reasons:

- a. No existing CFC rules link to or incorporate substance as determined under BEPS Action 5. Such a link was discussed within the work on BEPS Action 3, but in the end was only included as a possibility. A recent survey of jurisdictions with CFC rules undertaken by Working Party 11 in conjunction Working Party 2 did not identify any jurisdiction which had adopted CFC rules tied to the outcomes under BEPS Action 5.
- b. The assessment under BEPS Action 5 is a legislative assessment followed by a systemic implementation and enforcement assessment where needed. It does not apply or test practical outcomes at the entity or transaction level, which would have to be done separately. As the carve-out would need to apply to all FHTP compliant regimes including those with less mechanical and bright line approaches i.e. those applicable to non-IP regimes including as regards no or nominal tax jurisdictions, this may entail significant additional compliance and administrative implications.
- c. Excluding FHTP compliant regimes would lead to incoherent outcomes for jurisdictions with a generally applicable CIT rate that is below the minimum rate but is above a no or nominal rate. These jurisdictions are currently out of scope for the FHTP work. As they could not benefit from being "FHTP compliant," they would then potentially be subject to the inclusion and undertaxed payments rules, whereas jurisdictions with a higher general rate, but lower rate preferential regime may not - an outcome that would seem very hard to justify from a policy perspective. A similar incoherence would result for preferential regimes that cannot be FHTP compliant because they are outside the scope of FHTP, e.g. those relating to manufacturing.
- d. As noted in the Programme of Work, a more general concern is that a full carve out for all FHTP compliant regimes would undermine the policy intent and the effectiveness of Pillar Two. Such a full carve-out may mean that Pillar Two does not go much beyond (and may in fact be less effective) than the CFC rules jurisdictions already have today. Equally, it may not achieve anything much beyond what has already been achieved through the work on BEPS Action 5.

286. Finally, it is recognised that conceptually a formulaic carve-out based on payroll and tangible assets looks at the same general features that a general FHTP substance test would review, but does so in a way that avoids the downsides and challenges that would result from seeking to integrate the FHTP test itself into the Globe rules.

Facts and circumstances based substance carve-out

287. Another approach to designing a substance-based carve-out would be to use a facts and circumstances analysis, similarly to that used currently under the CFC rules of many jurisdictions. Carve-outs based on facts and circumstances can be targeted or tailored to some degree by identifying the most relevant factors for the analysis. However, they are more difficult to design and may result in increased compliance and administration costs and more uncertainty for taxpayers when compared to objective, formulaic substance-based carve-outs. These difficulties often increase as the scope of the carve out narrows to target only particular types of entity or income.

288. There are several challenges when developing substance carve-outs based on a facts and circumstances analysis in the context of GloBE, including:

- a. Such carve-outs are difficult to apply, particularly in the context of international operations, and may not lead to appropriate policy outcomes. The desire to move away from the difficulties of this type of traditional facts and circumstances approach appears to be one of the drivers behind the design of the US GILTI rules.
- b. Substance approaches built on a facts and circumstance analysis have proven difficult to agree in the past. In the two years of work on Action 3 of BEPS, members of the IF were unable to come to a consensus on the scope and relevant factors for a single substance-based carve-out for CFCs. In the end, the Action 3 Report simply provided examples of approaches that could be used to devise a substance-based standard, depending upon the jurisdiction's policy objectives.
- c. Even if a facts and circumstances test could be agreed, it would then need to be applied on a case-by-case basis and would require taxpayers and tax administrations to undertake a detailed analysis and make qualitative judgments that are difficult to standardise. If each IF member (or taxpayer) applies its own understanding of what substance requires within the context of a particular fact pattern, this is likely to result in inconsistency in the application of the rules. Within the context of the Globe rules this would be of particular concern as this could lead to a proliferation of uncoordinated applications of undertaxed payments and income inclusion rules resulting in significant uncertainty for taxpayers, disputes between taxpayers and tax administrations (as well as between tax administrations) with a substantial risk of double or over-taxation.

289. Consequently, a substance carve-out based on facts and circumstances was not adopted.

Carve-out for CFCs with low-levels of related party transactions

290. Another approach to carve-outs is to exclude all the income of an entity where only a small proportion of the income of that entity is derived from transactions with related parties. The Programme of Work identifies the possibility of developing a carve-out based on this approach for subsidiaries with low-levels of related party transactions. A carve-out for CFCs with low levels of related party transactions would be based on the premise that such entities are likely to present a lower risk from a BEPS perspective, on the assumption that the smaller amount of related party transactions means that there will be fewer opportunities for profit shifting.

291. One preliminary question in the design of such a carve-out is whether it would take into account both inbound and outbound related party transactions. If the carve-out focused only on inbound related party payments there may still be substantial scope for diverting third-party sales into low-tax jurisdictions. This type of carve-out would likely require anti-avoidance rules to prevent an MNE manipulating the total amount of related party transactions or the ratio of payments from related and unrelated parties to stay within the required threshold. It may also require anti-avoidance rules where an MNE would otherwise

circumvent the application of the rules by using related party agency arrangements where, for example, title passes directly from a principal company to an unrelated third party customer, with consignment manufacturing possibly eliminating a related party purchase transaction. A carve-out based on related party payments would also lead to additional compliance and administration costs of separating related and unrelated party transactions. It may also be challenging to arrive at an agreed limitation or threshold that was sensitive to the nature of the business undertaken by the subsidiary.

292. Owing to potential taxpayer manipulation and the corresponding need for complex anti-abuse rules, the added administrative burden of separating related and unrelated party transactions, and varying impact across industries, a carve-out based on low-levels of related party transactions was not adopted.

3.5.6. Adjustment for taxes

Note for WP11 Delegates – Adjustment for Taxes

Under all carve-out design options, a determination is required for the treatment of taxes paid in respect of the carve-out amount. For example, if before the application of the carve-out the taxpayer has €100 of income and €20 of taxes and after the carve-out the taxpayer has €80 of income, then a question arises as to whether the ETR for purposes of the GloBE proposal should be €20 of taxes divided by €80 of income (25%) or €16 of taxes divided by €80 of income (20%). If there is no carve-out, the ETR is 20% (€20/€100). Not adjusting the taxes would effectively attribute any tax paid on the excluded income to the income that is subject to the GloBE proposal.

Some delegates consider that a tax adjustment would be more consistent with the policy and rationale behind the carve-out. If the policy basis for the substance carve-out is to prevent the GloBE rules from taxing a routine return on substantive activities, then allowing the local tax on the excluded returns to be credited against unrelated excess low-tax income partially unwinds this intended result. Not adjusting the taxes would favour jurisdictions that have an effective tax rate that is close to the minimum rate over those jurisdictions that have nil or very low rates of taxation and will also favour larger economies by providing them with more potential to shelter low tax outcomes on mobile income. Other delegates however, note that the notions of substantive activities and routine returns are not exhaustively defined and the carve-out can only approximate the outcomes it is designed to achieve. These delegates point out that failure to credit the full amount of taxes levied on the income of the constituent entity in the local jurisdiction would ignore the true tax burden on that income.

3.6. Jurisdictional blending⁷⁸

293. The sections above deal with the general determination of an MNE's income for GloBE purposes and the covered taxes on that income. The next sections describe how to determine an MNE's ETR under

⁷⁸ This Report proceeds on the assumption that the rules for determining the ETR apply on a jurisdictional basis. As discussed in the March WP11 meeting [[CTPA/CFA/WP11/NOE\(2020\)1/REV1](#)] there are broad similarities in the basic design of global and jurisdictional blending approaches. Under a worldwide blending approach, the MNE would perform essentially the same basic steps as for jurisdictional blending although additional steps are required from a jurisdictional blending perspective. The additional compliance hurdle from a jurisdictional perspective is due to the fact that jurisdictional blending requires the MNE to perform a number of adjustments and computations, not just for the purposes of separating domestic and foreign operations but also to separate out one foreign operation from another. Given that the design of jurisdictional blending rules are necessarily more complex and taking into account the

the GloBE rules on a jurisdictional basis. Under a jurisdictional blending approach, a GloBE tax liability will arise when the ETR of a jurisdiction in which the MNE Group operates is below the agreed minimum rate. To determine the jurisdictional ETR, the MNE Group must first determine the income of each entity and then assign that income and the covered taxes paid in respect of that income to the relevant jurisdiction. More specifically, the jurisdictional ETR computation involves two steps: the first step is to determine the income of each entity in the group and make adjustments, at the entity level, in respect of consolidated items (Consolidation Adjustments); and the second step is to assign the income of and taxes paid by each entity to a jurisdiction. This section describes the rules for making these determinations and assignments.

3.6.1. Consolidation adjustments

Consolidation adjustments

Reliance on entity level financial information

MNEs can rely on the entity-level financial information that is used in preparing the parent's consolidated financial accounts to determine the profit (or loss) before tax of each constituent entity, even if such financial information is not prepared in strict accordance with the parent's accounting standard where (a) it is reasonable to do so, (b) the information is reliable, and (c) the use of such information does not result in material permanent differences from the accounting standard of the parent.

Treatment of intercompany items

Income, gains, expenses, and losses attributable to transactions between constituent entities should not be eliminated and should be recorded in accordance with the arm's length principle. Intercompany items can be excluded, however, to the extent the transaction is between constituent entities in the same jurisdiction. Items recognised in consolidation

Other items maintained at the consolidated level should only be taken into account in determining the profit and loss of a constituent entity where those items can be reliably and consistently traced to that entity.

Reliance on entity level financial information

294. Even where a subsidiary maintains financial accounts using the parent entity's accounting standard, the subsidiary is unlikely, in many cases, to be able to produce an income statement on a stand-alone basis that would meet the rigorous standards an independent financial auditor would apply in assessing compliance with the parent entity's accounting standard. There are several reasons for this.

295. First, the materiality threshold for a subsidiary on a stand-alone basis would generally be much lower than the materiality standard of the consolidated group. The accounting treatment of a transaction or item that is out of step with the parent entity's accounting standard may be acceptable in the context of the consolidated group's financial accounts. However, on a stand-alone company basis, the transactions or items may be material such that deviation from a strict application of the accounting standard would be unacceptable.

significant level of support amongst IF members for a jurisdictional blending approach, this Chapter focusses on how the GloBE rules could be applied on a jurisdictional basis.

296. Second, in the case of an acquisition, the purchaser is required to record the assets and liabilities of the acquired business at fair value based on an allocation of the purchase price (this practice is commonly referred to as “purchase accounting”). Purchase accounting commonly results in increased or decreased carrying values for fixed assets previously included in the acquired entity’s financial accounts and recording new intangible assets that were not previously included in the acquired entity’s financial accounts. The purchaser uses these fair value measures to prepare its consolidated financial accounts. In many cases, however, the fair value adjustments are not “pushed-down” to the acquired entity’s stand-alone financial accounts. In fact, push-down accounting is not permitted under some accounting standards, including IFRS. Instead, many MNE groups hold purchase accounting adjustments at the consolidated level, i.e., in financial accounts that are used exclusively to prepare the group’s consolidated financial statements. Adjustments for purchase accounting items is further discussed below.

297. Third, similar to purchase accounting adjustments, certain other financial accounting items are maintained at the consolidated accounting level, rather than the financial accounts of stand-alone legal entities. Common examples include stock-based compensation expenses, foreign currency gain and loss, and fair value accounting adjustments related to derivatives and pension liabilities. Adjustments for stock based compensation expenses, and other items held in consolidation are discussed below.

298. For the reasons described above, the profit (or loss) before tax of a particular subsidiary that is used in the preparation of the MNE group’s consolidated financial statements may not be, on a stand-alone entity basis, in perfect conformity with the parent’s financial accounting standard. In fact, on a stand-alone basis, the differences could be sufficiently significant that a financial accounting auditor would require adjustments.

299. The gap between financial accounts prepared in perfect accord with the parent’s accounting standard and the financial accounts that are likely to be maintained by the subsidiaries of an MNE raises a question of what it means to compute a subsidiary’s profit (or loss) before tax using the “financial accounting standard used by the parent entity in the preparation of its consolidated financial statements.” In other words, does the requirement mean that each subsidiary must compute its profit (or loss) before tax in strict accordance with the parent entity’s financial accounting standard as if it were a stand-alone entity? Alternatively, does the requirement mean more generally that each subsidiary must start with the profit (or loss) before tax that is rolled up in the preparation of the parent entity’s consolidated financial statements?

300. The rule set out above adopts the latter interpretation. A significant benefit of using financial accounts as a starting point for the GloBE tax base is the efficiency of beginning with an income measure that has already been computed for other purposes. A requirement to compute the profit (or loss) before tax of each constituent entity under the more rigorous application of the parent entity’s financial accounting standard than is required for that entity in the preparation of the MNE group’s consolidated financial statements would impose significant additional compliance costs. In addition, that income computation would not be subject to scrutiny by the financial accounting auditors. In contrast, the constituent entity’s profit (or loss) before tax that is computed in connection with the preparation of consolidated financial statements under the parent entity’s accounting standard is subject to audit, albeit with a materiality threshold established on a consolidated group basis.

301. As already noted above, the profit (or loss) before tax that is used in consolidation may not be a perfect application of the parent entity’s accounting standard. However, if an independent auditor reviewing the consolidated financial statements would not require any adjustments to the income from that subsidiary, the same approach would be acceptable for computing the GloBE tax base. Of course, if an independent auditor required adjustments in respect of the subsidiary’s financial accounts, those adjustments would be required for purposes of computing the GloBE tax base as well, unless they are related to income or expense excluded from the GloBE tax base.

302. In order to ensure data integrity, the rule permits the profit (or loss) before tax that is used in the preparation of the consolidated financial accounts to be used in the computation of the GloBE tax base only under certain conditions. First, it must be reasonable, meaning that better financial information (i.e., financial information kept in strict accordance with the parent's accounting standard) is unavailable. This criterion could be met if the local subsidiary has no compliance or regulatory obligation to prepare stand-alone financial accounts in line with the parent's accounting standard. Second, the information must be reliable, meaning that there must be appropriate mechanisms in place to ensure that the information is recorded accurately. In this regard, the financial accounting internal controls and accounting processes employed by the subsidiary must be tested and deemed acceptable to the financial accounting auditor pursuant to Generally Accepted Auditing Standards of the parent's or subsidiary's jurisdiction. A good set of generally accepted auditing standards requires a review not only of the financial statements, but also a review of the company's internal controls and other processes which bear on the integrity of the underlying data. Third, the financial information used must not result in material permanent differences from the financial accounting standard of the parent, determined by reference to the relevant entity and not with respect to the group's consolidated materiality threshold.⁷⁹

Treatment of intercompany items

303. Using a jurisdictional approach to blending under the GloBE rules will require transactions between constituent entities in different jurisdictions to be treated in the same manner as transactions with unrelated entities in order to determine the GloBE tax base for each jurisdiction. Therefore, under the rule set out above, income, gains, expenses, and losses attributable to transactions between constituent entities should not be eliminated and should be recorded in accordance with the arm's length principle. This has implications for both the timing and location of income.

304. In terms of timing, by not eliminating the effect of transactions between group members, a portion of the group's income or loss will be accelerated as compared to consolidated income when the buyer does not deduct its expense in the same year that the seller recognises the related income. For example, a manufacturing constituent entity's gain on sale to a distribution member will be offset by the distribution constituent entity's cost of goods sold when the latter sells those goods to a third party. If the distribution entity does not resell the goods in the same year, the combined income of all group entities on a separate company basis will exceed the group's consolidated income in that year because intercompany transactions are eliminated in the consolidation process. When the distribution entity recognises the cost of goods sold in the subsequent year, the aggregate separate company income will be less than the group's consolidated income by the same amount. Thus, the timing of the MNE group's income is affected by the separate company treatment, but the overall amount of income remains the same. In terms of location, by not eliminating intra-group income or loss, the MNE group's consolidated income will be allocated between the two jurisdictions when the buying and selling entities are in different jurisdictions.⁸⁰

305. However, the rule could be modified to permit elimination of transactions between constituent entities resident in the same jurisdiction. The modification could be required or permitted at the election of the taxpayer. This would prevent a timing difference attributable to transactions between constituent entities resident in the same jurisdiction and likely conforms more closely to the tax accounting, consolidation, or group relief rules applicable in the jurisdiction, which would more closely align the GloBE

⁷⁹ The Chapter on implementation will describe a process for evaluation of material differences.

⁸⁰ The timing of income between constituent entities in the same jurisdiction may be deferred until sale to a third party for local tax purposes under a group relief or consolidation regime. However, income from transactions with related parties outside the jurisdiction is likely to be recognised at the same time as income from transactions with third parties for local tax purposes. Thus, separate entity accounting for purposes of jurisdictional blending would conform in this respect to local taxation of the entities subject to the GloBE proposal.

tax base in a jurisdiction with the local tax rules. This exception is particularly beneficial in a system that addresses timing differences using a carry-forward approach.

306. If intra-group transactions are not recorded in the constituent entities' financial accounts based on the arm's length principle, the income and expense of each party to the transaction must be adjusted to conform to the arm's length principle. Application of the arm's length principle in the computation of the GloBE tax base is necessary to prevent misallocation of income among jurisdictions, ensure that the income of entities in each jurisdiction is taken into account at the proper time, and prevent the recognition of non-economic losses from transactions between entities in the same jurisdiction. In addition, the counterparties to an intercompany transaction are required to apply the same arm's-length price. This rule is necessary to prevent counterparties avoiding GloBE tax liability by applying transfer prices at different points within the arm's length range.

307. Transfer pricing adjustments based on the arm's length principle will often be required for tax purposes. The GloBE rules focus only on transactions between constituent entities within the same MNE Group and should generally follow the obligations that are imposed on those Constituent Entities under local law. Thus, requiring intra-group transactions to be reported based on the arm's length principle and at the same price under the GloBE rules may require an adjustment to the financial accounts but should not create significant additional compliance burden overall.

Items recognised in consolidation

308. Purchase accounting adjustments represent the largest and most common items of income and expense that may not be reflected in the relevant entity's separate financial accounts. When a corporation becomes a member of a consolidated financial group as the result of a stock acquisition, financial accounting rules generally require the assets of the newly acquired member to be re-valued based on their fair market values. The re-valuation results in either an increase or decrease in the carrying cost of each asset for financial accounting purposes. If the acquisition price⁸¹ exceeds the fair market value of the tangible assets less the liabilities assumed, the relevant financial accounting rule typically will require the recording of some new intangible assets, such as goodwill. In terms of recordkeeping, however, the acquiring corporation generally will not "push down" the adjustments to the carrying value of pre-existing assets or any new intangible assets to the acquired members financial accounting records or systems. The acquiring corporation may instead account for the adjustments in its financial accounting system that is used in connection with the preparation of consolidated financial accounts, sometimes referred to as the "consolidation reporting package." This creates a potential source of discrepancy between the consolidated profit (or loss) before tax and the stand-alone profit (or loss) before tax of the acquired entity.

309. However, purchase accounting adjustments may be unnecessary for GloBE purposes given one of the rules discussed above in section 3.3.4 in the context of adjustments for permanent differences. In particular, one of the rules is to exclude gains and losses arising from the disposition of stock. The corollary to this rule is that the acquired entity is required to use the historical carrying value of its underlying assets to compute its GloBE tax base after the acquisition, not the post-acquisition carrying value. Therefore, the fact that the acquiring corporation may not push down purchase accounting adjustments to the acquired subsidiary is not problematic; in fact, it facilitates the correct computation of the GloBE tax base. The rule that excludes the gain (or loss) on the disposition of stock is described above in section 3.3.4. Similarly, impairments and impairment recoveries of assets that are themselves maintained at the consolidated level should not be traced to the constituent entity that owns the underlying asset if the depreciation or

⁸¹ In the case of an acquisition of less than all the ownership of an entity, the value of the minority interest is also taken into account in determining the existence and amount of goodwill or other intangible assets of the acquired entity or entities.

amortisation of such assets (or the portion of the carrying cost of such assets that is held in consolidation) is not traced to the entity.

310. The parent entity of an MNE group commonly issues stock-based compensation to employees that are on the payroll of foreign subsidiaries. In some cases, the parent will push down the compensation expense to the relevant subsidiary via a stock recharge agreement or similar arrangement. Under these agreements, the foreign subsidiary reimburses the parent entity for the costs associated with stock-based compensation issued to its employees. The foreign subsidiary may be able to claim a local deduction for the payment under a stock recharge agreement. However, local tax and accounting requirements differ in what forms of compensation are eligible, the value of the compensation that can be deducted, and accounting requirements. Some jurisdictions may allow a local tax deduction even without a recharge agreement. Other jurisdictions may not allow a local tax deduction even when a recharge agreement exists. The result is that the cost associated with stock-based compensation is pushed down to the relevant subsidiary in some cases, for example when it is required in order to receive a local deduction, but not in all cases, for example, when a local deduction is not conditioned on the existence of a re-charge.

311. Similar to purchase accounting adjustments, whether an MNE pushes down the cost of stock-based compensation may not matter for GloBE purposes given the stock-based compensation rule discussed above in section 3.3.4 in the context of adjustments for permanent differences. In particular, the rule for stock-based compensation allows a deduction in the GloBE tax base of a jurisdiction to the extent it is allowed as a deduction in the local tax base of the subsidiary in the jurisdiction that employed or contracted with the party receiving the stock-based compensation. In other words, the treatment of stock-based compensation for financial accounting purposes is irrelevant because the rule relies on tax accounts for this particular item of expense. The use of tax accounts for stock-based compensation would be required for all constituent entities of the MNE group in order to ensure consistency across group members.

312. Other financial accounting items may also be maintained at the consolidated level, rather than the financial accounts of stand-alone entities. These items may include foreign currency gain and loss and fair value accounting adjustments related to certain items. Such items should only be taken into account in determining the profit (or loss) of a group entity where those items can be reliably and consistently traced to that entity. An item can be reliably traced to an entity where it relates wholly or exclusively to that entity or it relates to a group of entities and there is a clear basis for apportioning that amount between them. This tracing method must be applied consistently by the MNE group to items and constituent entities within the group and across accounting periods.

3.6.2. Assignment of income and taxes of entity to each jurisdiction

Assignment of income and taxes

Income of permanent establishments and constituent entities with a tax jurisdiction of residence

Profit (or loss) before tax earned by a constituent entity that is a permanent establishment is assigned to the jurisdiction where the permanent establishment is located. In other cases the profit (or loss) before tax earned by the constituent entity is assigned to its tax jurisdiction of residence.

Income of constituent entities without a tax jurisdiction of residence

In the case of a constituent entity that does not have a tax jurisdiction of residence (a stateless entity):

- (a) the share of profits of each owner that is a constituent entity is assigned to the owner's tax jurisdiction of residence if that owner's jurisdiction treats the entity as tax transparent, and

(b) any remaining profits, including the share of profits of any owner that is a Constituent Entity whose jurisdiction does not treat the entity as tax transparent, are assigned to the stateless jurisdiction.

An owner's tax jurisdiction treats an entity as tax transparent if the owner is subject to tax on its share of the entity's income or loss in its tax jurisdiction in the same manner as if the owner directly earned its share of the entity's income or loss.

Covered taxes

Any covered tax paid by a Constituent Entity with respect to its income or income of a tax transparent entity that it owns is assigned to the same jurisdiction as the related income.

Covered taxes paid by a Constituent Entity with respect to dividends distributed by another Constituent Entity are assigned to the jurisdiction of the Constituent Entity that paid the dividend provided that any shareholder level tax on a dividend shall not be credited against the income of a low-tax Constituent Entity to the extent that dividend was funded out of distributions received from other lower-tier subsidiaries.

Overview

313. A jurisdictional blending approach under the GloBE rules requires the MNE to allocate its foreign income and taxes between the different tax jurisdictions in which it operates.⁸² Generally, an MNE would be subject to tax under a jurisdictional blending approach where the tax on the income allocated to a jurisdiction was below the minimum rate. The MNE's liability for additional tax under the GloBE rules would be the aggregate of the amounts necessary to bring the total amount of tax on the income in each jurisdiction up to the minimum tax rate.

314. In order to determine, on a jurisdictional basis, whether an MNE's income is subject to a minimum level of taxation, the income earned by constituent entities and the covered taxes that are paid or shown as payable on the relevant return filed in respect of that income need to be correlated and assigned to the appropriate jurisdiction. Generally, the income earned by an MNE should be assigned to the jurisdiction of the constituent entity that earned the income, whether that constituent entity is a corporation or similar juridical entity or a permanent establishment of such entity, and the covered taxes paid by the MNE should be associated with the income that was the subject of the tax.

315. The starting point for determining the jurisdictional ETR is the assignment of income to jurisdictions. The rules for assigning income among jurisdictions build on the rules applicable to CbC reporting (CbCR). As noted above, the GloBE rules adopt, with some modifications, the CbCR definition of MNE group and constituent entity.⁸³ The CbCR rules generally require MNE groups to report certain information in respect of constituent entities based on the entities' respective tax jurisdictions of residence. A permanent establishment is considered a constituent entity separate from its head office. For purposes

⁸² A worldwide blending approach under the GloBE proposal requires a similar allocation of the MNE's income and taxes, except that the income and taxes only need to be allocated between the tax jurisdiction of the ultimate parent entity and a foreign tax jurisdiction. This section of the note assumes a jurisdictional blending paradigm. However, the principles apply equally to the assignment of income and taxes to the relevant jurisdictions under a worldwide blending model.

⁸³ It is recognised that no decision has yet been taken by the Inclusive Framework on whether the GloBE rules will adopt relevant definitions from the CbCR rules. However, given the strong correlation between the intended scope of the GloBE rules and the Country-by-Country reporting (CbCR) rules, this report assumes that the CbCR definitions will be adopted.

of jurisdictional blending, the same approach should apply to the assignment of income among tax jurisdictions. Covered taxes in respect of a constituent entity's income likewise should be assigned to the constituent entity's tax jurisdiction. Profit (or loss) of an entity and the taxes associated therewith can only be assigned to one jurisdiction.

Assigning income

316. The income assignment rule is straightforward in the case of permanent establishments. Profit (or loss) before tax earned by a constituent entity that is a permanent establishment is assigned to the jurisdiction where the permanent establishment is located. This rule is consistent with CbCR.

317. The income assignment rule is also straightforward in the case of constituent entities that have a tax jurisdiction of residence under the CbCR rules. Profit (or loss) before tax of such constituent entities are assigned to the entity's tax jurisdiction of residence. Generally, a constituent entity other than a permanent establishment is considered a resident in a tax jurisdiction under the CbCR rules if, under the laws of that tax jurisdiction, the member is liable to tax (other than a source-based withholding tax) therein based on place of management, place of organisation, or another similar criterion. A corporation created in a jurisdiction that does not have a corporate income tax is considered tax resident in the jurisdiction of creation, unless it is managed and controlled in a jurisdiction that does impose an income tax on the corporation on a residence basis.

318. Assigning income of Constituent Entities that do not have a tax jurisdiction of residence (stateless entities) is more challenging. As discussed in section 2.2, this category of Constituent Entities is comprised generally of tax transparent entities and reverse-hybrid entities. A tax transparent entity is an entity or arrangement that is tax transparent in the jurisdiction of the owner and in the jurisdiction of the entity.⁸⁴ Building on the analysis in the BEPS Action 2 Report, a reverse-hybrid entity is an entity or arrangement that is not tax transparent in the jurisdiction of the owner but is tax transparent in the jurisdiction in which the entity is created. An owner's tax jurisdiction treats an entity as tax transparent if the owner is subject to tax on its share of the entity's income or loss in its tax jurisdiction in the same manner as if the owner directly earned its share of the entity's income or loss. In some cases, the owner of the stateless entity may be a permanent establishment located in the tax jurisdiction in which the stateless entity conducts its business activities.

319. Under the CbCR rules, an entity that does not have a jurisdiction of tax residence is treated as a stateless entity, and, in the CbC report, its income is assigned to the "stateless" jurisdiction, which is a hypothetical jurisdiction treated as a tax jurisdiction for CbCR purposes. If the tax jurisdiction of an owner or owners of the entity treats the entity as tax transparent, the owner's share of its income is also assigned to the jurisdiction(s) of those owners. For purposes of jurisdictional blending, however, income can only be assigned to a single jurisdiction. Nonetheless, CbCR provides a useful template for assigning the income of stateless entities.

320. Adapting the CbCR approach to the GloBE rules requires the creation of a stateless jurisdiction for purposes of the GloBE rules. This stateless jurisdiction is treated the same as a tax jurisdiction for purposes of applying the GloBE rules on a jurisdictional basis. Thus, all of the income assigned to the stateless jurisdiction under this rule and the corresponding covered taxes should be aggregated for purposes of a stateless jurisdiction ETR computation and top-up tax computation.

321. The types of Constituent Entities that are treated as stateless under the rules of section 2.2 include tax transparent entities and reverse-hybrid entities. Each owner's share of the income of a stateless Constituent Entity is assigned to that owner's tax jurisdiction, unless the owner is a Constituent Entity and

⁸⁴ For this purpose, the entity's jurisdiction may be the jurisdiction under the laws of which the entity was created if it is a juridical entity or the jurisdiction in which it conducts its activities if it is a contractual entity or arrangement.

its tax jurisdiction does not treat the entity as tax transparent. Thus, in the case of a tax transparent entity that is owned exclusively by Constituent Entities that are tax resident in jurisdictions that treat the entity as tax transparent, all of the entity's income will be assigned to the jurisdictions of those Constituent Entity owners. If the jurisdiction of a Constituent Entity owner does not treat the entity as tax transparent, the entity is a reverse-hybrid with respect to that owner and that owner's share of the entity's income will be assigned to the stateless jurisdiction. The rule also deals with situations in which non-Constituent Entities hold a minority interest in a stateless Constituent Entity of the MNE Group. The non-Constituent Entity owner's share of the income will be assigned to the jurisdiction of those owners and not taken into account by the MNE Group in the computation of the ETR or top-up tax of the stateless jurisdiction. If an owner of a stateless entity is itself a stateless entity, the rule is applied to that owner's share of the income as if that owner directly earned its share of the income.

322. As explained in section 2.2, a business unit that is treated as a joint operation will be treated as a separate Constituent Entity if the income and expenses of the joint operation are included in the group's consolidated financial statements in proportion to the group's ownership interest in the business unit. The Constituent Entity is comprised, however, only of the MNE Group's share of the entity or arrangement as reflected in the consolidated financial statements. A joint operation may be subject to tax in a jurisdiction or may be a tax transparent entity. The general rules for determining tax residency apply to a joint operation that is treated as a Constituent Entity. Thus, the joint operation may be tax resident in a jurisdiction if it is subject to tax in that jurisdiction or, if it is tax transparent, it may be stateless. If the joint operation is a stateless entity, its income is assigned pursuant to the rules described above for stateless entities.

Assigning covered taxes

323. Covered taxes generally follow the income to which they relate under the rules for assigning covered taxes. In other words, the covered taxes associated with income assigned to a particular jurisdiction, including the stateless jurisdiction, generally are assigned to that jurisdiction.

324. Covered taxes paid with respect to the income of a permanent establishment, including taxes paid in the headquarters jurisdiction, are assigned to the location of the permanent establishment. Covered taxes paid with respect to the income of a constituent entity with a tax jurisdiction of residence are assigned to the constituent entity's tax jurisdiction. These covered taxes may be imposed by the constituent entity's tax jurisdiction or another tax jurisdiction. For example, withholding taxes paid in respect of a royalty received from a licensee in another jurisdiction would be assigned to the tax jurisdiction of the constituent entity that received the royalty. Similarly, taxes imposed on a shareholder of a constituent entity in respect of a dividend or under a controlled foreign company (CFC) regime should be assigned to the jurisdiction of the distributing constituent entity or CFC because those taxes are paid in respect of the constituent entity's or CFC's income. See Annex, Examples 3.6.2A, 3.6.2B, 3.6.2C and 3.6.2D.

Note to Delegates

Treatment of withholding and net basis taxes arising in respect of distributions from Constituent Entities

The GloBE rules generally seek to match covered taxes with the income to which they relate for purposes of the jurisdictional ETR computations. Dividends received from Constituent Entities are excluded from the GloBE tax base even if they are subject to a withholding tax or a net basis tax when distributed or received by the shareholder. However, the taxes on such dividends could, under the GloBE rules, be attributed to the Constituent Entity that earned the underlying income.

Withholding and net basis taxes often will not arise in the same year that the underlying income is earned; they will arise upon subsequent distribution of those earnings which could be some period of time later. When those earnings are distributed they may represent a mix of high and low tax income from various sources. Thus, dividend taxes that are assigned to the Constituent Entity that made the corresponding distribution will not necessarily be matched with the related income. Mechanisms to address timing difference discussed in Section 3.7 below may, however, address some of these issues.

Aside from timing issues it may be difficult to determine with certainty whether, or to what extent, a particular distribution is attributable to income of the immediately distributing company or funded out of previous distributions from one or more other constituent entities further down the ownership chain. Even with sophisticated methods for tracking and tracing the flow of intra-group dividends an MNE Group may be unable to reliably determine which distribution has originated from which constituent entity that earned the underlying income. An alternative to a track and trace approach would be to treat the dividend as being funded pro-rata from aggregate distributions made by Constituent Entities through the ownership chain over a certain agreed period. However this option is not without some complexity and might, encourage an MNE Group to structure the timing of its intra-group dividend payments to maximise its impact on the ETR calculation under the GloBE rules.

A simpler method would be to credit shareholder taxes only against the income of the company that paid the dividend. In order to address tax planning concerns, a transaction specific rule could be introduced that prevented any shareholder level tax on a dividend being credited against the income of a low-tax subsidiary to the extent that dividend was deemed to be funded out of distributions received from other lower-tier subsidiaries. The text in the paragraph below adopts this final simplified approach.

Question for delegates

1. Do delegates agree that there are significant technical design and compliance challenges in associating covered tax on a distribution with the income of the Constituent Entity that earned the underlying income?
2. Do delegates agree that a simpler method would be to credit shareholder level taxes only against the income of the company that paid the dividend?
3. Do delegates consider that, in order to address tax planning concerns, the GloBE rules should incorporate a transaction specific rule that prevented any dividend tax from being credited against the income of a low tax subsidiary to the extent that dividend was deemed to be funded out of distributions made from other lower tier subsidiaries?

325. Ideally, covered taxes paid with respect to distributions of a Constituent Entity's income, including net basis taxes and withholding taxes, should be assigned to the tax jurisdiction of the Constituent Entity that earned the underlying income. However, tracking and tracing distributions through the ownership chain

would be extremely complex and burdensome. Accordingly, such taxes should be assigned to the jurisdiction of the Constituent Entity that distributed the dividend that triggered the tax liability. However, covered taxes paid by a shareholder in respect of a distribution from a Constituent Entity in a low-tax jurisdiction are not taken into account in any jurisdiction to the extent that the relevant dividend is treated as funded out of distributions made from lower-tier subsidiaries.

326. Covered taxes paid in connection with a sale of Constituent Entity stock may, at the option of the seller, be assigned to the jurisdiction of the sold Constituent Entity to the extent those taxes represent additional tax on the retained earnings of the sold Constituent Entity.

327. As with other Constituent Entities, covered taxes paid or incurred on an owner's share of the income of a stateless entity are assigned to the same jurisdiction as the corresponding income. Typically, this will mean that tax imposed on each owner's share of a tax transparent entity's income will be assigned to each respective owner's tax jurisdiction. For example, partners of a partnership that is a constituent entity may be taxable in their jurisdiction on their share of the partnership's income. However, if the owner is located in a tax jurisdiction that does not treat the stateless entity as tax transparent it may impose tax on distributions from the stateless entity or impose tax on the owner's share of the stateless entity's income under a CFC regime. In such cases, the covered taxes paid by the latter should be assigned to the stateless jurisdiction along with the income. The assignment of income and related taxes for stateless entities is illustrated in Annex, Examples 3.6.2E and 3.6.2F.

Computing the jurisdictional ETR

328. Generally, the ETR of each jurisdiction will be computed by dividing the aggregate of adjusted covered taxes assigned to the jurisdiction by the aggregate of the profit (or loss) before tax assigned to the jurisdiction. Where the aggregate profit before tax assigned to a jurisdiction is zero or negative (i.e. loss-making), there will be no GloBE income and no GloBE tax liability with respect to that jurisdiction for the MNE group for that year. Adjusted covered taxes are all covered taxes reduced by covered taxes attributable to income and gains that are excluded from the GloBE tax base. The excluded taxes include taxes paid in respect of dividends from, or gains from dispositions of interests in, entities that are not constituent entities and taxes attributable to gains from the sale of stock in excess of the retained earnings of a constituent entity. The amount of covered taxes included in the ETR computation of a jurisdiction under the carry-forward approach for addressing temporary differences is discussed further below in section 3.7.

Note for WP11 delegates

CFC regime taxes and other cross-jurisdictional taxes

Under the jurisdictional blending approach, covered taxes are assigned to the jurisdiction of the Constituent Entity that earned and recorded the related income. Consequently, covered taxes collected by the tax authority in one jurisdiction, such as withholding taxes and CFC taxes, may be taken into account in the ETR computation of another jurisdiction.

These “cross-jurisdictional” taxes present some challenges for the GloBE rules, because they are typically levied at high rates and in respect of passive (and therefore highly-mobile) income. The income that triggers these types of taxes can be shifted easily to an otherwise low-taxed jurisdiction together with the associated covered taxes, to the extent the assigned income and taxes exceed the minimum rate, the excess tax credits can be used to reduce the amount of top-up tax on other income arising in the jurisdiction.

The original and revised draft of the chapter endeavoured to address these challenges by setting out two different approaches for the treatment of CFC regime taxes under jurisdictional blending, with the understanding that the approaches could be extended to withholding and other taxes if delegates deemed such extension appropriate.

- The approach described in the original draft chapter excluded CFC income from the CFC’s GloBE tax base and excluded the related CFC regime taxes from the covered taxes of both the shareholder and the CFC if the CFC tax rate exceeded the minimum rate agreed under GloBE.
- The alternative described in the revised chapter, computed the CFC tax paid by the shareholder and pushed the tax down to the CFC’s jurisdiction. Delegates were then asked whether they preferred to allow the CFC taxes to be taken into account in the ETR computation of the total jurisdictional income or only allowed in the ETR computation of the related CFC income. In the event delegates agreed to limit the crediting of CFC taxes, the revised chapter further contemplated separate carry-forwards for CFC income to address temporary differences between the taxation of the CFC income in the jurisdiction of the parent and the CFC.

There was a lively discussion on the proper treatment of cross-jurisdictional taxes at the 30 June 2020 WP11 meeting. Some delegates continued to doubt the utility of separate treatment for CFC taxes. These delegates were primarily concerned with the added complexity of separating CFC income from other income and calculating separate carry-forwards for CFC income.

However, a number of delegates expressed concern about the treatment of cross-jurisdictional taxes on passive income, especially withholding taxes. These delegates noted that the majority of the complexity is in the computation of the CFC tax or net-basis dividend taxes paid by the shareholder, rather than the separation of the CFC’s income for purposes of computing the GloBE ETR. Furthermore, that complexity is absent in the case of a withholding taxes, which these delegates consider to be the primary tool for manipulating the ETR of low-taxed jurisdictions.

Both of these group of delegates consider that the primary risk that needs to be addressed in the design of these rules relates to passive income. The design challenge is to minimize that risk without creating undue complexity. Described below is an approach that could be applied to address the risks of passive income with a minimum of added complexity.

Proposed solution.

Under the proposed rule, in any case in which withholding taxes and CFC taxes are imposed at a rate that equals or exceeds the minimum tax rate, these amounts would be excluded from all ETR

computations and the GloBE tax base for the jurisdiction of the entity that earned the relevant income. If withholding or CFC taxes are imposed at a rate below minimum tax rate, the taxes are assigned to the jurisdiction of the entity that earned the income under the normal rules described in section 3.6.2.

Because the principal concern arises from payments that are subject to withholding taxes and CFC rules, the scope of the rule can be limited to dividends, interest, rents, royalties, annuities, and similar items that are subject to a withholding tax or a CFC tax. This targets the problem at cross-jurisdictional taxes on highly-mobile passive income without engaging in a difficult line drawing exercise that may be inconsistent with the treatment under the local tax law of some jurisdictions. Linking the definition to the imposition of a tax makes sense because the purpose of the limitation is to prevent taxes actually paid from raising the ETR on other income. Moreover, the definition would be relatively simple for tax administrations to audit.

The amount of income to be excluded in the case of a withholding tax would be the amount of income subject to the withholding tax. Similarly, the amount of income to be excluded in the case of a CFC charge would be the amount of passive income subject to the CFC charge. Interest expense arising in the jurisdiction would also be excluded from the ETR computation and the GloBE tax base for the jurisdiction to guard against situations in which a taxpayer debt-funded the passive income and the related interest expense reduces other income in the jurisdiction possibly increasing the ETR on that other income. Because the rule is aimed at highly-mobile passive income, which generally does not have much in the way of related expenses apart from interest, it does not appear necessary to develop detailed expense allocation rules.

The amount of withholding tax on the relevant income is easily determinable. The amount of CFC taxes paid by the shareholder in the aggregate, however, would need to be determined before they can be assigned to the CFC's jurisdiction.⁸⁵ And once, determined would need to be allocated between CFC taxes on passive income and other income. Presumably, the shareholder's jurisdiction has a methodology for determining the net income of the CFC that is subject to the CFC rules. The shareholder could determine the tax it paid based on this information, and then prorate the tax between the passive income and other CFC income. If a single constituent entity is subject to multiple CFC regimes on its income, then the largest amount of its income subject to a CFC regime in that period could be used for the computation of the cap.

The proposed rule adopts an exemption approach rather than a separate computation and carry-forward approach to withholding taxes and CFC taxes because an exemption approach is simpler to apply. A carry-forward approach would require a separate IIR tax credit and local tax carry-forward to be tracked for each jurisdiction in which the MNE Group pays withholding tax on passive income or is subject to a CFC regime. Tracking separate carry-forwards would add significant complexity and administrative burden.

Questions for delegates

1. Do delegates support a limitation or cap on cross-jurisdictional covered taxes on passive income for purposes of computing the ETR on passive income and other income in a jurisdiction?
2. Do delegates have views on whether a carry-forward approach that separately tracks IIR tax credits and local tax carry-forwards for passive income is needed to implement the limitation or cap?

3.7. Mechanisms to address temporary differences

Temporary differences

Loss carry-forward

Losses in a jurisdiction may be carried forward and allowed as a deduction in the computation of the GloBE tax base in the subsequent year, thereby reducing the GloBE tax base in that year or increasing the loss carry-forward arising in that year. Losses are defined as the excess of expenses over income included in the GloBE tax base of the jurisdiction.

Pre-regime losses

Losses also include aggregate losses that are incurred by a Constituent Entity over the [three] year period prior to the MNE Group becoming subject to the rules (excluding any loss from the disposal of an investment) provided such losses were (or would have been) reflected in a corresponding adjustments to the equity of the MNE Group.

Excess taxes

Excess taxes in a jurisdiction for a year may create an IIR tax credit, a local tax carry-forward, or both. Excess taxes are defined as the amount of covered taxes paid during, or reflected as due and payable in the tax returns of constituent entities in respect of, a year in excess of the minimum tax rate on the aggregate GloBE tax base for a jurisdiction for that year.

IIR tax credit

Excess taxes in a jurisdiction create an IIR tax credit to the extent of IIR tax paid in the preceding [X] years in respect of the same jurisdiction that has not given rise to an IIR tax credit. An IIR tax credit can be used to reduce the shareholder's IIR tax liability in respect of any jurisdiction arising in the year the IIR tax credit was created or within [X] years of such year.

Local tax carry-forward

Excess taxes in a jurisdiction that do not create an IIR tax credit create a local tax carry-forward that may be carried forward [X] years and treated as tax expense for that jurisdiction in a subsequent year in which the local tax paid by the constituent entities falls below the minimum tax rate.

Ordering rule

In determining the shareholder's GloBE tax liability under the income inclusion rule, an IIR tax credit is applied before a local tax carry-forward.

Modification to determination of annual depreciation expense

Depreciation expense allowed with respect to tangible property of a constituent entity in computing the GloBE tax base may be determined using the depreciation rates and accounting conventions allowed in the computation of taxable income in the constituent entity's tax jurisdiction.

Modification to tax expense computation for entities subject to a distribution-based corporate income tax

⁸⁵ The amount of CFC tax arising in respect of foreign income must be determined on a reasonable and consistent basis. For example, an MNE may choose to adopt a precise approach to calculating CFC taxes that would take into account foreign tax credits allowed, and domestic expense allocations required, by the shareholder's jurisdiction in the income tax computation. Alternatively, CFC regime taxes imposed in the shareholder's jurisdiction could be determined using a simplified ratio. For example, the CFC regime taxes could be determined by multiplying the total taxes paid by the shareholder by the ratio of taxable CFC income to total taxable income reported in the shareholder's tax return.

A shareholder of a constituent entity that is subject to a corporate income tax on distribution of its income may elect to increase the tax expense included in the numerator of the GloBE ETR fraction of the constituent entity's tax jurisdiction by an amount equal to the minimum tax liability (determined without regard to the increase) in the year the income is earned (deemed minimum tax). The subsidiary must recapture the amount of such deemed minimum tax to the extent that corporate income tax is not paid upon distribution of income within [X] years after the year in which the income was derived. This rule only applies in the case of a corporation that is subject to corporate income tax on distributions at a rate that equals or exceeds the agreed minimum tax rate.

Post-filing adjustments to tax liability

For purposes of computing the GloBE ETR of the income assigned or allocated to a jurisdiction, post-filing increases (or decreases) to a constituent entity's liability for a covered tax are treated as adjustments to the entity's tax expense or carry-forwards in the year in which the tax increase (or decrease) is finally determined.

Transfers of tax attributes

Losses and local tax carry forwards are tax attributes of the MNE Group and cannot be transferred or used by a person outside the Group. However where there is a change in the control of a Constituent Entity in a transaction that includes a transfer of deferred tax assets, the buyer and seller may agree an adjustment to the amount of their losses or local tax carry forwards in the jurisdiction of that Constituent Entity provided such adjustment is consistent and in line with the actual effect of the transfer for local tax purposes.

3.7.1. Introduction

329. Temporary differences are differences in the timing of the recognition of income and expense under financial accounting and tax accounting rules. They are not differences in the types of income or expense allowed in the calculation of net income. Instead, they are differences in the proper time for including those items in the calculation of net income.

330. Temporary differences can be the sole cause of a low ETR at the beginning of the temporary difference and a high ETR upon reversal, and vice versa. They have an effect on the periodic measurement of the ETR but do not affect the average ETR over the life of the entity.

331. Temporary differences should not give rise to permanent tax liability under the GloBE rules. Therefore, a mechanism to address the effects of temporary differences on the ETR and the GloBE tax liability are necessary.

332. The effects of temporary differences on the GloBE tax base and the ETR computation are not unique to jurisdictional blending. However, the need for a mechanism to address the effects of temporary differences is most acute in a jurisdictional blending model. Under a worldwide blending model, temporary differences in one jurisdiction may be offset by an equal and opposite temporary difference in another jurisdiction. Under jurisdictional blending, the effects of temporary differences are confined to the jurisdiction in which they arise. Accordingly, this paper discusses approaches to addressing the effects of temporary differences in the context of the income inclusion rule within a jurisdictional blending model. While the discussion focuses on the application of the income inclusion rule, similar principles can be applied in the context of the undertaxed payments rule. Generally, the loss carry-forwards and local tax carry-forwards will be taken into account to determine the jurisdictional ETR under the undertaxed payments rule as well. However, a tax credit similar to the IIR tax credit will not be available to recoup taxes paid in prior years due to the undertaxed payments rule.

333. Temporary differences can be addressed under the GloBE rules using a carry-forward approach or a deferred tax accounting approach. From a time value of money perspective, deferred tax accounting generally is more favourable to taxpayers because it leaves in place the benefits of immediate expensing of assets, accelerated depreciation, and other tax deferral mechanisms that are commonly adopted by jurisdictions to encourage capital investment and for other reasons. The basic carry-forward approach with some modifications can preserve the most significant of those benefits but does not wholly align with the tax deferral benefits allowed in every local jurisdiction.

334. The principal policy risk of deferred tax accounting, however, is that it relies on a taxpayer's estimate of future liability for tax in a subsidiary jurisdiction to determine its current liability under the GloBE rules. The carry-forward approach, in contrast, relies on actual tax liabilities existing at the time tax liability under the GloBE rules is determined.

335. The carry-forward and deferred tax accounting approaches both impose some compliance and administration burdens. On the surface, the deferred tax accounting approach appears to be simpler because taxpayers use deferred tax accounting for financial purposes already. However, differences between the policies of the GloBE rules and financial reporting will likely mean that modifications would need to be made to certain deferred tax accounting outcomes in order to adapt deferred tax accounting to the GloBE rules. These modifications would add a significant amount of additional complexity and may lead to uncertainty. Although maintaining memorandum accounts in respect of carry-forwards is somewhat burdensome, it is a familiar exercise for both taxpayers and tax administrations. Accordingly, while there appear to be some advantages with a deferred tax accounting approach the members of the Inclusive Framework do not consider that such an approach would serve as an appropriate mechanism to address timing differences. They do consider, however, that financial information on deferred tax accounting could play a useful role in the development of simplification options described below in section 3.10.

3.7.2. The carry-forward approach

336. The basic operation of the carry-forward approach relies on two carry-forwards and a credit to address the various effects of temporary differences on the GloBE tax base and ETR computation. Both carry-forwards and the credit would be tracked using memorandum accounts maintained by the shareholder that is subject to the IIR. The carry-forwards would be tracked on a jurisdictional basis.

337. Under the carry-forward approach, the covered tax expense included in the numerator of the ETR computation for a particular tax year includes only the amount of taxes reported in the tax returns filed with respect to the income of that tax year. Thus, the covered taxes in the numerator for a tax year include the taxes paid in respect of that year both during the year and with the tax return for that year to the extent those taxes are reported as payable with respect to the income for that tax year. However, any covered taxes reported in a tax return that is not paid, for example due to an administrative practice of allowing loss carry-forwards in the administrative assessment of tax rather than as part of the self-assessment in the tax return, is not included in the numerator of the ETR fraction. The covered taxes in the numerator does not include any amount of tax expense that is accrued for financial accounting purposes and that is not reported in the tax returns filed with respect to income of the relevant tax year, for example, uncertain tax positions, contested tax liabilities, and deferred tax liabilities. Finally, any amount of tax that is reported in the tax returns with respect to the income for a year that is not paid within [x] years should be treated as a reduction in covered taxes in the year [x+1]th year.

338. Limiting the covered taxes expense in the numerator of the ETR fraction to taxes reported in the tax returns for the relevant year could, in some situations, result in an MNE Group being subject to both the IIR or UTPR and the subject to tax rule in respect of a single transaction. For example, a Constituent Entity could be resident in a jurisdiction that is generally low-taxed and thus likely subject to a WHT under the STT on payments received from another Constituent Entity. A timing difference between the accrual of the income and the payment, however, could result in an ETR below the minimum rate in the year of

accrual, which would result in a top-up tax liability in the payer's jurisdiction under the IIR or UTPR. Assuming the income is actually paid the year after, the Constituent Entity would be subject to the STT as well when it received the income because it is resident in a low-taxed jurisdiction. However, if the income accrual and receipt had occurred in the same tax year, the WHT imposed under the STT would have been taken into account to compute the ETR of the jurisdiction, which could have raised the ETR above the minimum tax rate and prevented application of the IIR or UTPR. Payments subject to withholding taxes are commonly made in the year immediately succeeding the year in which the income accrues for financial accounting purposes. The IIR tax credit can adequately address this situation. However, the limited availability and use of the UTPR tax credit would result in frequent instances of double taxation on transactions subject to a withholding tax.

339. The GloBE rules ameliorate this mismatch between the income accrual and tax payment by allowing accrual of withholding taxes for income that are expected to be paid shortly after the year in which the related income accrues. Specifically, any withholding tax accrued by a Constituent Entity for financial accounting purposes on an item of income other than a distribution from another Constituent Entity that will be paid within 12 months following the end of the taxable year in which the Constituent Entity accrues the related item of income for financial accounting purposes may be included in the covered taxes expense for the year in which the income is accrued. Under this rule, a Constituent Entity that knows it will be liable for withholding tax under an STT in the year following the accrual of the relevant income will be able to include the accrued WHT levied under the STT in its covered tax expense for purposes of the jurisdictional ETR computation, with the likely result that the IIR/UTPR will not apply. The rule not limited to withholding taxes imposed under an STT rule. It does not apply, however, to withholding taxes that are accrued on distributions from other Constituent Entities.

340. In some jurisdictions, loss carry-forwards are limited to a number of years. Imposing a time restriction on the use of carry-forwards can reduce the compliance and administration burdens associated with maintaining the relevant memorandum accounts. Other jurisdictions allow loss and other tax attribute carry-forwards to be carried forward for an unlimited time period.

341. The GloBE loss carry-forward is crafted so that it is effectively unlimited in duration. The GloBE rules apply to a wide range of industries and business sectors. These industries have business cycles of different lengths, with some industries, such as the mining industry, experiencing very long business cycles. Some MNE groups or constituent entities of an MNE group that are profitable over the business cycle may be profitable in some years and not profitable in other years during the cycle. Unlimited carry forward of losses ensures that MNE groups will not be subject to tax under the GloBE rules on more than their economic income due to an expired loss carry-forward.

342. The ability to use excess local taxes to create an IIR tax credit in respect of IIR tax paid in prior years and the local tax carry-forward are limited in duration, however. This limitation does two things. First, it effectively treats a long-term deferral as a permanent difference for purposes of the GloBE rules. In other words, if a carry-forward attributable to a timing difference expires before the timing difference resolves itself, the timing difference will produce the same result under the GloBE rules as if it were a permanent difference. Second, it limits the period for which taxes that are imposed at a rate above the minimum rate can be used to shield income taxed below the minimum rate from GloBE tax liability. However, the IIR tax credit is not limited in duration, which eliminates, or significantly reduces, the possibility that IIR tax paid due to a timing difference will result in taxation under the GloBE rules.

Note for WP11 delegates

There were a wide variety of views expressed on the question of time limitations on carry-forwards. In particular, there were divergent views on the duration of the excess local tax carry-forward and the IIR tax credit. Some delegates thought a finite year limitation was appropriate, while others considered an unlimited carry-forward appropriate. Given the divergence of views expressed on this question and the need to identify a consensus solution, delegates may take the view that the position set out in the previous version of this document (unlimited carry forward of losses and a limitation on the carry forward of excess tax credits) strikes an appropriate compromise between the views expressed by delegates.

Question for delegates

Do delegates agree that an unlimited carry forward of losses and a limitation on the carry forward of excess tax credits strikes an appropriate compromise between the views expressed by delegates.

Loss carry-forward

343. The loss carry-forward is needed to prevent taxation in excess of economic income under the GloBE rules. Financial accounting does not have a loss carry-forward concept. The financial accounting income for each year is determined without regard to any losses incurred in prior years. The annual GloBE tax base computation starts with financial accounts and thus may also include income in excess of the economic income over a period. The loss carry-forward is allowed as a deduction to prevent taxation in excess of economic income.

344. The loss carry-forward under the GloBE rules is relatively straight-forward and will be familiar to many taxpayers and tax administrations. A loss carry-forward is created for a jurisdiction in any year in which the expenses taken into account in computing the jurisdictional GloBE tax base, including prior losses carried forward from previous years, exceed the amount of income taken into account in computing the jurisdictional GloBE tax base. Allowing the loss carry-forward, in its entirety, to be taken into account in computing the GloBE tax base in the succeeding year, even if it creates a new loss carry-forward, effectively means that the losses can be carried forward indefinitely. Consistent with the jurisdictional blending model, loss carry-forwards arising in a jurisdiction can only be used as a deduction in the computation of the GloBE tax base in that same jurisdiction.

345. The loss carry-forward under the GloBE rules will not generally be expected to align with rules governing loss carry-forwards in the local jurisdiction. Rather, the GloBE loss carry-forward is intended to prevent taxation in excess of economic income and recognises that an MNE should not be subject to tax under the GloBE rules on the mere recovery of prior period losses. The loss carry-forward allowed under GloBE may be inconsistent with the rules governing loss carry-forwards in the jurisdiction in which the loss arises. For example, the tax rules in the local jurisdiction may place a limitation on the amount of loss that may be carried forward or the time period for which it can be carried forward. Alternatively, the local jurisdiction may allow losses to be carried back and used against tax liabilities arising in prior years, which may generate a tax refund. Under those circumstances, the loss carry-forward for GloBE purposes may be a different amount than the loss carry-forward for local tax purposes. In addition, losses in one subsidiary may be used to offset the income of another subsidiary in the same jurisdiction in the computation of the jurisdictional GloBE tax base, while a similar type of offset may not be allowed under local tax rules. In that case, one subsidiary could have a loss carry-forward for local tax purposes even though the loss was fully deducted in computing the GloBE tax base for the jurisdiction. No adjustment is necessary to address these differences because the GloBE tax base is not trying to mirror the local tax base and any GloBE tax consequences resulting from the differences will be addressed by the local tax carry-forward and the IIR tax credit described below.

IIR tax credit and local tax carry-forward

346. The carry-forward rules are designed to smooth the ETR of the jurisdiction over a period of time, irrespective of whether fluctuations in the ETR arise from temporary or permanent differences. The GloBE rules apply when the ETR in a jurisdiction is below the minimum tax rate. Temporary or permanent differences between the local tax base and the GloBE tax base may cause the ETR in a jurisdiction to be above or below the minimum tax rate in a particular year. Over time, the temporary differences will reverse and various permanent differences may have opposite effects on the ETR. The rules effectively smooth the ETR for the jurisdiction over a period of time by allowing a shareholder to recoup GloBE taxes paid previously or avoid paying GloBE taxes in the future whenever the ETR in the jurisdiction exceeds the minimum tax rate. Specifically, whenever the tax in a jurisdiction exceeds the minimum tax rate, a shareholder that previously has paid IIR tax in respect of the jurisdiction is allowed to create an IIR tax credit to the extent the previously paid IIR tax has not already been treated as an IIR tax credit. An IIR tax credit can be used to satisfy a current or future IIR tax liability with respect to any jurisdiction.⁸⁶ If the shareholder has not previously paid GloBE tax in respect of a jurisdiction, tax paid in that jurisdiction in excess of the minimum tax rate is treated as a local tax carry-forward that the shareholder can use in the computation of its ETR for that jurisdiction in a future taxable year, which may increase the ETR of the jurisdiction up to the minimum rate in that year.

347. There will be many cases in which the tax rate in a jurisdiction exceeds the minimum rate by an amount sufficient to avoid GloBE tax liability even after taking into account a permanent difference. By incorporating mechanisms that take into account the effects of temporary and permanent differences on the computation of income and tax liabilities over a period of years, the rules neutralise the consequences stemming from application of the annual accounting concept under the GloBE rules. Although the rule is primarily aimed at temporary differences that reverse over time, it also ameliorates the effect of permanent differences because their effect on GloBE tax liability may also be due to their timing. For example, equal and offsetting, but otherwise unrelated, permanent differences would have no effect on the GloBE tax liability if they arise in the same tax year but would produce a GloBE tax liability if they arose in separate tax years. While this is not a temporary difference, it does have a timing aspect and is therefore appropriately addressed by a carry-forward of excess local taxes. In addition, rules designed to separate the amount of excess local taxes attributable exclusively to temporary differences would be very complex and unduly complicate the GloBE rules.

348. Both the IIR tax credit and the local tax carry-forward hinge on excess taxes paid in respect of a jurisdiction. The rule defines excess taxes as the amount of covered taxes reported in the tax returns of the constituent entities in the jurisdiction filed with respect to the income of a particular tax year, in excess of the minimum tax rate on the aggregate GloBE tax base for that jurisdiction for that year. If the GloBE tax base computation for a jurisdiction results in zero income or a loss for a year, any local tax paid in respect of the year would be excess taxes for that year and would be included in a local tax carry-forward. This situation could arise where, for example, the local tax base denied certain deductions that were recognised under the GloBE tax base. The definition of excess taxes is intended to ensure that the ETR is computed based on the taxes actually paid in respect of the relevant year. It does not include income taxes that are accrued, for example based on the likely disallowance of an uncertain tax position, but that are not reflected as due in the tax return filed for the year.

⁸⁶ A UTPR Tax Credit arises in the situation where (i) the UTPR was applied in respect of low-tax income of Constituent Entities located in the Ultimate Parent Jurisdiction and (ii) subsequently, tax is paid in the Ultimate Parent jurisdiction in excess of the minimum tax rate. This mechanism is further described below.

349. Under the IIR tax credit rule, in any year in which there are excess taxes in respect of a jurisdiction, the shareholder first looks back to see if it previously has paid IIR tax in respect of that jurisdiction.⁸⁷ If the shareholder has paid IIR tax in respect of any of the [X] preceding taxable years, an IIR tax credit is created. The IIR tax credit created for a year is equal to the lesser of the excess taxes for the year and the IIR tax paid during the [X]-year period that has not already given rise to an IIR tax credit. The IIR tax credit is illustrated in Annex, Example 3.7.2B. IIR tax credits can be used to reduce IIR tax liabilities arising in the year the credit is created or within [X] years thereafter.⁸⁸ Although an IIR tax credit results from a payment of IIR tax and a subsequent payment of excess taxes in the same jurisdiction, IIR tax credits can be used to reduce IIR tax liability arising with respect to any jurisdiction. The use of the IIR tax credit in respect of IIR tax liabilities arising in respect of other jurisdictions is illustrated in Annex, Example 3.7.2C.

350. Under the local tax carry-forward rule, the excess taxes for a jurisdiction that do not create an IIR tax credit create a local tax carry-forward. During the [X] year period after a local tax carry-forward is created, it may be included in the ETR computation in a subsequent year in which the local tax paid by the subsidiaries in the same jurisdiction falls below the minimum tax rate. The local tax carry-forwards can only be used to compute the ETR for the jurisdiction in which they arose and are used in chronological order. Local tax carry-forwards are reduced by the amount used to increase the local tax to the minimum tax rate in any year. The local tax carry-forward is illustrated in Annex, Example 3.7.2A.

351. If a Parent potentially subject to IIR tax liability with respect to multiple jurisdictions in the same year, it may allocate its IIR tax credits, if any, among those jurisdictions as it chooses.

352. The IIR tax credit may be used against a shareholder's IIR tax liability arising in respect of any jurisdiction in the period the credit arises or a subsequent period.⁸⁹ At first blush, the ability to credit the IIR tax in one jurisdiction against IIR tax liabilities arising in respect of another jurisdiction may seem tantamount to worldwide blending. It is not the same, however. An IIR tax credit only arises when IIR tax is paid in respect of a jurisdiction, and subsequently, tax is paid in that same jurisdiction in excess of the minimum tax rate. Conceptually, a shareholder becomes eligible for a credit of IIR tax paid in respect of a jurisdiction when it can demonstrate that the tax was paid in respect of a temporary difference in the jurisdiction that reversed after the tax payment. The carry-forward approach uses the payment of tax in excess of the minimum tax rate as a proxy for the reversal of a temporary difference.⁹⁰

353. If the timing of the income under the local tax base matched the timing of income under the GloBE tax base, there would have been no IIR tax liability in the first instance and no need for a subsequent IIR tax credit. From the taxpayer's perspective, the credit mechanism is functionally equivalent to a refund of IIR tax previously paid. However, instead of getting a cash refund from the tax administration and separately paying another IIR tax liability, the shareholder uses the credit to pay that tax liability. The fact that the credit can be used to satisfy an IIR tax liability arising in respect of a different jurisdiction does not change the analysis. Eligibility for the IIR tax credit is always rooted in a temporary difference arising and reversing with respect to the same jurisdiction or the interaction of two offsetting permanent differences in the same jurisdiction. In contrast, allowing excess taxes paid in respect of the income in one jurisdiction to create an IIR tax credit for IIR tax paid in respect of another jurisdiction would be tantamount to global blending.

⁸⁷ The payment of IIR tax includes taxes that are paid through the use of a IIR tax credit that has arisen in a previous period.

⁸⁸ Further consideration will be given to permitting IIR tax credits to reduce other tax liabilities of the shareholder.

⁸⁹ It could not be claimed in connection with a liability in another jurisdiction arising pursuant to the other jurisdiction's application of the undertaxed payments rule.

⁹⁰ The references to temporary differences in this paragraph are not meant to limit the creation or use of an IIR tax credit to situations involving a temporary difference.

Note for WP11 delegates

Enhancing the usefulness of the IIR tax credit

From a time value of money perspective, the IIR tax credit loses value the longer it goes unused. The more opportunities an MNE Group has to use the credit, the sooner it will be able to effectively recover IIR tax previously paid due to temporary differences. Thus, broadening the circumstances in which a taxpayer can use an IIR tax credit against IIR tax liabilities makes the IIR credit more useful.

In some situations, however, an IIR tax credit could essentially be stranded in an entity that is permanently unable to use it. For example, if an IIR tax credit arises in respect of an otherwise high-tax jurisdiction and the Parent does not have operations in other low-tax jurisdictions that will create an IIR tax liability that can be satisfied with the IIR tax credit, the Parent may never be able to claim its IIR tax credit. This situation may occur more often in cases where the IIR is applied by a Parent in the MNE Group other than the Ultimate Parent Entity because they apply their IIR only to Constituent Entities that they directly or indirectly own.

To reduce the instances of stranded IIR tax credits, the opportunities for using them can be expanded in two ways. The first is to allow the credit to be used against any domestic income tax liability of the Parent that has the IIR tax credit. Although styled a credit, the IIR tax credit is essentially a substitute for a refund of IIR tax paid in prior years due to timing differences. Accordingly, the credit could be applied against any tax liability of the entity paid the IIR tax arising in the entity's tax jurisdiction. Importantly, allowing the credit to be used against a covered tax liability would not reduce the amount of that covered tax for purposes of determining the jurisdictional ETR for the year the credit is allowed. This is because the IIR tax credit is simply a mechanism for refunding IIR tax; it is not a reduction of the other tax.

The second way to expand the use of the IIR tax credit is to allow a Parent in the MNE Group to use its share of an IIR tax credit created by a lower-tier Parent against its own IIR tax liability until it is needed for use in the jurisdiction in which it was created. Generally, this expansion would only be relevant where the IIR is applied by both the Ultimate Parent Entity and a Partially-Owned Intermediate Parent. However, it could become relevant if the IIR were applied by a Parent and that Parent subsequently became a subsidiary of another entity subject to an IIR, for example due to an acquisition or adoption of the GloBE rules by a higher level Parent in the ownership chain. In such cases, a Parent may create an IIR tax credit and another Parent that owns an interest in that intermediate Parent may incur an IIR tax liability. The Parent with the IIR tax liability could be allowed to use the portion of the IIR tax credit that belongs to the MNE Group to reduce its own IIR tax liability. If the Parent that created the IIR tax credit has a subsequent IIR tax liability, it can use its entire IIR tax credit, but to prevent the double use of the IIR tax credit, the Parent that "borrowed" the credit must then pay the IIR tax in its jurisdiction that would have been owed absent the borrowed IIR tax credit. The tax administrations of each jurisdiction will need to cooperate to guard against double-counting of the IIR tax credit.

These two expansions are not mutually exclusive. However, a borrowed IIR tax credit could be restricted so that it could only be used to reduce an IIR tax liability of the borrowing Parent and could not be used against another covered tax liability of the borrowing Parent. Such use would reduce the real covered tax of the borrowing Parent and could result in the Parent's jurisdiction becoming a low-tax jurisdiction.

Question for delegates

1. Do delegates have views on whether jurisdictions adopting the GloBE rules should be permitted to allow the IIR tax credit to be used against other tax liabilities arising in the jurisdiction of the Parent with the IIR tax credit?

2. Do delegates have views on whether a Parent should be permitted to use a tax credit arising due to another Parent's application of the IIR with a requirement to pay the corresponding IIR tax in its jurisdiction if the Parent that created the IIR tax credit subsequently uses the IIR tax credit against its own IIR tax liability?

UTPR tax credit

Note for WP11 delegates

The previous version of the UTPR Chapter [[CTPA/CFA/WP11/NOE\(2020\)16/REV1](#)] identified the issue that can arise when the UTPR is applied in respect of low-tax income of Constituent Entities that pay excess taxes in subsequent years. Unlike the IIR, the UTPR does not create a credit under those circumstances to be used in the UTPR jurisdiction against future UTPR tax liabilities.

A rule designed to allow for a UTPR tax credit to offset future UTPR tax liability in the UTPR jurisdictions would be extremely complex. This is because the UTPR tax may be allocated across multiple jurisdictions and may not be imposed in full in the year it is allocated (see below the section on the timing of the UTPR adjustment). Therefore, reversing the UTPR adjustment requires the taxpayer to have information on:

- (i) each low-tax jurisdiction that subsequently has excess taxes; and
- (ii) the extent to which top-up tax had previously been allocated to that taxpayer in respect of the low tax outcome in that jurisdiction; and
- (ii) the extent to which that UTPR tax adjustment has been made in respect of the amount allocated.

This could also give rise to further coordination complexity, for instance, in the case of a partial increase of the ETR in the low-tax jurisdiction, which would only allow for a partial reversal of the UTPR adjustment (e.g. would that partial reversal be required first from the UTPR jurisdictions that already imposed the full UTPR adjustment or would it be apportioned across UTPR jurisdictions further to the allocation keys that were used to apportion top-up taxes).

If the UTPR applied in respect of low-tax income of Constituent Entities located in more than one jurisdiction, but excess taxes were paid subsequently in only one of them, these coordination questions would be even more complex to resolve and require close coordination across UTPR jurisdictions to avoid double counting of UTPR tax credits.

On the other hand, delegates have urged simplification of the UTPR where possible. Simpler solutions seem to be more promising and could achieve a similar outcome from an MNE perspective in most situations.

In the case of UTPR taxes imposed in respect of low-tax income of Constituent Entities located in subsidiary jurisdictions, the MNE Group could adjust its group holding structure in order to bring a low-tax Constituent Entity within the scope of an applicable IIR and benefit from IIR tax credits where relevant. However, in the case of UTPR taxes imposed in respect of low-tax income of Constituent Entities located in the Ultimate Parent Jurisdiction, such restructuring would not be possible.

Therefore, the solution that was suggested in the previous version of the UTPR Chapter is that the top-up tax that was imposed under the UTPR in relation to low-tax income of the Constituent Entities located in the Ultimate Parent Jurisdiction ("UTPR taxes") would be deducted from potential IIR tax liabilities of the Constituent Entities located in the Ultimate Parent Jurisdiction in the period where the Ultimate

Parent Jurisdiction has excess taxes (UTPR Tax Credit mechanism). This UTPR Tax Credit mechanism, which was discussed at the 22 July WP11 meeting, is further described below.

Delegates raised concerns in relation to this mechanism since it could be seen as depriving the Ultimate Parent Jurisdiction of its own right to tax the Ultimate Parent Entity's subsidiaries under the IIR because it is forced to provide a credit for UTPR taxes collected in subsidiary jurisdictions in respect of low-tax income that arose in that Ultimate Parent Jurisdiction. Ultimate Parent Jurisdictions could, however, avoid that outcome by introducing a domestic minimum tax (see section 3.9 below), which would avoid any application of the UTPR in respect of the low-tax income of Constituent Entities located in the Ultimate Parent Jurisdiction.

On balance, the UTPR Tax Credit mechanism seems to provide a relatively simple solution to the issue that can arise when the ETR of the Ultimate Parent Jurisdiction is lower than the minimum rate because of a timing difference. It further reinforces the UTPR's role as a backstop to the IIR because:

- It does not apply in respect of low-tax income of Constituent Entities located in subsidiary jurisdictions which provides an incentive for the MNE groups to adjust their holding structure in order to bring its low-tax Constituent Entities within the scope of an applicable IIR, and
- It provides an incentive for the MNE groups to be headquartered in a jurisdiction that either adopted the IIR to be able to use potential UTPR tax credits or that introduced a domestic minimum tax to avoid being subject to the UTPR in respect of low-tax income arising in the parent jurisdiction.

354. The UTPR tax credit arises when top-up tax is paid in respect of a low-tax Constituent Entity located in the Ultimate Parent Jurisdiction in one year and the MNE Group pays local tax in excess of the minimum tax rate in that jurisdiction in a subsequent year. In this situation, the Constituent Entity applying the IIR in the Ultimate Parent Jurisdiction is allowed to create a UTPR tax credit to the extent that top-up tax was previously paid pursuant to the UTPR in respect of the Constituent Entities in the jurisdiction of the Ultimate Parent Entity and not already treated as a UTPR tax credit. Under such mechanism, the Constituent Entity in the parent jurisdiction that is liable for IIR taxes would be allowed to use such a UTPR tax credit, to satisfy a current or future IIR tax liability with respect to any jurisdiction. In this way, at the group level, the UTPR taxes imposed in relation to low-tax profits made in the Ultimate Parent Jurisdiction would be treated similarly to IIR taxes.

355. The UTPR tax credit is different from the IIR tax credit in several ways. First, it only arises in respect of low-tax income of Constituent Entities located in the jurisdiction of the Ultimate Parent Entity. The UTPR Tax credit mechanism would only apply in instances where (i) the UTPR was applied in respect of low-tax income of Constituent Entities located in the Ultimate Parent Jurisdiction and (ii) subsequently, tax is paid in the Ultimate Parent jurisdiction in excess of the minimum tax rate. Second, the UTPR tax credit can only be used to reduce an IIR tax liability arising in the jurisdiction of the Ultimate Parent Entity and not an IIR tax liability arising in another jurisdiction. Transitional rules and adjustments for acquisition and disposal of Constituent Entities

*Transitional rules and adjustments***Note for WP11 delegates**

The document [CTPA/CFA/WP11/NOE\(2020\)13/REV1](#), which was discussed by WP11 delegates at their virtual meeting on 25 and 30 June 2020, included proposals for transitional rules that would take into account losses or excess taxes paid in the years prior to the MNE group becoming subject to the GloBE rules. That proposed rule took into account pre-regime losses in the computation of the GloBE tax base. The rule provides that where an MNE Group first becomes subject to the GloBE rules, the MNE can recognise, on a jurisdictional basis, any operating losses (i.e. losses incurred other than on the disposal of assets held for investment) incurred in that jurisdiction as carry-forward losses for the purposes of the GloBE tax base.

As part of the discussions at the meeting, further consideration was given to whether it was also necessary to take into account excess taxes paid in prior years. The changes to this section describe a further transitional rule for addressing this issue.

Question for delegates

- (a) Do delegates agree with the further proposal for the treatment of accelerated taxes paid prior to the introduction of the GloBE rules?
- (b) Do delegates have further comments on the treatment of pre-regime losses and accelerated taxes paid?

356. There are a number of events that could trigger the application of the GloBE rules to an MNE Group for the first time. Where an MNE Group already has revenues in excess of the revenue threshold, it will become subject to the GloBE rules once they have been introduced into the domestic law of a jurisdiction in which the MNE Group operates. Smaller MNE Groups, however, will become subject to the GloBE rules for the first time if they grow their revenues above the threshold, either organically or as a result of a merger or acquisition.

357. At the point an MNE Group becomes subject to the GloBE rules, it will be required, under a jurisdictional blending approach, to compute the ETR on its income in each jurisdiction where it operates and compare it to the agreed minimum tax rate. Failure to take appropriate account of operating losses that the MNE Group has suffered in the period or periods immediately prior to becoming subject to the GloBE rules could, however, result in a distorted picture of the MNE Group's tax position in that jurisdiction and may subject the MNE Group to taxation in excess of its economic profit. For example, a Constituent Entity may have incurred operating losses in the years immediately prior to the MNE Group becoming subject to the GloBE rules. These losses will be reflected as a reduction in the equity or retained earnings of the MNE Group. Further, the MNE Group may have provided the Constituent Entity with financial support to cover these losses in the form of additional equity funding, intra-group loans or guarantees of third party debt. Frequently, the operating losses of the Constituent Entity will also be recognised for local tax purposes and these losses may be eligible to be carried forward and be available to reduce taxable income arising in a future period in the same jurisdiction. Ignoring the effect of these prior period losses under the GloBE rules would mean that the MNE Group could be subject to an immediate GloBE tax on profits arising in subsequent periods despite the fact that, the local tax jurisdiction is otherwise a high-tax jurisdiction and that the income subject to charge under the GloBE rules, represents, from the MNE Group's perspective, a recovery of prior losses. Failure to take appropriate account of pre-regime losses could therefore result in the MNE Group being overtaxed on its investment, by converting what was essentially a difference in the recognition of timing of profit and loss into a permanent difference based on the arbitrary fact that the MNE Group was brought within the scope of the GloBE rules after those losses arose.

358. Another transition-related issue relates to timing differences that arise prior to the MNE Group being subject to the GloBE rules. Of particular concern are those timing difference that result in the acceleration of taxes paid prior to an MNE Group being subject to the GloBE rules, which then reverse after the MNE Group is subject to the GloBE rules. Absent a corrective rule, the result would be a lower GloBE ETR in the year(s) of reversal and thus potential GloBE top-up tax in those years, despite the fact that the local tax jurisdiction is otherwise a high-tax jurisdiction.

359. In order to address these concerns, the GloBE rules incorporate transitional provisions that take appropriate account of losses suffered by a Constituent Entity in prior years and timing differences that led to accelerated taxes paid in prior years.

Pre-regime losses

360. Starting with pre-regime losses, the GloBE rules allow a carry-forward of pre-regime losses, but the carry-forward is limited to recent operating losses in order to avoid taking into account historical losses from many years ago that have become permanent as a result of a change in the entity's operations. The carry-forward of pre-regime losses should only apply to the extent the loss was taken into account as a reduction in the equity of the MNE Group at the consolidated level. At the same time, some simplification is required in the computation of the carry-forward. In particular, it would be unduly burdensome to require each Constituent Entity to re-calculate its prior year income and taxes in line with the GloBE principles in order to determine the appropriate amount to be carried forward into the determination of the GloBE tax base.

361. The provision allowing for the recognition of pre-regime losses allows the Constituent Entity to recognise and carry forward any net operating losses that arose over the [three] year period prior to the MNE Group becoming subject to the GloBE rules. Operating losses exclude any loss from the disposal of investments. The carry-forward only applies to the extent such losses were (or would have been) reflected in a corresponding reduction in the equity of the MNE Group. This means that if the Constituent Entity with operating losses is acquired by the MNE Group one year prior to the MNE Group becoming subject to the GloBE rules, then the amount of the loss carry-forward will be limited the losses arising in the last year before the GloBE rules apply.

Accelerated taxes

362. To address the issue of pre-regime accelerated taxes, the GloBE rules allow the aggregate amount of pre-regime accelerated taxes paid by Constituent Entities within a jurisdiction to be treated as an excess tax carry forwards. The amount of pre-regime accelerated taxes should be equal to the excess, if any, of the amount of deferred tax assets recorded by a Constituent Entity for financial accounting purposes (computed without regard to any net operating losses) reduced by the amount of deferred tax liabilities recorded by the Constituent Entity for financial accounting purposes during the same period. The result is an MNE Group can treat its net deferred tax asset position as a local tax carry-forward, which helps align book and tax and reduce instances of MNE Group's paying top-up tax due to the reversal of a timing difference that arose prior to the GloBE rules.

Adjustments for acquisition and disposal of Constituent Entities

Note for WP11 delegates

The document [CTPA/CFA/WP11/NOE\(2020\)13/REV1](#), which was discussed by WP11 delegates at their virtual meeting on [date], 2020, noted that carry-forwards are calculated on a jurisdictional not an entity basis and are associated with the MNE Group as a whole rather than with any particular Constituent Entity. Therefore, it was noted that there would not typically be any adjustment needed to the amount of carry forward losses or excess taxes in the event of the acquisition or disposal of a Constituent Entity. It was noted, however, that in a narrow range of cases the risk of double, over-or under-taxation could arise when a Constituent Entity enters or exits an MNE Group.

The rule proposed in this section addresses this risk by requiring the buyer and the seller to adjust the amount of any carry forward losses or excess taxes by the amount of the deferred tax asset retained by the target company immediately following the sale.

The rule is a narrow exception to the rule that generally treats carry-forwards as tax attributes of the MNE Group however it creates a limited adjustment intended to address the risk of mismatches. The rule is designed to be straightforward for both the buyer and seller to apply without requiring a significant amount co-ordination between the parties.

Question for delegates

- (a) Do delegates agree with the proposal for the treatment of carry forward losses and excess taxes in the event of a sale of a target company?
- (b) Do delegates have further comments on this section?

363. In addition to rules dealing with what happens when an MNE Group enters the GloBE regime for the first time, further rules are required to address the situation where Constituent Entities join or leave an MNE Group that is already subject to the GloBE rules. The ability to transfer the benefit of carry-forwards from one MNE Group to another can be expected to be more restricted under the GloBE rules than ordinary tax rules because the GloBE carry-forwards are determined and applied on a jurisdictional basis. Thus, under the GloBE rules the carry-forwards are strongly associated with the MNE Group as a whole than with a Constituent Entity. Nevertheless, there are cases where part of the consideration for the sale of a Constituent Entity can include the benefit of certain deferred tax assets such as carry-forward losses or the benefit of taxes paid in advance of income which are available to reduce tax on future income.

364. The ability to carry-over the tax attributes of a Constituent Entity on a sale or disposal is a question of local law design. Many jurisdictions have shareholder continuity rules that prevent a company from carrying forward the benefit of a credit, loss, or other relief where there is a change in control. However, these rules are not comprehensive. They may require a significant change in shareholding before they apply and they would not, for example, typically prevent a company carrying forward the benefit of tax pre-payment or the tax paid on accelerated income. The ability to carry over the target company's local attributes in a sale transaction could, in the absence of a corresponding adjustment under the GloBE rules give rise to the risk of double, over-or under-taxation.

365. For example this situation could arise where a Constituent Entity such as a company, that is entitled to retain certain accrued tax benefits (such as carry-forward losses), is sold to an independent purchaser. If the target company derives income in a period subsequent to the transfer then that income will be sheltered by the carry-forward losses that are available under local law. Unless the GloBE rules recognise the transfer tax benefits that are permitted for local law purposes then:

366. The seller could effectively double dip on the value of the transferred tax losses through increased consideration for the sale of the target shares and by using the losses that it is treated as retaining under the GloBE rules to shelter other low-tax income

367. The buyer could suffer economic double taxation in the form of an increased purchase price for the target company shares and a tax charge under the GloBE.

368. The rule proposed in this section addresses this risk by requiring the buyer and the seller to adjust the amount of any carry forward losses or excess taxes by the amount of the deferred tax asset retained by the target company immediately following the sale. The GloBE rules require the buyer and seller to identify those deferred tax assets that are in fact transferred to the buyer under local law and to make a corresponding adjustment to the amount of the carry-forward to recognise the effect of the transfer.

369. For example, if a target entity has historical net operating losses and the jurisdiction of the target allows the buyer to carry-over the target's historical losses to reduce future taxable income, then the buyer is allowed to include the target's historical losses in its GloBE loss carry-forward in the jurisdiction of the target. Commensurately, the seller is required to reduce its loss carry-forward in the same jurisdiction.

3.7.3. Modification to address immediate expensing and accelerated depreciation of assets

Note for WP11 delegates

At the 3 July 2020 WP11 meeting, delegates discussed proposals for special treatment of accelerated depreciation in the GloBE tax base computation. A number of delegates advocated for special rules to address the significant timing differences that arise in connection with accelerated depreciation and immediate expensing of tangible assets.

Accelerated depreciation and immediate expensing are investment incentives commonly offered by IF jurisdictions. However, the timing differences attributable to accelerated depreciation and immediate expensing of tangible property are likely to produce frequent and significant IIR tax liabilities. The carry-forward rules for addressing temporary differences may, in some cases, be inadequate to deal with accelerated depreciation. An IIR tax credit arises when the MNE Group pays taxes in a jurisdiction in excess of the minimum tax on that year's income and has previously paid IIR tax in respect of that jurisdiction. Regular reinvestments in tangible assets used in a business will often reduce taxes paid in subsequent years such that an excess of local taxes to create an IIR tax credit does not arise for extended time periods.

If the period for creating an IIR tax credit in respect of IIR tax paid is limited in duration under the GloBE rules, a temporary difference could turn into a permanent difference due to normal business reinvestments. This result seems particularly inappropriate under the GloBE rules because investments and re-investments in tangible assets are generally not considered to pose any BEPS risks.

Delegates noted that any special rules for addressing accelerated depreciation would be elective and therefore taxpayers would not be compelled to take on additional complexity unless they chose to themselves. These delegates acknowledged that special rules would increase the burden on tax administrations but suggested that simplification measures be explored to alleviate that burden.

Some delegates expressed reservations about modifications to address immediate expensing and accelerated depreciation of tangible assets. These delegates generally considered that temporary differences arising from the use of the financial accounting rules should be dealt with exclusively through

the proposed carry-forward mechanisms. These delegates raised concerns over the complexity of an approach that would require modifications based on the local tax rules for depreciation, and the additional administrative and audit challenges this would involve. In particular, these delegates are concerned that this type of approach would require additional rules for accurately calculating gains or losses from asset sales based on the difference between the sale proceeds and the adjusted accounting carrying value for an asset, taking into account depreciation deducted at tax depreciation rates, rather than the accounting gain or loss.

In order to address these concerns the Secretariat was asked to explore simplification options that could alleviate some of the complexity for taxpayers and administrative burden for tax administrations, including options that leverage deferred tax accounting adjustments made by the MNE. Accordingly the Secretariat has developed the following options that could address delegates' concerns about complexity and administrability.

The first option is based on deferred tax accounting. Under this option, the MNE Group would increase the covered taxes in the jurisdiction by the amount of the deferred tax liability associated with the accelerated depreciation or immediate expensing of assets during the year. The carry-forward approach to addressing temporary differences was preferred over deferred tax accounting, in large part, due to the need to make estimates and judgments associated with establishing deferred tax assets and liabilities. However, the deferred tax liabilities arising from accelerated depreciation or immediate expensing of assets is expected to be more straightforward because the timing differences are easily determined at the time the asset is acquired. However, some accounting systems may establish deferred tax liabilities related to depreciation taking into account other related items of income and expense, such as differences in capitalized costs for financial and tax purposes further consideration may need to be given to whether further adjustments were required to the calculation of the deferred tax liability that arises for accounting purposes to determine the amount that would be taken into account for GloBE purposes.

The second option is to provide for immediate expensing of all assets for purposes of the GloBE rules. This would require a couple of permanent adjustments to the financial accounting income. First, the entire cost of an asset would be deducted for GloBE purposes in the year the asset is acquired. Second, the financial accounting depreciation expense on all tangible assets would be excluded from the computation of the GloBE tax base to prevent double deduction of the assets' costs.

This two-part adjustment, however, would only work for assets that are not used in the production of inventory. The depreciation expense attributable to those assets is included in inventory costs and recovered through cost of goods sold. This could be addressed by excluding the depreciation expense portion of cost of goods sold from the computation of the GloBE tax base. However, taxpayers may not be able to accurately determine the amount of depreciation cost included in cost of goods sold each year.

Another way to address the potential double counting due to inventory costs would be to amortize the cost of the assets used to produce inventory back into income over their useful life or a specified period and make no adjustment to cost of goods sold. The income inclusion would effectively nullify the second deduction of the inventory cost through the cost of goods sold. The design of this option could be adjusted to provide something more like accelerated depreciation than immediate expensing, for example, by allowing immediate expensing of half the cost of the asset and disallowing half of the depreciation expense in subsequent years. An advantage of the second option is that it creates a level playing field for all jurisdictions because the impact of the accelerated deduction on the real effective tax rate is not dependent upon the tax rules in each local jurisdiction. It also provides the benefit of accelerated deductions in jurisdictions that do not have an income tax.

Question for delegates

- (a) Do delegates agree that the GloBE rules should take account of impact of accelerated depreciation on the ETR
- (b) Do delegates have any comments on either of the design options set out by the Secretariat?

370. Immediate expensing and accelerated depreciation of business assets is one of the most common income tax incentives offered by jurisdictions. Consequently, these tax incentives likely will be a common cause of significant temporary differences. These tax incentives may cause the ETR in the jurisdiction to fall below the minimum tax rate, producing tax liability under the income inclusion rule, and resulting in significant and frequent IIR tax paid and ultimately IIR tax credits. The GloBE tax liability arising from this temporary difference will disgorge the tax benefits intended by the tax incentive. Furthermore, in capital-intensive businesses, there is a significant risk that continuous re-investments in assets may prevent the use of the IIR tax credits for an extended period of time and perhaps for the life of the business, potentially leading to over-taxation.

371. There are several alternative approaches to avoid a proliferation of IIR tax credits and potential over-taxation under the carry-forward approach due to immediate expensing and accelerated depreciation of capital assets. One approach would be to adopt something like a deferred tax accounting methodology with respect to depreciable property that is eligible for immediate expensing or accelerated depreciation for tax purposes. Deferred tax accounting neutralises the effect on the ETR of immediate expensing and accelerated depreciation for tax purposes, just like any other temporary difference. Indeed, some of the strongest support for deferred tax accounting in the public consultation came from capital-intensive businesses and industries. Leveraging from deferred tax accounting principles, the carry-forward approach could be modified such that the numerator of the ETR fraction (i.e., taxes paid) is increased by the deferred tax liability associated with an investment in property or accelerated depreciation during the year. To avoid the tax being double-counted in the numerator, another rule would be needed to treat the amount of the tax increase for any particular year as a reduction of tax liability in subsequent years (i.e., when the temporary difference reverses and the tax is actually paid). The reversal could be accomplished based on the deferred tax accounting for the relevant property or by simply allocating a pro rata amount to each year of the relevant asset's financial accounting depreciation period or a specified period, such as five, seven, or ten years. However, this approach also suffers from the problem of allowing the tax expense to be determined based on estimates of taxes to be paid in the future as well as the other shortcomings associated with deferred tax accounting, as described above.

372. Another approach would be to compute the GloBE tax base using the cost recovery allowance or depreciation rates and conventions that the MNE used for local tax purposes in place of the depreciation rates and conventions used for financial accounting purposes. Under this approach, the local tax depreciation rules would be applied to the carrying cost of assets as determined for financial accounting purposes. The relevant depreciation conventions would include depreciation rates, depreciation periods, and placed in service conventions. It would not, however, permit deductions in excess of the actual cost of the asset. This approach would significantly reduce temporary differences in respect of the carrying cost of depreciable property.⁹¹ The rule set out above adopts this second approach.

373. The use of the tax depreciation conventions rather than the financial accounting depreciation introduces additional complexity into the computation of the GloBE tax base and represents a departure

⁹¹ The rule simply applies the tax depreciation conventions to the carrying value of assets as determined for financial accounting purpose. It would not conform the cost capitalisation rules of the financial accounts to the cost capitalisation rules of the jurisdiction. Thus, the depreciable base of the property for GloBE tax purposes and local tax purposes may still differ, which will result in some difference in the amount of depreciation computed for each period. Conforming the capitalisation of costs to depreciable assets with the tax cost capitalisation would, in some cases, require numerous other adjustments to the timing of various expenses.

from the policy of determining the GloBE tax base using financial accounts. However, using the tax depreciation conventions would eliminate a significant temporary difference and reduce both the frequency and amount of IIR tax paid due solely to temporary differences. Overall, this modification to the financial accounts to determine the GloBE tax base is likely less burdensome from a compliance and administration perspective than a proliferation of IIR tax credits. To ensure that it is not unduly burdensome, the rule allows the MNE to elect to use the tax depreciation conventions.

3.7.4. Modification to address distribution-based corporate income tax systems

374. Some members of the Inclusive Framework have income tax regimes that impose an income tax on a corporation when the corporation's income is distributed to its shareholders, rather than when it is earned. The statutory tax rates in these jurisdictions may equal or exceed the agreed minimum rate of tax, thereby ensuring that ultimately the income is not subject to a low rate of tax. Absent a distribution, however, the income is not subject to tax in the year it is earned and included in the financial accounts.⁹² This means that it would be subject to tax under the GloBE rules as the covered tax expense for the year will be below the minimum tax rate in respect of the financial income.

375. To avoid tax liability under the GloBE rules, MNEs with subsidiaries subject to a corporate distribution tax regime would need to correctly estimate the amount of the subsidiary's GloBE tax base for the year before year-end and distribute enough earnings so that the local tax liability incurred on those earnings equalled or exceeded the minimum tax rate. For example, if the distribution tax rate were 20% and the minimum tax rate were 10%, the subsidiary would need to distribute half of its GloBE tax base before year-end in order to incur a local tax liability equal to the minimum tax liability on the relevant income. In practice, MNEs with subsidiaries in these jurisdictions would often be liable for tax under the GloBE rules, although subsequent distributions would produce IIR tax credits that could be used to satisfy other tax liabilities.

376. In order to avoid these results, the rule allows corporations that are subject to a distribution-based corporate income tax regime to increase its covered taxes for the year up to the minimum tax liability for purposes of the GloBE ETR computation in the jurisdiction, but requires the corporation to recapture the increase to the extent an equal amount of distribution tax is not paid within a specified time period. The specified time period would be truncated on a per share basis if shares of the entity were disposed by the GloBE tax group before the end of the specified number of years. Corporate income taxes paid upon distribution would be charged against the annual tax increases in chronological order. Distribution taxes paid in excess of the outstanding balance of annual tax increases in prior years would go into the ETR computation for the tax year in which paid and may create a local tax carry-forward.

377. Mechanically, the numerator of the ETR fraction (i.e., covered tax expense) is increased by the amount of the distribution tax necessary to bring the tax paid during the year (in excess of the outstanding balance of accrued minimum tax) to the minimum tax on the current year's GloBE tax base. The annual increase in covered taxes up to the minimum tax would be recorded in a memorandum account and tracked by year. Corporate income taxes paid in connection with distributions would reduce the outstanding balance of annual increases, if any, in chronological order. If the corporate income taxes paid in connection with distributions during a year exceeded the outstanding balance of annual increases at the beginning of that year, the excess would increase the numerator of the ETR fraction and reduce the amount that needed to be accrued to achieve a minimum level of tax in that year. At the end of the specified period, any outstanding balance of an annual increase would reduce the numerator of the ETR fraction, but not below zero. The reduction to the numerator of the ETR fraction essentially imposes GloBE tax liability on the unpaid accrual of minimum tax at the end of the specified period. Any amount of the outstanding balance

⁹² These tax regimes also contain rules intended to protect the jurisdiction's tax base from tax avoidance through the use of transactions, such as loans to shareholders, that are the economic equivalent of a distribution.

in excess of the numerator of the ETR fraction would create an equal amount of IIR tax liability for that year. The modification to address distribution based corporate income taxes is illustrated in Annex, Example 3.7.4A. and Example 3.7.4B.

3.7.5. Post-filing adjustments to tax liability and the GloBE tax base

378. The ETR for a jurisdiction under the carry-forward approach is determined by dividing the covered taxes in the jurisdiction with respect to that year by the GloBE tax base for the jurisdiction. However, an MNE group's liability for covered taxes may increase or decrease after the tax return for the year is filed due to various reasons. This could include a change in the amount of income recognised for local tax purpose due to an examination of the returns by the local tax authority, a review of the returns by the entity's management or tax advisers, or a loss in a subsequent period that is allowed to be carried back under applicable tax law, or a refund of tax to the taxpaying entity or its shareholder upon distribution of dividends. Increases would normally result in additional tax paid and decreases would normally result in a refund of tax (either in cash to, or as a reduction of another tax liability of, the taxpaying entity or its shareholders) after the IIR tax return for the relevant year was filed. The tax underpayments or overpayments may have impacted the shareholder's IIR tax liability and the amount of one of its carry-forwards for the corresponding tax year or its IIR tax credits. In other words, if the final tax liability had been correctly determined when the tax return was filed, the shareholder may have paid more or less IIR tax and may have established a larger or smaller local tax carry-forward or IIR tax credits.

379. The GloBE rules incorporate a carry-forward adjustment mechanism to address the effect of post-filing tax increases and decreases in subsidiary jurisdictions on the IIR tax liability and carry-forwards.

380. Under the carry-forward adjustment mechanism, the effects of a post-filing tax increase or decrease would be taken into account prospectively by adjusting the balances of the relevant carry-forwards when the increase or decrease is determined with finality. For this purpose, determined with finality means that the period for disputing the tax adjustment has expired either due to the passage of time or due to an administrative or judicial determination. For example, a payment of tax based on an administrative assessment to avoid additional interest expense while a claim is being litigated is not a final determination, but the judicial determination is a final determination when the time for appealing the decision expires without an appeal. Although the post-filing tax increase or decrease is primarily treated as an adjustment to the carry-forwards that arose in prior periods, the effect of those adjustments will be on the MNE's current and future tax liability under the GloBE rules.

381. Under the carry-forward adjustment mechanism, a tax decrease or refund in a jurisdiction would be treated as reduction in the amount of the relevant local tax carry-forward. Because local tax carry-forwards are limited in duration, they will need to be tracked based on the year in which they were created. Sometimes, a local tax carry-forward created for a year will have been used to reduce IIR tax liability in a subsequent year before it is discovered that the carry-forward was overstated. Rather than sifting through and unwinding all of the effects of the over-stated carry-forward in subsequent years, a local tax decrease should be treated as:

- a. a decrease in the outstanding balance of the local tax carry-forward for the year to which the refund relates, if any;
- b. a decrease in the outstanding balance of local tax carry-forwards established for subsequent years, to the extent thereof;
- c. and then, a reduction to the tax expense for the year in which the decrease becomes final, to the extent thereof.

382. If the tax decrease exceeds the local tax carry-forwards described in (a) and (b) and the tax expense for the year, the excess should be treated as a current liability for IIR tax because it represents

IIR tax that should have been due in respect of a prior year. If a tax decrease or refund does not relate to a specific taxable year, for example because it arises upon distribution of a dividend, the decrease or refund should be treated as a reduction of the current year tax liability to the extent thereof, and then a reduction of excess taxes paid in prior years. Any amount in excess this excess amount should be treated as a current liability for IIR tax. Application of the rules in the case of a post-filing reduction in local tax liability is illustrated in Annex, Example 3.7.5A.

383. Under the carry-forward adjustment mechanism, a tax increase in a jurisdiction creates IIR tax credits to the extent of IIR tax paid in the look-back period that had not already given rise to an IIR tax credit. The excess, if any, is treated as a local tax carry-forward in respect of the year to which it relates or the last year in which IIR tax was paid. The [X] year period for using such local tax carry-forwards runs from the year in respect of which the carry-forward is established rather than the year in which the tax increase becomes final. Application of the rules in the case of a post-filing increase in local tax liability is illustrated in Annex, Example 3.7.5B.

384. In addition to errors in the computation of annual tax liability, an MNE group may occasionally make an error in the computation of its GloBE tax base. For financial accounting purposes, the MNE group generally must correct material “prior period errors” retrospectively by restating the comparative amounts for the prior period(s) presented in which the error occurred. “Prior period errors” are omissions from, and misstatements in, the consolidated financial statements for one or more prior periods. A prior period error that requires a restatement for prior periods in the MNE group’s consolidated financial statements should also be corrected in the MNE group’s GloBE tax base computations for the relevant tax years, which may in turn require an adjustment to the MNE Group’s GloBE tax liability for the respective tax year.

3.8. Computation of the ETR and top-up tax

Computation of the ETR for the Jurisdiction

The effective tax rate for a jurisdiction is equal to:

$$\text{Adjusted Covered Taxes} / \text{Adjusted GloBE Income}$$

Where,

- a. Adjusted Covered Taxes means the covered taxes assigned to the jurisdiction, except taxes attributable to income excluded from the GloBE tax base, increased by the lesser of the total local tax carry-forward or the amount of the local tax carry-forward necessary to achieve an ETR that equals to minimum rate; and
- b. Adjusted GloBE Income means the combined income and loss of all Constituent Entities located in the jurisdiction for the year decreased by the loss carry-forward for the jurisdiction.

Computation of the top-up tax for each Constituent Entity

The amount of top-up tax for each Constituent Entity in a jurisdiction is equal to:

$$\text{Adjusted GloBE Income of the Constituent Entity} \times \text{Top up Tax Percentage}$$

Where,

- a. Adjusted GloBE Income of the Constituent Entity means, in respect of the income of a Constituent Entity in the relevant period, the income of that entity as calculated for the purposes of the GloBE rules reduced by its share of any loss carry forward and of any loss suffered by other Constituent Entities in the same jurisdiction in the same period and the proportionate share of any carve-out for the jurisdiction.
- b. Top-up Tax Percentage means the excess of the minimum ETR over the ETR as calculated for that jurisdiction in the relevant period.

385. The computation of the ETR for each jurisdiction and the top-up tax for each Constituent Entity in the jurisdiction is based on the foregoing rules. This section describes the three-step process to compute the ETR for each jurisdiction and the top-up tax applicable to each Constituent Entity in a low-tax jurisdiction.⁹³ The ETR for the jurisdiction is computed first. If the ETR is below the minimum rate, a top-up tax percentage is computed. Finally, the top-up tax for each Constituent Entity in the jurisdiction is computed. After each Constituent Entity's top-up tax is computed under the rules of this chapter, liability for the top-up tax is allocated to other Constituent Entities under the income inclusion rule and the undertaxed payments rule pursuant to the rules in Chapter 4.

⁹³ Attributing a portion of the top-up tax to the each low-tax Constituent Entities Entity is necessary in situations where the profits made by some of these low-tax Constituent Entities are not covered by the UTPR. As explained under sections 4.2.2 and 4.3.2 this can be the case if an IIR applies to the profits made by some (but not all) Constituent Entities located in the low-tax jurisdiction. For instance this can be the case if the ultimate parent entity is not subject to an IIR but a sub-holding parent entity that owns some but not all low-tax Constituent Entities located in a given jurisdiction is subject to an IIR.

386. To compute the ETR of a jurisdiction that has adjusted GloBE income greater than zero,⁹⁴ the adjusted covered taxes for the jurisdiction are divided by the adjusted GloBE income for the jurisdiction. For purposes of the ETR computation, the adjusted GloBE income for the year is equal to the excess of the income for the year of Constituent Entities located in the jurisdiction over the losses for the year of Constituent Entities located in the jurisdiction and the loss carry-forward for the jurisdiction.⁹⁵ For purpose of computing the jurisdictional ETR, the income or loss of a Constituent Entity is the total income or loss of the entity, irrespective of whether the MNE Group owns 100% of the entity. If the adjusted GloBE income for a jurisdiction is zero or a loss, there is no GloBE tax liability for the jurisdiction, and any loss is carried forward under the loss carry-forward rules described in section 3.7.2. For purposes of the ETR computation, the adjusted covered taxes are the covered taxes assigned to the jurisdiction pursuant to the rules in section 3.6.2, except taxes attributable to income excluded as a permanent adjustment from the GloBE income of the Constituent Entities located in the jurisdiction, increased by the lesser of the total local tax carry-forward or the amount of the local tax carry-forward necessary to achieve an ETR that equals to minimum rate. The amount of the local tax carry-forward necessary to achieve the minimum rate is equal to the excess of the adjusted GloBE tax base for the jurisdiction multiplied by the minimum rate over the covered taxes assigned to the jurisdiction. The amount of local tax carry-forward included in the adjusted covered taxes of the ETR computation for any year reduces the amount of the local tax carry-forward available in subsequent years.

387. If, after taking into account local tax carry-forwards, the ETR is below the minimum rate, the top-up tax percentage must be computed for the jurisdiction. The top-up tax percentage is the excess of the minimum rate over the ETR for the jurisdiction.

388. Finally, the top-up tax for each Constituent Entity that has positive net income for the year in the jurisdiction is computed by multiplying the adjusted GloBE income of each such Constituent Entity by the top-up tax percentage. The adjusted GloBE income of the Constituent Entity is equal to the entity's income for the year reduced by its share of the current year losses and of the loss carry-forward arising in the jurisdiction and its share of the carve-out for the jurisdiction. The current year losses, the loss carry-forward allowed, and the carve-out for a jurisdiction are allocated to Constituent Entities proportionally based on their net income. Specifically, current year losses, the loss carry-forward allowed, and the carve-out amount determined for the jurisdiction are allocated to a Constituent Entity with positive net income based on the ratio of that entity's net income to the total net income of Constituent Entities in the jurisdiction that have positive net income for the year.

⁹⁴ A jurisdiction that has income of zero or a loss for a year is not a low-tax jurisdiction for that year.

⁹⁵ The MNE Group may have several Constituent Entities located in a low-tax Jurisdiction, all of those being referred to as low-tax Constituent Entities for the purpose of this report. It may happen that some low-tax Constituent Entities of the MNE have an ETR above the minimum rate on a stand-alone basis, but that the average MNE's jurisdictional ETR in the jurisdiction where they are located is below the minimum rate because other low-tax Constituent Entities of the MNE have an ETR below the minimum rate on a stand-alone basis. The ETR of each low-tax Constituent Entity on a stand-alone basis is only relevant to determining the aggregate top-up tax percentage in that Jurisdiction. The aggregate top-up tax percentage is then multiplied by the Adjusted Globe Income of each Constituent Entity to determine the allocable top-up tax for each Constituent Entity in that jurisdiction. The implication of this approach is that a Constituent Entity that is located in a low-tax Jurisdiction may be attributed top-up tax even in circumstances where, on a stand-alone basis, its ETR was above the minimum rate.

3.9. Simplification options

Note for WP11 Delegates

At the March and July 2020 WP11 meetings there was strong support for developing simplification measures that would reduce the complexity and administrative burden associated with complying with the GloBE rules, particularly in the context of jurisdictional blending. It was also widely recognised that this was an area that would benefit from a future and more detailed public consultation. With this in mind, this section provides language to be included in the October Report that provides an overview of the simplification options that have been considered by WP11, without concluding which, if any, of these options have been agreed. Simplification options would primarily be administrative and finalised as part of the implementation of the rules.

Question for Delegates

- (a) Do delegates have any further comments on these options?

389. During the December 2019 Public Consultation, many MNEs stressed that simplification measures are needed to reduce the complexity and administrative burden associated with complying with the GloBE rules, particularly in the context of jurisdictional blending.

390. Several submissions pointed out that large MNEs often operate in more than 100 jurisdictions and would be required to undertake the same number of ETR calculations under a jurisdictional blending approach. Other submissions expressed concern that, under jurisdictional blending, it would be necessary to compute the ETR in jurisdictions that are likely to be above the agreed minimum rate year-after-year, given the base and tax rate in these jurisdictions.

391. Against this background, the Inclusive Framework has explored several potential simplification measures, as set out below. These simplification measures would benefit from future public consultations with business and therefore no decision has been taken on which, if any, of these simplification measures to incorporate into the final design of the GloBE rules.

392. The simplification measures that have been considered in Working Party 11, include:

- a. Country-by-country reporting ETR safe-harbour;
- b. De minimis profit exclusion;
- c. Single jurisdictional ETR calculation to cover several years; and
- d. Tax administrative guidance.

393. These simplification measures could be applied at the election of the taxpayer and could be layered on top of one-another such that multiple simplification measures could be applied simultaneously. It also may be the case that different aspects of the simplification measures could perhaps be combined.

3.9.1. Country-by-country reporting ETR safe-harbour⁹⁶

394. This simplification measure would allow MNEs to leverage the work done to prepare their annual CbC report. Large MNEs are required to file a CbC report containing, among other things, certain financial

⁹⁶ It is recognised that no decision has yet been taken by the Inclusive Framework on the threshold (including the level of that threshold). The CbCR ETR safe-harbour simplification option would be impacted by this determination because

information pertaining to their allocation of global profits and tax liability. A CbC report contains jurisdictional financial information in two columns that could be useful for purposes of computing jurisdictional ETRs for the GloBE rules: (i) Profit (Loss) before Income Tax; and (ii) Income Tax Accrued (Current Year).

395. This simplification measure would likely best operate as a safe-harbour. For example, if the jurisdictional ETR based on the CbC report was above a certain threshold, which could be set above the agreed minimum rate, then no further work would be required for that jurisdiction. In other words, the filing of the CbC report would be all that is required for that jurisdiction for purposes of the GloBE rules.

396. At least two restrictions would be required. First, the simplification measure would only be available for MNEs that prepare their CbC report based on the parent's consolidated financial accounts, which is an option, but not a requirement, under the CbCR rules. Based on initial consultations, a large majority of MNEs use the parent's consolidated accounts as their CbC data source. Assuming that to be the case, restricting the use of this simplification measure based on CbC data source would not be expected to materially reduce its reach and impact. Furthermore, MNEs that do not currently use the parent's consolidated accounts could change their data source and avail themselves of the simplification measure. If this simplification measure was to create an incentive for MNEs to converge to the parent's consolidated accounts as their CbC data source it would result in the attendant benefit of improving CbC risk assessment for tax administrations.

397. The second restriction is that several adjustments would need to be made which relate to differences between the financial information reported in CbC reports and the financial information required for calculating a jurisdictional ETR in accordance with the GloBE rules. Ideally, a jurisdictional ETR could be computed by simply dividing Income Tax Accrued (Current Year) by Profit (Loss) before Income Tax as reported for each jurisdiction in the CbC report. However, the unadjusted information in these two columns will not suffice for an accurate jurisdictional ETR computation. Nonetheless, adjustments could be made to produce a reasonably reliable approximation of the jurisdictional ETR, as described below.

Required adjustments

398. Profit (Loss) before Income Tax could be adjusted as follows:

- a. Any income or loss of non-group members reported in Profit (Loss) before Income Tax under the equity method of accounting would need to be removed;
- b. Permanent adjustments required under the GloBE rules to financial accounting income would need to be added to or subtracted from Profit (Loss) before Income Tax; and
- c. Subject to ongoing public consultation and further discussion in Working Party 11, other adjustments may also be required.

399. Income Tax Accrued (Current Year) could be adjusted as follows:

- a. Withholding taxes and net basis taxes paid in respect of dividends from a group member would need to be moved from the shareholder's jurisdiction to the jurisdiction where the underlying income arose or to the distributing subsidiary's jurisdiction;
- b. CFC taxes should be assigned, where possible, to the jurisdiction in which the underlying income arises (i.e. to the jurisdiction of the CFC) and should be excluded from the ETR computation if the underlying income is excluded.⁹⁷

only groups with turnover of €750 million are required to file CbC reports. It is also recognised that the CbC threshold is currently under review.

⁹⁷ See Section 3.6.2 on *Assignment of income and taxes of entity to each jurisdiction* for the approach for the treatment of CFC income and related taxes in the ETR calculation under the GloBE.

- c. Withholding taxes paid in respect of dividends received from a corporation accounted for using the equity method would need to be removed;
- d. Covered taxes that are not income taxes for financial accounting purposes would increase Income Tax Accrued (Current Year);
- e. Refunds of tax would need to be treated as a reduction of Income Tax Accrued (Current Year); and
- f. Subject to further discussion in Working Party 11, other adjustments may also be required.

400. It is possible that some of the adjustments, as described above, could be incorporated into the actual CbCR rules. However, several of the necessary adjustments may not; and they would then need to be made in addition to what is required for CbCR.

401. Notwithstanding the required adjustments described above, starting with the CbC report and making adjustments would likely be simpler for an MNE compared to the alternative of computing the jurisdictional ETR from the ground-up. MNEs already have the systems and processes in place to efficiently and reliably compile their CbCR information. Further, some of the required adjustments may not be difficult to determine. For example, it should be relatively straightforward to determine the amount of withholding taxes on dividends paid to a jurisdiction as well as the amount of income tax refunds received from a jurisdiction. Some of the other adjustments may not be necessary to compute a “conservatively-low” jurisdictional ETR.

402. One further option could be to incorporate deferred tax accounting information into the determination of an ETR safe-harbour. This option would combine the information presently provided in the CbC report with the information on the MNE’s deferred tax accounting position in each jurisdiction where it operates, in order to provide a more accurate picture of the MNE’s expected tax liability in each jurisdiction without the burden of computing and tracking carry-forwards and tax credits. The BEPS Action 13 report includes specific instructions that Income Tax Accrued (Current Year) “should not include deferred taxes or provisions for uncertain tax liabilities”.⁹⁸ This is appropriate in the CbCR context as it focuses on the current tax in a jurisdiction for the fiscal year. However, in calculating an ETR for a particular jurisdiction, this can create a mismatch between the calculation of Profit (Loss) before Income Tax, which is calculated under financial accounting principles, and Income Tax Accrued (Current Year), which is essentially based on taxable profits calculated under tax rules in the relevant jurisdiction. The GloBE rules for addressing temporary differences compensate for this mismatch using carry-forwards and a tax credit mechanism. This option would eliminate the need to compute and track the carry-forwards and tax credits for jurisdictions in which the MNE consistently reports an ETR in excess of the safe-harbour ETR. Consideration would be required for instances in which the MNE is above the safe-harbour ETR for one or more prior years, but below the safe-harbour ETR in the current year and whether this would require the MNE to go back and compute its carry-forward attributes for the prior years.

403. As part of the CbCR 2020 review, consideration is being given to including movements in deferred tax as an additional column alongside Income Tax Accrued (Current Year). If an additional column is not added, the definition of Income Tax Accrued (Current Year) could potentially be amended, so as also to include movements in deferred tax.

⁹⁸ OECD (2015), Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
<http://dx.doi.org/10.1787/9789264241480-en>, page 34.

3.9.2. *De minimis profit exclusion*

404. Another simplification measure could consist of excluding jurisdictions from the GloBE rules which have less than a certain percentage of the MNE group's pre-tax profit. This may result in a significant reduction of compliance costs, while continuing to ensure that the GloBE rules remain effective in addressing some of the most important tax planning structures using low taxed principal or entrepreneurial IP structures.

405. Under these structures, an MNE shifts the ownership of valuable IP into a vehicle that is subject to low effective rates of taxation. The vehicle then exploits the IP and/or enters into manufacturing and/or sales and marketing arrangements with other group entities which often allow the IP vehicle to capture the full return from the exploitation of that IP. The net effect of these arrangements is that significant amounts of profits are rolled-up into the IP vehicle with the other entities in the group deriving only nominal returns.

406. The changes to the transfer pricing guidance that were introduced under Actions 8-10 of the BEPS Action Plan prevent MNEs from shifting intangible income into such IP vehicles unless they perform relevant functions in respect of the development, enhancement, maintenance, protection and exploitation of the transferred intangible (commonly referred to as DEMPE functions). The requirement imposed on the IP holding vehicle under Actions 8-10 to undertake the related DEMPE functions impedes the MNE from splitting the ownership of its valuable IP amongst a large number of different low taxed IP vehicles.⁹⁹

407. A de minimis profit exclusion rule would build on these operational constraints imposed on MNEs by Actions 8-10. It would operate by targeting the GloBE rules at only those jurisdictions above a certain de minimis profit threshold. Because IP vehicles will generally be the most profitable within the group, a low de minimis threshold, such as 2.5 percent of the group's pre-tax profit, would ensure the GloBE rules applied to all the MNE's IP vehicles while avoiding the compliance burden associated with applying the rule to every jurisdiction.

408. Effectively, this simplification measure puts a ceiling on the number of jurisdictional ETR calculations. For example, if the de minimis threshold were to be set at 2.5 percent of the group's pre-tax profit, then a maximum of 40 jurisdictional ETR calculations would be required, rather than the 100 or more calculations that may otherwise be required. In order to apply this simplification measure, MNEs would still be required to compute the pre-tax profit for every jurisdiction; however, MNEs would only need to compute covered taxes for jurisdictions with profits above the de minimis threshold. To reduce the compliance burden of computing pre-tax profit for every jurisdiction, it may be possible to use unadjusted CbC data (or potentially adjusted for the same items described in the context of the CbCR ETR safe-harbour), assuming the CbC data source was the parent's consolidated financial accounts.

409. Setting the de minimis threshold at a relatively low percentage should prevent an MNE from fragmenting its IP holdings among a large number of low tax structures in order to avoid the GloBE rules. Given the nature of the DEMPE functions required to support the transfer of the IP, it would not seem likely or commercially practical, at an operational level, for an MNE to divide its IP amongst a sufficiently large number of jurisdictions to reduce the profitability of each IP vehicle below the de minimis threshold.

410. In order to be implemented, further technical work would be required in several areas, including:

411. Whether the denominator of the de minimis calculation would be global pre-tax profit (i.e., including the parent jurisdiction) or foreign pre-tax profit (i.e., excluding the parent jurisdiction);

412. The treatment of losses, which absent an adjustment could upset the ceiling feature of the simplification measure;

⁹⁹ Since this simplification measure relies on DEMPE concepts to protect against fragmentation risk, it would only be available in jurisdictions that follow the guidance provided in BEPS Actions 8-10.

413. How to best coordinate this rule with the management of temporary differences, in particular how to deal with jurisdictions that bounce in and out of scope from year-to-year;

414. Whether further rules are necessary to neutralise the risk of fragmentation; and

415. Where to set the de minimis percentage balancing simplification with other considerations, including the overall effectiveness of the GloBE rules.

416. A de minimis based simplification measure could also be structured as fixed de minimis threshold, such as €100,000, rather than a relative de minimis threshold, such as 2.5% of group profit. The benefit of the relative threshold is it puts a ceiling on the number of jurisdictional ETR calculations for every MNE whereas a fixed threshold would apply differently across MNEs and in some cases may not result in material simplification. These two approaches could also perhaps be combined, for example, the lesser of 2.5% of group profit and €100,000.

3.9.3. Single jurisdictional ETR calculation to cover several years

417. This simplification measure would be designed to require an MNE to perform the jurisdictional ETR calculation for every jurisdiction in the base year. But, in the case that the ETR of a particular jurisdiction exceeded a certain threshold rate (in the base year or any subsequent year) then the MNE would not be required to compute the ETR for that jurisdiction for the next 3-5 years (the grace period). The threshold rate could be set above the agreed minimum rate.

418. A key element of this simplification measure would be balancing simplification with accuracy and potential for distortions. On the one hand, the grace period would need to extend for several years in order to provide material simplification. On the other hand, the longer the grace period the more likely it is to hide or overlook inaccuracies and distortions.

419. Certain restrictions would be required to make this simplification measure acceptable to governments. An example of such a restriction is to require MNEs to make an annual representation that no business change occurred over the grace period. Special anti-abuse rules may also be required. For example, rules may be needed to address situations whereby an MNE structures intercompany transactions designed to spike the ETR in the base year in order to escape the GloBE rules in the grace period. Special rules may also be needed to address situations whereby a jurisdiction could introduce a regime with balloon tax payments designed to spike the ETR in the base year, with no-tax or low-tax in the grace period.

420. A key disadvantage of this simplification measure is that MNEs would be required to establish all the necessary processes and systems in every jurisdiction in order to compute the base year ETR. Therefore, an MNE with operations in 120 jurisdictions would still be required to undertake 120 jurisdictional ETR calculations in the base year. Once an MNE has established all the necessary processes and systems, it may not be significantly more work to compute the jurisdictional ETR every year. In other words, this simplification measure may not deliver meaningful simplification.

421. If this option were to be pursued, it may be preferable to compute the base year ETR based on covered taxes and income data from multiple consecutive years rather than a single year, to safeguard against inappropriate exemptions. A multi-year approach should not be particularly onerous from a compliance perspective, since the MNE would have already configured its systems to compile all relevant data, and performed all the relevant calculations, in respect of the first year, which should facilitate doing so in respect of a multiple years.

3.9.4. Tax administrative guidance

422. This simplification measure seeks to reduce instances where MNEs prepare and tax administrations need to review a large number of ETR calculations that consistently show that the ETR

exceeds the agreed minimum rate year-after-year. For these “low-risk jurisdictions”, tax administrations that were following a risk-based approach would eventually stop reviewing an MNE’s ETR for operations in these jurisdictions and MNEs that were required to continue determining their ETR for compliance purposes would legitimately question the associated compliance costs. Therefore, the question is whether this ex-post result could be avoided by establishing a structured and transparent ex-ante process with overall lower costs for businesses and tax administrations alike.

423. This simplification measure would establish an ex-ante process whereby tax administrations (via Working Party 11) would work together with stakeholders, for instance, via a business advisory group, to identify jurisdictions where the tax base does not materially depart from the GloBE tax base (other than in areas where different accounting-tax approaches are common and low-risk, for example dividends may be taxable under local tax rules) and the tax rate is sufficiently high. For instance, this work could determine that Jurisdiction X, given its tax base and tax rate, would almost always result in an ETR above the minimum tax rate and hence absent a change in that jurisdiction’s tax rules, MNEs would enjoy a presumption that their ETR in that jurisdiction exceeded the agreed minimum rate. Further work would be required to identify all the relevant factors that would be considered in the determination process.

424. The mechanism could work such that tax administrations would publish guidance (developed within an Inclusive Framework process) that set out jurisdictions deemed to be low-risk and then MNEs would not be required to perform the ETR calculation for those jurisdictions, unless a tax authority specifically requested it within a certain period of time, potentially by reference to the statute of limitation rules in the respective jurisdictions. If the ETR calculated at the tax authority’s request was below the agreed minimum rate, the MNE would be subject to tax under the GloBE rules on the relevant income but would not be subject to underpayment or other tax penalties with respect to the income that benefitted from the presumption. To be most effective, tax administrations participating in such an ex-ante process and working alongside relevant stakeholders, could focus their effort in the period after the GloBE rules are finalized, and before the rules are effective or the first filing obligation deadline.

425. The determination of “low-risk” could apply to all MNEs operating within a certain jurisdiction, or it could be restricted to MNEs within or without certain sectors. For example, it may be the case that in a certain jurisdiction virtually every MNE is likely to be above the agreed minimum rate, except MNEs in a certain sector because of sector-specific tax incentives. In such a case, the low-risk determination could apply to every MNE, except for MNEs in that particular sector. In the case of a sectoral approach, consideration would be required for the treatment of firms that operate across multiple sectors.

426. In general, the low-risk determination would apply every year (i.e., without a time restriction), but would require a re-determination in the case of tax law revision or reform that materially changed the jurisdiction’s tax base and/or tax rate. For this purpose, a notification process could be set.

427. This option may require tax authorities to dedicate significant resources to understanding the design and potential impact of different countries tax systems. However, it is recognised that tax authorities would need to undertake a risk assessment process even in the absence of this simplification measure and that there would be benefits in terms of synergies and certainty in developing definitive guidance, and that the key challenge therefore would be to design a technical, non-political and transparent process to achieve it.

4 Mechanics for applying the GloBE rules

4.1. Overview

428. The previous Chapter (Chapter 3) set out the mechanism to identify those jurisdictions where an MNE Group has “low-tax income” (i.e. income that is subject to tax below the agreed minimum rate) and the methodology for determining the amount of top-up tax due on that income (i.e. the amount of GloBE tax necessary to bring the aggregate amount of tax on the low-tax Income up to the minimum rate).

429. The method set out in Chapter 3 is based on a jurisdictional blending approach.¹⁰⁰ It calculates the income of each Constituent Entity in the MNE Group and determines the covered taxes on that income. It then aggregates the income and taxes of the Constituent Entities that are located in the same jurisdiction to identify the jurisdictions where the MNE Group has low-tax Income. The difference between an MNE’s actual Effective Tax Rate (ETR) in a low-tax jurisdiction and the agreed minimum rate is referred to as the “top-up tax percentage” and the Constituent Entities located in the low-tax jurisdiction are referred to as “low-tax Constituent Entities”.

430. Once the low-tax jurisdictions have been identified and the low-tax income and top-up tax percentage have been determined for each of those jurisdictions, the Income Inclusion Rule (IIR) and of the Undertaxed Payments Rule (UTPR) operate to attribute that low-tax income and corresponding top-up tax to another Constituent Entity under the IIR or to determine the amount of adjustment to be made in respect of a taxpayer applying the UTPR.

- a. The IIR applies at the level of the parent jurisdiction and levies top-up tax on the low-tax income of those foreign Constituent Entities that are directly or indirectly controlled by the parent entity. The operation of the IIR is discussed in Section 4.2.¹⁰¹
- b. The UTPR operates as a back-stop to the IIR while also providing jurisdictions with a tool to protect themselves from the effect of base eroding transactions. The rule operates by way of a limitation

¹⁰⁰ Although no decision has yet been taken by the Inclusive Framework on blending, Chapter 4 and this Chapter proceed on the assumption that the rules for determining the ETR are to be applied on a jurisdictional basis. As explained in Chapter 4, the basic design of the rules for global and jurisdictional blending are broadly similar. Given that the design of jurisdictional blending rules are necessarily more complex and the significant level of support amongst IF members for a jurisdictional blending approach, Chapter 4 and this Chapter focus on how the GloBE rules could be applied on a jurisdictional basis.

¹⁰¹ The IIR is intended to apply to foreign Constituent Entities. A domestic minimum tax on income, however, could also be introduced in some jurisdictions. Such a domestic minimum tax on income would aim at ensuring that the MNE’s jurisdictional ETR in their jurisdiction is at least equal to the agreed minimum rate and at preventing the application of the IIR or the UTPR in other jurisdictions in relation to profits made in their own jurisdiction.

on the deduction of intra-group payments or through an equivalent incremental adjustment.¹⁰² The amount of the adjustment under the rule is calculated by reference to remaining pools of low-tax income that arise within the MNE Group and are not subject to tax under the IIR.¹⁰³ This low-tax Income could include, for instance, profits made by those Constituent Entities that are located in the parent jurisdiction if the MNE's jurisdictional ETR in the parent jurisdiction is below the minimum rate. To ensure that the UTPR does not result in over-taxation the UTPR is coordinated with other applicable UTPRs in other jurisdictions. Such coordination is achieved by way allocating top-up tax to UTPR Taxpayers on the basis of their intra-group payments. The operation of the UTPR and of the coordination mechanisms is described in Section 4.3.

- c. Section 4.4. describes situations where the GloBE rules apply to specific structures.

4.2. Income Inclusion Rule (IIR)

431. The IIR requires a taxpayer that is the “parent” of the MNE Group (or part of the MNE Group) to pay top-up tax on its proportionate share of the income of any low-tax Constituent Entity in which that taxpayer has a direct or indirect ownership interest.

432. The IIR includes an ordering rule that is designed to ensure that the IIR in different jurisdictions cannot be applied to the same interest in low-taxed income. The primary mechanism for co-ordinating the application of the IIR in each jurisdiction is through the top-down approach. This approach gives priority to the application of the income inclusion rule in the jurisdiction of the Constituent Entity that is at or near the top of the ownership chain in the MNE Group, starting with the Ultimate Parent Entity. In the event the Ultimate Parent Entity is not located in a jurisdiction that has implemented the IIR, then responsibility for applying the IIR falls to the Constituent Entity that is directly owned and controlled by that Ultimate Parent Entity, and so on, down the chain of ownership.

433. The application of the top-down approach is subject to a further rule that specifically addresses the application of the IIR in the case of “split-ownership structures”. Split-ownership structures are those where a significant portion (e.g., 10% or more) of the equity interests in a Constituent Entity are held by persons outside the MNE Group. This rule pushes the obligation to apply the IIR down to the partially-owned “intermediate” parent. The intermediate parent then applies the IIR to its share of the income of any low-taxed Constituent Entity in which that Intermediate Parent has a direct or indirect ownership interest. This split ownership rule ensures that the IIR captures all the income of the low-taxed Constituent Entity that is beneficially owned by the Intermediate Parent, without imposing a disproportionate tax burden on the MNE Group in relation to income that is beneficially owned by entities outside the group. The operation of the IIR and the ordering rules is set out in the box below.¹⁰⁴

¹⁰² Sentence modified further to a suggestion from Canada.

¹⁰³ Although no decision has yet been taken by the Inclusive Framework on rule order, this Chapter proceeds on the assumption that the IIR takes priority over the UTPR. Given that the design of the UTPR as a primary rule is necessarily more complex and the significant level of support amongst IF members for giving priority to the IIR, this Chapter focusses on how the GloBE rules could be applied when the IIR takes priority over the UTPR.

¹⁰⁴ Coordination between different jurisdiction to apply the top-down approach and split-ownership rules are discussed in Chapter 6.

1. Income Inclusion Rule

A Parent (including a Partially Owned Intermediate Parent) that owns (directly or indirectly) an equity interest in a foreign low-taxed Constituent Entity at the end of a reporting period shall be subject to a top-up tax under the income inclusion rule in respect of its proportionate share of the income of that Constituent Entity for that period.

A Parent entity (that is not a Partially Owned Intermediate Parent) that directly or indirectly controls the low-taxed Constituent Entity is treated, for the purposes of determining its proportionate share of the income of that Constituent Entity, as holding those equity interests that are held by another Constituent Entity and that are not otherwise subject to the income inclusion rule.

2. Top-down approach

A Parent is a Constituent Entity that:

- owns (directly or indirectly) an equity interest in another Constituent Entity in the same MNE Group;
- is located in a jurisdiction that has adopted an income inclusion rule; and
- is not controlled, directly or indirectly, by another Constituent Entity or Entities that are subject to the income inclusion rule;

and also includes a Partially Owned Intermediate Parent.

3. Split-ownership structures

A Partially Owned Intermediate Parent is a Constituent Entity that is located in a jurisdiction that has adopted an income inclusion rule, other than the Ultimate Parent Entity, and 10% or more of its equity interests are held directly or indirectly by persons that are not Constituent Entities of the MNE Group. A Constituent Entity that is a Partially Owned Intermediate Parent as a result of indirect ownership by persons that are not Constituent Entities does not apply the income inclusion rule if all of its equity interests are held directly or indirectly by Constituent Entities required to apply the income inclusion rule.

If the Parent holds all or any portion of its equity in the low-taxed Constituent Entity through a Partially Owned Intermediate Parent, then the Parent will not apply the income inclusion rule to the income of that Constituent Entity to the extent such income has already been brought into account under the income inclusion rule that applies in the jurisdiction where the Partially Owned Intermediate Parent is located.

4.2.1. Income inclusion rule

434. The IIR operates by requiring a parent entity (in most cases, the Ultimate Parent Entity) to bring into account its share of the income of each Constituent Entity located in a low-tax jurisdiction and taxes that income up to the minimum rate (after crediting any covered taxes on that income). The IIR imposes a top-up tax only on that portion of the low tax income of a foreign Constituent Entity which is beneficially owned (directly or indirectly) by the member of the group that applies the IIR (the Parent).

435. The IIR operates in a way that is similar to a CFC rule in that it subjects a domestic taxpayer to tax on its share of the foreign income of any controlled subsidiary; however, there are a number of differences between the IIR and the CFC rules of many jurisdictions. In particular, the IIR is designed to be co-ordinated with the GloBE rules that apply in other jurisdictions where the MNE Group operates to ensure that, in aggregate, these rules do not result in incremental taxation on low taxed profit that is above the agreed minimum rate. The IIR is intended to be implemented consistently in every jurisdiction and operate in a

way that produces the same overall result in order to ensure that an MNE group is subject to a minimum level taxation in each jurisdiction that it operates regardless of where it is headquartered and without giving rise to the risk of double or over taxation.

Calculation of the top-up tax under Chapter 3

436. Both the IIR and the UTPR are based on the same effective tax rate calculation. As described in Chapter 3, the ETR computation is determined on a jurisdictional blending basis taking into account the profits, losses and covered taxes paid by all the Constituent Entities of the MNE Group in the jurisdiction and adjusted for the carry-forward of losses and excess tax credits. Chapter 3 of this Report sets out the method for identifying those Constituent Entities that are located in a low tax jurisdiction and for calculating the amount of top-up tax in respect of each low-taxed Constituent Entity. As described in that Chapter:

- a. the ETR is first computed at the jurisdictional level to determine whether the jurisdiction is, in fact, a “low-tax jurisdiction” (i.e. a jurisdiction where the MNE’s jurisdictional ETR is below the agreed minimum rate) and to compute the top-up tax percentage necessary to bring the aggregate amount of tax on the income of that jurisdiction up to the minimum rate.
- b. This top-up tax percentage is then applied to the income of each Constituent Entity in that low tax jurisdiction, adjusted for losses of other entities for the same period, loss carry-forwards, and any carve-out amount, thereby ensuring that the total amount of top-up tax arising in that jurisdiction is allocated to each Constituent Entity in proportion to its adjusted income.

437. The computation of the top-up tax in respect of each Constituent Entity is, therefore, undertaken prior to, and independently of, the mechanisms for allocating liability for such top-up tax under IIR and UTPR as described in this Chapter. Importantly, when the parent entity applying the IIR is not the Ultimate Parent Entity, the ETR of a jurisdiction is not computed solely by reference to the Constituent Entities owned by that parent entity; instead, the ETR is computed by reference to all the Constituent Entities controlled by the MNE Group in that jurisdiction. See Example 4.2.1A. of the Annex. The implication of determining the top-up tax in respect of each Constituent Entity based on a group-wide average ETR for the jurisdiction is that top-up tax may be computed for an entity that would not be a low-taxed Constituent Entity on a standalone basis. See Example 4.2.1B. of the Annex. In this sense, the IIR can be contrasted with the usual structure of CFC rules which typically apply to subsidiaries on a standalone entity basis based on the profits, losses and taxes paid by each controlled-foreign-corporation. The fact that the taxpayer and the controlled foreign corporation are part of a larger MNE Group is not usually relevant to the calculation of income or creditable taxes under a CFC rule.

438. The ETR computation and the mechanism for collecting the top-up tax are separate design features of the GloBE rules. The IIR provides for a mechanism to collect the top-up tax based on the parent entity’s direct or indirect ownership of the low-taxed Constituent Entities. The UTPR serves as a backstop to the IIR by providing a mechanism to collect any remaining top-up tax in relation to foreign profits that are not in scope of an applicable IIR.

439. Liability for the amount of top-up tax computed for a low-taxed Constituent Entity is allocated to the parent entity in proportion to the parent entity’s equity interest in the income of that entity. As described below, liability for the top-up tax usually falls on the Ultimate Parent Entity of the MNE Group. However, under certain circumstances, the GloBE rules are designed so that the liability for the top-up tax shifts to one or more other Constituent Entities of the MNE Group. This coordination of income inclusion rules among jurisdictions is part of the design of the GloBE rules, whereas CFC rules, though they may have tax credit rules designed to avoid double taxation, typically don’t have this level of co-ordination.

4.3. Top-Down Approach

440. If each Constituent Entity in the ownership chain were required to apply the income inclusion rule, the rules of multiple jurisdictions could apply to the same low-taxed Constituent Entities, which could give rise to double taxation. Thus, the GloBE rules require a coordination mechanism to prevent overlapping application of the income inclusion rules of different jurisdictions from giving rise to double taxation of income attributable to the same equity interests in low-taxed Constituent Entities. The primary mechanism for co-ordinating the interaction between different income inclusion rules in different jurisdictions is the top-down approach.

441. The top-down approach arises from the interplay of two rules.

442. The first rule is the general income inclusion rule. Under this rule, any Constituent Entity that meets the definition of a Parent is obligated to apply the income inclusion rule but only to its proportionate share of the income of any Constituent Entity in which it holds (directly or indirectly) an equity interest.

443. The second rule defines the term “Parent” in such a way that the income inclusion rule of Constituent Entities that are beneath the Parent applying the income inclusion rule in the ownership chain are not applicable.

444. Together, these two rules ensure that the Ultimate Parent Entity of the MNE Group has the first priority to apply the income inclusion rule and provides for an orderly determination of which Constituent Entity or Entities in the MNE Group will apply their income inclusion rules when the Ultimate Parent Entity is located in a jurisdiction that has not adopted the income inclusion rule. The operation of the top-down approach prevents the application of multiple income inclusion rules to a Parent’s equity interest that is indirectly owned through another Constituent Entity or Entities.

445. Starting with the jurisdiction of the Ultimate Parent Entity, the top down approach requires the Ultimate Parent Entity to apply the income inclusion rule in the jurisdiction where it is located. The application of the rule at the Ultimate Parent Entity level will de-activate the income inclusion rule in jurisdictions where the other Constituent Entities are located. If the Ultimate Parent Entity does not apply the income inclusion rule, then the next Parent down the ownership chain applies the rule. The Parent is only required to apply its income inclusion rule and pay top-up tax with respect to the Low-Taxed Constituent Entities in which it has a direct or indirect equity interest. The top-up tax computed with respect to a Low-Taxed Constituent Entity is allocated to the Parent based on its ownership percentage of that entity.

446. Applying the IIR to the ultimate parent entity as part of a top-down approach has a number of benefits from a design perspective:

- a. **Reduces tax burdens and coordination issues.** The top-down approach reduces the number of jurisdictions where the IIR can potentially apply and thereby reduces the complexity associated with applying the rule in multiple jurisdictions. This, in turn, reduces the administrative and compliance burden for both tax administrations and the different Constituent Entities within the MNE Group.
- b. **Use of a single accounting standard.** The top-down approach is compatible with the policy decision to use the accounting standards of the Ultimate Parent Entity of the group for calculating the effective tax rate. The consolidated financial statements of the MNE group are prepared by the Ultimate Parent Entity as defined by the accounting rules. A top-down approach is compatible with this design element of the GloBE rules because it significantly reduces the instances where the income inclusion rule is applied by an entity other than the one that has prepared the consolidated financial statements.

- c. **Consistent with jurisdictional blending.** Jurisdiction blending allows that all the profits, losses and taxes of the Constituent Entities of the MNE Group located in the same jurisdiction are blended for purposes of the effective tax rate calculation. Giving priority to the Ultimate Parent Entity to apply the income inclusion rule is conceptually more consistent with jurisdictional blending because the blending is based on the income of all entities in the jurisdiction directly or indirectly owned by the Ultimate Parent Entity, which will in many cases include entities that are not owned or controlled by lower-tiered entities that might apply the income inclusion rule.

4.3.1. Two or more Parents within the same MNE Group applying the income inclusion rule

447. Under the top-down approach, when the Ultimate Parent Entity is not subject to an income inclusion rule, then two or more Constituent Entities in different ownership chains of the same MNE Group may meet the definition of a Parent, and each of these Parent entities can be required to apply the income inclusion rule to Low-Taxed Constituent Entities in which they own an equity interest. Example 4.2.1B illustrates this situation in which two intermediate Parents are required to apply their income inclusion rule because the Ultimate Parent Entity of the MNE Group is located in a jurisdiction with no income inclusion rule. In the example, each Parent applying its income inclusion rule separately owns the low-taxed Constituent Entities to which it is applying the rule.

Allocation of top-up tax based on proportionate ownership

448. In some cases two or more intermediate Parents in different ownership chains within the same MNE Group may hold equity interests in the same low-taxed Constituent Entity. The GloBE rules coordinate the simultaneous application of more than one jurisdiction's income inclusion rule to the same low-taxed entity through the top-up tax allocation methodology. Under the ordinary terms of the income inclusion rule, the top-up tax computed for a Constituent Entity is allocated to the Parent based on its proportionate share of the income of the low-taxed Constituent Entity, determined by reference to its equity interest. Accordingly, each Parent applying an income inclusion rule with respect to the income of the same low-taxed Constituent Entity is allocated a proportionate share of the top-up tax of that entity.

449. A Parent applies this income inclusion rule with respect to each Low-Taxed Constituent Entity of its MNE Group that it directly or indirectly owns, regardless of whether, on a standalone basis, it controls that Constituent Entity. In other words, as long as the low-taxed entity and the intermediate Parent are directly or indirectly controlled by the Ultimate Parent Entity of the same MNE Group, the intermediate Parent applies its income inclusion rule in respect of its interest in the Low-Taxed Constituent Entity. However, a Parent does not apply its income inclusion rule in respect of minority interests in entities that are not Constituent Entities of its MNE Group. This rule is illustrated in Example 4.2.2A in which a Parent is required to apply its income inclusion rule even though it directly holds only 40% of the interests of the low-taxed Constituent Entity because the remaining 60% is owned by the Ultimate Parent Entity (located in a jurisdiction with no income inclusion rule). The top-up tax computed in respect of a given Low-Taxed Constituent Entity could be allocated among one, two, or more non-controlling Parents under this rule to the extent those Parents own independent interests in the entity.

Co-ordination with the UTPR where no controlling Parent entity can apply the IIR

Note for WP11 delegates

Coordinating the application of the IIR and UTPR to a single Constituent Entity

The rules for coordinating the application the IIR and the UTPR with respect to a single Constituent Entity that is wholly-owned by the MNE Group but not wholly-owned by a single Parent generated a number of comments from delegates.

The rules set out in the original draft of the Chapter sought to preserve a simple test for whether the UTPR should be applied to a Constituent Entity within the MNE Group.

The general rule for the UTPR is that it only applies to a Constituent Entity that is not controlled by another Constituent Entity that is subject to an IIR (a Parent). The expectation is that the tax administration can verify whether the low-taxed Constituent Entity is controlled by a Constituent Entity of the MNE Group subject to an IIR based on a list of jurisdictions that have adopted the GloBE rules.

However, the rules set out in the draft Chapter required a Parent other than the Ultimate Parent Entity (UPE) to apply the IIR regardless of whether it controls the low-taxed Constituent Entity provided that both are part of the same MNE Group. As a result of this rule, one or more intermediate parent entities applying the IIR may not control the low-taxed Constituent Entity. In these situations, the UTPR would also apply with respect to the low-taxed Constituent Entity because it is not controlled by a Parent subject to the IIR. Therefore, the amount of top-up tax available for allocation under the UTPR must be reduced by the tax paid under the IIR to avoid double-taxation.

In cases where the low-taxed Constituent Entity was controlled by a Parent, the draft chapter proposed a force-of-attraction rule that required the controlling Parent to pay the top-up tax attributable to minority interests owned by other Constituent Entities that did not apply an IIR.

A number of delegates raised concerns about the force of attraction rule. These delegates questioned whether it was appropriate to subject a Parent to tax on income that it does not beneficially own albeit that this income is beneficially owned by another member of the same group. Some delegates expressed concerns that the force-of-attraction rule may not be permissible under their domestic law. Other delegates considered that the rule was necessary to ensure that the IIR operated in a comprehensive way – these delegates were of the view that the GloBE rules must contain either a force-of-attraction rule to collect the relevant top-up tax pursuant to the IIR or an exception to the binary test for applying the UTPR so that the top-up tax is collected pursuant to that rule.

Other delegates advocated extension of the force-of-attraction rule to those cases where the Parent does not hold a controlling interest in the low-taxed Constituent Entity. These delegates doubted that lack of control of the low-taxed Constituent Entity would be determinative of whether a jurisdiction was able to tax a Parent on income in excess of its beneficial ownership and observed that extending the force-of-attraction to non-controlling interests would reduce the instances in which the UTPR applies, thus reducing complexity and administrative burdens.

One way to integrate the concerns raised in the comments would be to provide jurisdictions with flexibility to adopt a force-of-attraction rule while also expanding the potential scope of the UTPR to address any potential leakage in cases where there is no such rule in place. Under this approach, a jurisdiction would have the option of requiring a Parent that controls a low-taxed Constituent Entity to include the share of low-taxed entity's income that is not subject to an IIR and is directly or indirectly beneficially owned by the Ultimate Parent Entity. In the absence of such a force-of attraction rule, the UTPR would tax such income. The effect of this approach for low-taxed Constituent Entities that are wholly-owned within the MNE Group would be that the IIR would apply in priority to the UTPR where:

- that entity is wholly-owned by a Constituent Entity located in a jurisdiction with an IIR; or
- that entity is controlled by another group member that is located in a jurisdiction with an IIR that includes an effective force-of-attraction rule.

In all other cases, the UTPR would apply in respect of income beneficially owned another group member but the amount of top-up tax allocable under the UTPR would exclude any top-up tax allocated under an IIR.

This approach would allow jurisdictions to decide for themselves whether to adopt a force-of-attraction rule and would extend the scope of the UTPR to ensure the GloBE rules remained comprehensive. However, it would result in a somewhat more complex test to determine the applicability of the UTPR. To enhance administrability, the list of jurisdictions that have adopted the GloBE rules would need also to include a note about the adoption of a force-of-attraction rule.

Questions for delegates

1. Do delegates have views on whether the UTPR should apply with respect to all low-taxed Constituent Entities that are not wholly-owned by a Parent but only to the extent the top-up tax is not allocated under an IIR?
2. Do delegates have views on allowing jurisdictions the option of including a force-of-attraction rule in their IIR?

450. Generally, the top-up tax allocated to the Parent is based on its proportionate share of the income of the low-taxed Constituent Entity, determined by reference to its equity interest. When all of the equity interests in the Low-Taxed Constituent Entity are owned by a Parent or Parents, all of the top-up tax determined with respect to that entity will be allocated under the income inclusion rule. When some of the equity interests of a Low-Taxed Constituent Entity are owned by Parents and the remainder is owned by Constituent Entities that are not subject to an income inclusion rule, however, all of the top-up tax cannot be allocated under the general rule. In these circumstances, some of the top-up tax that is not allocated under the general rule will be allocated to other Constituent Entities pursuant to the Undertaxed Payments Rule if the Low-Taxed Constituent Entity is not controlled by a Constituent Entity located in a foreign jurisdiction that has adopted the income inclusion rule. Thus, when the Low-Taxed Constituent Entity is not controlled by a single Parent, the undertaxed payments rule applies to the entity. In cases where the income inclusion rule and the undertaxed payments rule apply to the same Low-Taxed Constituent Entity, the undertaxed payments rule provides a credit for taxes paid under the income inclusion rule.

451. Example 4.2.2A illustrates the application of both the income inclusion rule and the undertaxed payments rule to a single Low-Taxed Constituent Entity. In Example 4.2.2A, 60% of the equity interests of a subsidiary in a low tax jurisdiction are directly owned by the Ultimate Parent Entity (which is not subject to an income inclusion rule) and 40% of the equity interests are owned by a Parent. In this case the Low-Taxed Constituent Entity is not controlled by a Parent. Accordingly, the top-up tax of the Low-Taxed Constituent Entity is subject to allocation under the UTPR; however the UTPR provides for a credit for the taxes allocated to any Parent under the income inclusion rule. This mechanism is further discussed below in section 4.5.2.

452. Thus, where a Low-Taxed Constituent Entity is subject to the income inclusion rule of non-controlling Parent Entities, all of its top-up tax is subject to allocation under the GloBE rules – part under the income inclusion rule and part under the undertaxed payments rule. Accordingly, no special rule is needed to prevent avoidance of top-up tax in this situation because the normal operation of the income inclusion rule and undertaxed payments rule ensure that the MNE Group's entire share of the top-up tax is within the GloBE rules.

453. However, when a Parent controls the Low-Taxed Constituent Entity, the undertaxed payment rule does not apply in respect to the income of the Low-Taxed Constituent Entity. Thus, if the other equity interests of that Low-Taxed Constituent Entity are owned by other Constituent Entities that are not subject to an income inclusion rule, the related top-up tax will not be allocated to any other Constituent Entity in the MNE Group. Such top-up tax would be stranded in a Low-Taxed Constituent Entity notwithstanding that it

was attributable to equity interests owned by other Constituent Entities of the MNE Group. Accordingly, an additional rule is needed to ensure that the income attributable to minority interests owned by Constituent Entities that are not subject to an income inclusion rule does not escape the GloBE rules. In these circumstances, the Parent that owns a controlling interest in the Low-Taxed Constituent Entity is required to increase its share of the top-up tax by the amount of top-up tax that would be allocable to other Constituent Entities under the income inclusion rule if those entities were Parents. Consequently, the controlling Parent of a Low-Taxed Constituent Entity will pay its proportionate share of the top-up tax as well as the share of top-up tax related to equity interests owned by other Constituent Entities of the MNE Group that do not apply the income inclusion rule. As a result, all of the top-up tax attributable to equity interests of a Low-Taxed Constituent Entity owned by the MNE Group will be collected under the income inclusion rule. This rule is illustrated in Example 4.2.2B. If the controlling Parent of such Low-Taxed Constituent Entity does not apply this rule and does not pay the share of top-up tax related to equity interests owned by other Constituent Entities of the MNE Group that do not apply the income inclusion rule, the undertaxed payments rule will apply instead to allocate this share of top-up tax. This mechanism is further discussed below in section 4.5.2.

Integrity measures to ensure the neutrality of the IIR

Note for WP11 delegates

Rules to address inversions and tax benefits directly linked to the application of the IIR

The document [CTPA/CFA/WP11/NOE\(2020\)17](#) included a box that discussed the adoption of a special rule to excluded passive holding companies from the application of the income inclusion rule because these entities were not effectively the headquarters of the group or otherwise perform any other substantial business function.

During the WP11 virtual meeting held on July 20, 2020, most delegates were opposed to such rule for several reasons, including, because it would be complicated to define the term “passive holding companies”. Rather, some delegates suggested that a rule was needed to address the risk of inversions to jurisdictions that provided supplementary tax incentives related to the application of the income inclusion rule.

A new proposal was included in the document [CTPA/CFA/WP11/NOE\(2020\)17/REV1](#) to deal with inversion structures in which the Ultimate Parent Entity moves its tax residence to a jurisdiction that provides tax benefits directly linked to the application of the IIR. The document suggested that this anti-inversion rule could be based on a continuity of shareholding test that would measure whether there had been any material change of ownership as a result of the transaction.

During the WP11 virtual meeting held on July 30, 2020, most delegates were opposed to inversion rules for reasons largely related to complexity. Some delegates expressed concern about whether such rules would be effective as a matter of EU law.

Delegates did however note that, in order to ensure a level playing field, it would be important to ensure that a jurisdiction did not actively provide MNE Groups with tax incentives that were directly linked to the application of the income inclusion rule. For example, if the jurisdiction of the Ultimate Parent Entity provides a preferential rate of tax for MNE Groups headquartered in its jurisdiction to compensate them for the additional tax payable under the Income Inclusion Rule then the jurisdiction should not be treated as having an IIR that was in line with the GloBE rules. The application of this integrity measure would not constitute a separate rule but would naturally be taken into account as part of a multilateral review process described in Section 6.5.2 below.

Questions for delegates

Do delegates agree that a multilateral review process could be used to protect the integrity of the IIR.

Would these integrity measures be sufficient or are further rules required to directly address the risk of inversions and the use of passive holding companies.

4.3.2. Split-ownership

454. The preceding Section explained the rules for the top-down approach, which de-activates the income inclusion rule of a Constituent Entity when that entity is controlled by another Constituent Entity that is subject to an income inclusion rule. This Section provides an exception to the top-down approach in split-ownership structures and requires a Partially Owned Intermediate Parent Entity to apply its income inclusion rule in priority to the income inclusion rule of its controlling Parent.

455. In some cases, not all the income of the MNE Group belongs to Ultimate Parent Entity because equity interests of the other Constituent Entities of the MNE Group could be held by third parties. One approach to addressing these cases would be to continue to apply the IIR under a top down approach and limit the application of the income inclusion rule to the share of income belonging to the Ultimate Parent Entity. However this approach has two particular problems.

456. The first problem is that it could result in horizontal inequities and economic distortions since the income of two or more entities that operate in the same circumstances would be taxed differently depending upon how their equity interests are held. Specifically, an MNE group that is structured so that its equity holders own all of the group's equity through a single corporation will be liable for more top-up tax under the GloBE rules than a similarly situated MNE Group where a portion of the equity interests in its subsidiaries is held directly by some of its shareholders. This disparity creates an economic distortion because it makes a minority interest in a holding company below the Ultimate Parent Entity more valuable, after tax, than an equivalent equity interest in the Ultimate Parent Entity. This horizontal inequity further suggests that in an acquisition, the acquiring MNE Group can reduce the overall tax burden of the MNE Group by acquiring a target corporation or group of corporations (that is otherwise outside the scope of the GloBE rules) with stock of a subsidiary rather than stock of the parent. The existing shareholders of the Ultimate Parent Entity will bear the same level of top-up tax on their interests in the target corporations, the new minority shareholders of the acquiring subsidiary will avoid the top-up tax on their interest in those same target corporations. There are, of course, many factors considered in an acquisition structure. However, without a rule to address split-ownership structures in an MNE Group, the GloBE rules will introduce a new, significant economic factor into the analysis of corporate acquisition structuring that may distort the structure of corporate acquisitions. Moreover, the horizontal inequity creates tax planning incentives that conflict with the overall design of the GloBE rules. For example, an MNE Group can simply distribute or spin off a minority interest in its subsidiaries to its existing shareholders and reduce the Ultimate Parent Entity's top-up tax liability without changing the owners' economic interests in the underlying corporations. See Example 4.2.3A of the Annex.

457. The second problem is that if Ultimate Parent Entity is located in a jurisdiction that has not adopted the income inclusion rule, the next intermediate parent entity down the ownership chain would need to apply the rule based on Ultimate Parent Entity's share of the low-taxed income. If the rule was applied by an intermediate parent entity that is not wholly-owned by the Ultimate Parent Entity, then the later would be indirectly subject to a lower tax burden. This outcome would also impact the income belonging to minority interest holders of the intermediate parent entity applying the rule even if the policy was to exclude these minority interests. Example 4.2.3B. of the Annex illustrates this situation. Under the top-down approach, an intermediate parent entity (B Co) is required to apply the income inclusion rule with respect to the income of a low-taxed entity (C Co). The Ultimate Parent Entity of the Group (Hold Co) holds 60% of the shares of B Co, while the remaining 40% is owned by minority shareholders. If the top-up tax imposed by B Co's jurisdiction is limited to the Ultimate Parent Entity's ownership percentage of C Co, then Hold

Co would not bear the full burden of the top-up tax on the low tax income of the Constituent Entity because it only owns a portion of the intermediate parent entity paying the tax ($60\% \times 60\% = 36\%$). A way to solve this problem would be by applying the income inclusion rule based on the intermediate parent's proportionate share of the low-taxed income. This ensures that the Ultimate Parent Entity is indirectly subject to the income inclusion rule based on its proportionate share of the low-taxed income. However, the effective tax rate and top-up tax computation cannot be changed depending on which parent entity or entities apply the income inclusion rule because the GloBE rules are based on a single effective tax rate and top-up tax computation for the reasons described in section 3.2.1.

458. To address these issues, the split-ownership rules require Partially Owned Intermediate Parents to apply the income inclusion rule. This avoids any competitive advantages and other distortions in situations where an intermediate parent entity through which the low-taxed entity is held is not wholly-owned by the Ultimate Parent Entity. It also ensures that the GloBE rules work properly because it ensures that the effective tax rate and top-up tax computation are always computed the same way and that the MNE Group's GloBE liability does not change regardless of whether the Ultimate Parent Entity is located in jurisdiction that has adopted the GloBE rules. These rules also allow the low-tax income of the MNE Group that is beneficially owned by the minority to be taxed at the minimum rate. The split-ownership rules apply to situations where there is a Partially Owned Intermediate Parent that has equity interests in the low-taxed Constituent Entity. It does not apply to the income of a low-taxed Constituent Entity that is directly owned by the minority shareholders. The difference between these two situations is illustrated in Example 4.2.3.K.

459. The split-ownership rule operates as an exception to the top-down approach as it gives priority to apply the income inclusion rule to the partially owned intermediate parent entity. This rule ensures that the income inclusion rule applies more comprehensively to the low-taxed income of the MNE Group where a significant portion of that income is not beneficially owned by the Ultimate Parent Entity. By pushing the taxing obligation down to the Partially Owned Intermediate Parent the rule taxes the income belonging to the minorities without requiring the Ultimate Parent Entity to pay top-up tax on income that it does not beneficially own and without requiring minorities that are not Constituent Entities to apply the income inclusion rule.

460. The Partially Owned Intermediate Parent applies the income inclusion rule based on that entity's ownership share of low-taxed Constituent Entity. Where the income of the low tax Constituent Entity is subject to tax under an IIR at the level of a Partially Owned Intermediate Parent, the split-ownership rule exempts that income from further taxation further up the ownership chain. This mechanism ensures that the GloBE tax burden is borne proportionally by the Ultimate Parent Entity and the minority owners of the Partially Owned Intermediate Parent based on their ownership percentage.

Methodology

461. This rule applies in cases where a Partially Owned Intermediate Parent holds equity interests of a Constituent Entity located in a low-tax jurisdiction as determined in accordance with Chapter 3. The rule operates by allowing the Partially Owned Intermediate Parent to apply the income inclusion rule in priority to any other parent entities located further up the ownership chain (including the Ultimate Parent Entity). In these situations, the Partially Owned Intermediate Parent is required to apply the rule with respect to its ownership percentage of the low-taxed Constituent Entities. In other words, the Partially Owned Intermediate Parent calculates its top-up tax liability based on the group-wide formula in Section 3.8. This ensures that the low-taxed income is subject to tax at the minimum rate in accordance with the principles of the GloBE rules while avoiding a disproportionate burden on the Ultimate Parent Entity or its shareholders.

462. This rule would not be applied to situations in which the Ultimate Parent Entity holds more than 90% of the equity interests of an intermediate parent entity. This limitation is designed to limit the need to

co-ordinate the interaction between the IIRs in different jurisdictions in those cases where a relatively small number of equity interest in a group company are held by minority shareholders (such as employees, legacy shareholders from a prior acquisition or financing counterparties) and ensures that the additional complexity only applies in situations where an important percentage of profits would otherwise remain undertaxed. The application of this rule depends on the corporate structure of the MNE Group at the end of the accounting period.

463. The equity interests referred in this rule are those that give rights to the profits of the Partially Owned Intermediate Parent. For example, if minority shareholders outside the MNE Group have no voting rights on the Partially Owned Intermediate Parent but have the right to collect 30% of the profits distributed by such entity, then it should be considered that 30% of the equity interests are held by persons that are not Constituent Entities of the MNE Group.

464. In certain cases, equity holders interest could have a preferred right to collect a specific amount of the distributed profits in preference to that of the other interest holders. For example, minority shareholders could hold cumulative preferred shares that give the right to the first one million euros of profits. The percentage of profits attributable to preferred shareholders will fluctuate annually based on the total earnings of the relevant corporations. For purposes of determining whether a minority shareholder of preferred stock holds a sufficient share of the equity interests to invoke the application of the split ownership rule, the measurement of profit entitlement should be assessed over a period of time (e.g. the prior three years) rather than on a year-by-year basis.

465. Although the Partially Owned Intermediate Parent applies the income inclusion rule to its proportionate share of the income of its subsidiary Constituent Entities, the Ultimate Parent Entity or another intermediate parent entity may still be required to apply the income inclusion rule. If the Ultimate Parent Entity wholly owns other Constituent Entities, it would be required to apply the income inclusion rule with respect to the income of such entities. In these cases, the parent entity is required to exclude the income already subject to an income inclusion rule of the Partially Owned Intermediate Parent.

466. The operation of this rule is illustrated in Example 4.2.3C. of the Annex. In this example, the Ultimate Parent Entity (Hold Co) owns 60% of an intermediate parent entity (B Co), while the remaining 40% is owned by minority shareholders. This makes B Co a Partially Owned Intermediate Parent because more than 10% of its equity interests are held by persons that are not Constituent Entities. B Co holds 100% of the interests of a Constituent Entity (C Co 1) in a Low-Tax Jurisdiction. The Ultimate Parent Entity (Hold Co) also owns 100% of another Constituent Entity (C Co 2) in a Low-Tax Jurisdiction, through another intermediate parent (B Co 2). The rule requires the Partially Owned Intermediate Parent to apply the income inclusion rule with respect to the income of its subsidiary (C Co 1). The Ultimate Parent Entity (Hold Co) is still required to apply the income inclusion rule with respect to its wholly-owned subsidiary (C Co 2). To avoid double taxation, the Ultimate Parent Entity's income inclusion rule excludes the income of C Co 1.

467. There could be two or more Partially Owned Intermediate Parents in the same ownership chain. These rules give priority to the Partially Owned Intermediate Parent closest to the Constituent Entity in the Low-Tax Jurisdiction provided that all of its equity interests are not held by another Constituent Entities subject to the income inclusion rule. This ensures that the tax burden is distributed appropriately between the Ultimate Parent Entity and the minority shareholders of all the intermediate parent entities in the ownership chain. This also follows the top-down approach because it gives priority to the Constituent Entity in the upper part of the ownership chain when both of them are in the same situation (both of them hold, directly or indirectly, the same equity interests of the low-taxed Constituent Entity and their equity interests are held directly or indirectly by the same persons). This is illustrated in Example 4.2.3D of the Annex. Example 4.2.3E of the Annex illustrates this rule in a situation where one of the Partially Owned Intermediate Parents is itself a low-taxed Constituent Entity.

468. This rule applies where two Partially Owned Intermediate Parents are applying the income inclusion rule with respect to the same income and equity interests of the low-taxed entity. If this is not the case, the Partially Owned Intermediate Parent in the upper tier has to still apply the income inclusion rule to the income that was not subject under the income inclusion rule of the Partially Owned Intermediate Parent of the lower tier. This is illustrated in Example 4.2.3F of the Annex. The same result would follow if the Ultimate Parent Entity or another intermediate parent is required to apply the income inclusion rule with respect to income not subject to the income inclusion rule applied by the Partially Owned Intermediate Parent. This is illustrated in Example 4.2.3G. of the Annex.

469. In cases where the Partially Owned Intermediate Parent required to apply the rule is located in a jurisdiction that has not adopted the income inclusion rule, then the next Partially Owned Intermediate Parent down the ownership chain located in a jurisdiction that has adopted the income inclusion rule (if one exists) is required to apply the income inclusion rule provided that part of its equity interests are held indirectly by persons outside the MNE Group. This is illustrated in Example 4.2.3H. of the Annex.

470. If there is no such intermediate parent entity below, then the next Partially Owned Intermediate Parent above the first Partially Owned Intermediate Parent located in a jurisdiction that has adopted the income inclusion rule applies its income inclusion rule. This is illustrated in Example 4.2.3J. of the Annex.

471. The rule set out in this Section does not require the Partially Owned Intermediate Parent to have control over the low-tax Constituent Entity. It only requires that the Partially Owned Intermediate Parent owns equity interests that give rights to the profits of the low-tax Constituent Entity. The absence of control by the Partially Owned Intermediate Parent is not relevant because the low-taxed Constituent Entity is already under the control of the MNE Group. This is illustrated in Example 4.2.3F.

4.4. Switch-over rule

472. A jurisdictional blending approach will require each member of the multinational group to determine the appropriate portion of the income derived, and taxes paid, by that group entity in each jurisdiction where that entity operates. Accordingly, a jurisdictional blending approach would require each foreign subsidiary of the multinational group to allocate an appropriate portion of its income (together with the taxes on that income) to a permanent establishment (PE) that may be maintained by that foreign subsidiary in another jurisdiction. The logic of the design of the GloBE proposal means that where the Parent derives PE income that benefits from a tax exemption under the laws of the parent jurisdiction, then the income of that exempt PE should be apportioned between the PE jurisdiction and the parent jurisdiction (together with any tax on that income) in order to accurately calculate the jurisdictional ETR in the parent jurisdictions.

473. Allocating the income of the parent between the parent and PE jurisdiction will align the measurement of the PE's income and taxes under the GloBE proposal with the domestic tax outcomes under the laws of the parent jurisdiction and ensure equality of treatment of exempt PEs and foreign subsidiaries under the GloBE proposal. Failure to apply such an approach to a parent's exempt PE income would create an unintended difference between the treatment of a parent's PEs and directly-owned foreign subsidiaries. It would allow low-tax income arising in the PE jurisdiction to be blended with high tax income in the parent jurisdiction, thereby understating the amount of low-tax income in the PE jurisdiction and allowing the MNE to avoid a GloBE tax liability by sheltering such low tax income with excess taxes paid in the parent jurisdiction.

474. A parent that seeks to apply the income inclusion rule to the income of an exempt PE will, however, be prevented from doing so where the parent jurisdiction has entered into a bilateral tax treaty that obliges the parent jurisdiction to exempt the income of the PE. A switch-over rule is therefore required in order to allow the state of the parent's residence to tax the income of the PE up to the minimum rate as provided for under the income inclusion rule. Accordingly the Programme of Work calls on the Inclusive Framework

to explore options and issues in connection with the design of a switch-over rule in which a contracting state had bound itself by tax treaty to use the exemption method. Such a rule would allow a contracting state to limit the application of the exemption method where the profits attributable to a permanent establishment (PE) or derived from immovable property in the other contracting state are low tax profits of a Constituent Entity under the GloBE rules.

475. This switch-over rule would allow the parent's state of residence to apply an income inclusion rule to tax the income of the PE in those cases where the income inclusion rule would apply as a matter of domestic law. The switch-over rule would permit the residence state to tax the low-tax profits of a PE up to the agreed minimum rate, using the same ETR test as the income inclusion rule. The application of the rule would, by virtue of its domestic law trigger, only apply when and to the extent that the head office was required to apply the income inclusion rule to the PE.¹⁰⁵

¹⁰⁵ The Inclusive Framework could explore the adoption of a switch-over rule that is not limited to the situations where the parent is required to apply the income inclusion rule to its own foreign permanent establishments. This type of rule could, for example, be applied to the permanent establishment on a standalone basis where that income is subject to an effective tax rate below the minimum rate. Such a rule could be adopted as part of a best practice approach that could be incorporated into the OECD Model Tax Convention.

4.5. Undertaxed Payment Rule (UTPR)

Undertaxed payments rule (UTPR)

The UTPR applies in respect of the income of low-tax Constituent Entities

The UTPR requires a taxpayer that is a member of an MNE Group to make an adjustment in respect of any top-up tax that is allocated to that taxpayer from a low-tax Constituent Entity of the same group.

The IIR has priority over the UTPR

No top-up tax shall be allocated under the UTPR if that low-tax Constituent Entity is controlled, directly or indirectly by a foreign Constituent Entity that is subject to an IIR which has been implemented in accordance with the GloBE rules.

Allocation of the top-up tax

The top-up tax is allocated to a UTPR Taxpayer in two steps as follows:

- (a) First, if the UTPR Taxpayer makes any deductible payments to the low-tax Constituent Entity during the relevant period, the top-up tax of such Constituent Entity is allocated to the UTPR Taxpayer in proportion to the total of deductible payments made to that entity by all UTPR Taxpayers.;
- (b) Second, if the UTPR Taxpayer has net intra-group expenditure, in proportion to the total amount of net intra-group expenditure incurred by all UTPR Taxpayers.

The top-up tax allocated to a UTPR Taxpayer under the each step is limited to an amount equal to the domestic CIT rate multiplied by the gross amount of deductible intragroup payments taken into consideration in calculating its portion of top-up tax.

No top-up tax is allocated to UTPR Taxpayers that are located in jurisdictions where the MNE's jurisdictional ETR is below the agreed minimum rate.

Maximum amount of top-up tax that can be allocated under UTPR

The total top-up tax allocated under the UTPR from all low-tax Constituent Entities located in the Ultimate Parent jurisdiction cannot exceed the top-up tax percentage multiplied by the total amount of deductible intragroup payments received by these low-tax Constituent Entities from foreign Constituent Entities.

Definition of UTPR Taxpayer

A UTPR taxpayer is any Constituent Entity that is located in a jurisdiction that has implemented the UTPR in accordance with the GloBE rules.

Adjustment to be made under the UTPR

A taxpayer that is allocated top-up tax under the UTPR shall be denied a deduction for an intra-group payment or required to make an equivalent adjustment under domestic law that results in the taxpayer having an incremental tax liability equal to the allocated top-up tax amount.

4.5.1. The UTPR applies in respect of the income of low-tax Constituent Entities

476. The UTPR has the same general purpose as the income inclusion rule (IIR). More specifically, the policy rationale of the UTPR is to protect jurisdictions against base erosion while ensuring that, in aggregate, the GloBE rules result in the MNE Group paying a minimum level of tax in respect of its low-

tax income.¹⁰⁶ While the IIR and UTPR have the same general purpose they have different function and operate in a very different way. The IIR provides for a mechanism to collect the top-up tax based on a Parent's¹⁰⁷ direct or indirect ownership of the low-tax Constituent Entities. The UTPR serves as a backstop to the IIR and reduces the incentives for tax driven inversions¹⁰⁸ by providing a mechanism for making an adjustment in respect of any remaining top-up tax in relation to profits of a Constituent Entity that is not in scope of an applicable IIR. The UTPR operates through an allocation key that is based on intra-group payments.

477. Because the UTPR has the potential to apply in any jurisdiction where a Constituent Entity makes an intra-group payment and because the outcomes under UTPR will vary based on the amount of intra-group payments made by each entity, the UTPR is a more complex rule to apply and requires a greater amount of co-ordination between jurisdictions than the IIR. In practice, however, the scope for the application of the UTPR is expected to be relatively narrow. This is because the UTPR only applies to the income of a low-tax Constituent Entity when that low-tax Constituent Entity is not otherwise subject to an IIR that is implemented in accordance with the GloBE rules under the laws of another jurisdiction.¹⁰⁹ To simplify both the compliance with and the administration of the GloBE rules the taxpayer has the opportunity under the UTPR compliance procedures, described in Section 4.3.8 below, to certify that the UTPR does not apply because, for example, there are no low-tax Constituent Entities within the MNE Group or that all these entities are under the control of another Constituent Entity that applies an IIR that has been implemented in accordance with the GloBE rules.

478. When the IIR and UTPR are introduced into domestic law, they will *not* apply to capture the domestic low-tax income from the perspective of the taxpayer (i.e. low-tax profits that arise in the same jurisdiction as the taxpayer). These domestic low-tax profits will however be covered by the rules of Constituent Entities located in other jurisdictions. In the case of a subsidiary that is located in a different jurisdiction than its parent entity, the jurisdictional scope of the UTPR may include low-tax income that arises in the jurisdiction of the Ultimate Parent Entity in a relevant period. This application of the UTPR would result from the fact that:

- a. the profits made in the jurisdiction of the Ultimate Parent Entity are out of scope of any applicable IIR since any IIR that would apply in the parent jurisdiction would only cover "foreign" profits, i.e. profits made in all other jurisdictions than the parent jurisdiction, and
- b. the jurisdiction of the Ultimate Parent Entity is a foreign jurisdiction from the perspective of the subsidiary jurisdiction applying the UTPR.

479. Therefore, in the situation where (i) the ultimate parent jurisdiction has implemented an IIR in accordance with the GloBE rules and (ii) the MNE's jurisdictional ETR falls below the minimum rate in the ultimate parent jurisdiction for a given period, both the IIR and the UTPR could apply within the group, but they would not apply in relation to the same low-tax income. The IIR would cover the MNE's low-tax income

¹⁰⁶ See paragraph 7 of the OECD (2019), Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, OECD/G20 Inclusive Framework on BEPS, OECD, Paris, www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm) which provides that "Pillar Two seeks to develop rules that would provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation"

¹⁰⁷ The definition of Parent is set out in Section 4.2 and may include a Partially Owned Intermediate Parent. [This footnote has been inserted further to a suggestion from Canada.]

¹⁰⁸ [This sentence has been amended further to a suggestion from Japan and New Zealand]

¹⁰⁹ See also section 4.3.2 on the priority of the IIR over the UTPR

in all the subsidiary jurisdictions, while the UTPR only would apply to the profits made in the ultimate parent jurisdiction, and only if the MNE's jurisdictional ETR is below the agreed minimum rate in such jurisdiction in a relevant period. As discussed below in section 4.3.8 on the compliance and administration of the UTPR, the taxpayer would be provided the ability to certify that the MNE's ETR in the ultimate parent jurisdiction is at least the agreed minimum rate in order to avoid that the UTPR applies in relation to these profits. In case the UTPR actually applies in respect of the Constituent Entities located in the ultimate parent jurisdiction, see below section 4.3.5. on the Calculation of the top-up tax.

480. As mentioned above, where the MNE's jurisdictional ETR is not already at or above the minimum rate, a jurisdiction¹¹⁰ could introduce a domestic minimum tax with the aim of ensuring that the MNE's jurisdictional ETR in the jurisdiction is at least equal to the agreed minimum rate and thereby preventing the application of the UTPR in subsidiary jurisdictions in relation to profits made in the jurisdiction.¹¹¹

4.5.2. The IIR has priority over the UTPR

Note for WP11 delegates

Under specific situations, both the IIR and the UTPR could apply in relation to (a respective portion of) the income of a low-tax Constituent Entity. These situations were discussed in the previous version of this Chapter as well as in the Chapter that described the top-down approach for the IIR. An interaction mechanism has also been discussed with a view to ensuring that (i) the IIR has priority over the UTPR and (ii) the interaction between both rules does not result in over taxation.

Further to the discussions held at the WP11 meetings in July, the interaction mechanism has been clarified in the description set out above in section 4.2.2. The changes made to this section aim at mirroring the clarifications added in section 4.2.2. and providing more details about the practical application of the interaction between the IIR and the UTPR.

Question for WP11 delegates

1. Do WP11 delegates have any comments on the changes made to this section?

481. The top-up tax computed in relation to the MNE's profits is either collected through the application of the IIR in a "Parent jurisdiction" or gives rise to a corresponding adjustment under the UTPR in a "UTPR jurisdiction". As mentioned previously, the IIR takes priority over the UTPR. Therefore, no top-up tax may be treated as giving rise to an adjustment under the UTPR in respect of a Constituent Entity that is controlled, directly or indirectly by a foreign Constituent Entity that is subject to an IIR in accordance with the GloBE rules. When the UTPR applies, the UTPR of several other jurisdictions could, however, apply in relation to the income of a single low-tax Constituent Entity and this Chapter explains how these UTPRs are to be coordinated so as to minimise complexity and avoid double taxation.

Interaction between IIR and UTPR when IIR applied at level of Intermediate Parent

482. In the situation where no IIR applies at the Ultimate Parent Entity (UPE) level, the IIR can apply at a sub-holding level.¹¹² Under these circumstances, and as discussed in Section 4.2 above, it is possible

¹¹⁰ This sentence has been amended further to a suggestion from Canada

¹¹¹ The scope of such a domestic minimum tax on income could also be limited to the MNEs that are in scope of the GloBE rules.

¹¹² See section 4.2.2 on the Top-Down Approach

that the low-tax Constituent Entities located in a given jurisdiction are not all owned by the same Parent applying the same IIR. In this situation, some of the low-tax Constituent Entities will be within the scope of an applicable IIR while others may be in the scope of the UTPR. An example of this structure is illustrated in Example 4.2.1A. Whether the income of a low-tax Constituent Entity is covered by an IIR or a UTPR is therefore determined on an entity-by-entity basis, for each of these low-tax Constituent Entities. The test for determining whether the IIR will be the mechanism for taxing the income of a low-tax Constituent Entity (or whether that amount gives rise to an adjustment under the IIR) is based on a control test. The low-tax income of a Constituent Entity will be subject to adjustment under the IIR where there is another Constituent Entity in the ownership chain that controls this low-tax Constituent Entity and is subject to the IIR. Where there is no such Constituent Entity in the ownership chain, then that amount gives rise to an adjustment under the UTPR. Therefore the determination of whether the UTPR applies to the profits of a low-tax Constituent Entity should generally be a binary one that depends on whether or not such low-tax Constituent Entity is controlled by another foreign Constituent Entity that is subject to an IIR in accordance with the GloBE rules.

Crediting IIR tax imposed by a minority shareholder

483. It is expected that in most cases either the low-tax Constituent Entities will be controlled by another Constituent Entity that is subject to the IIR (and the UTPR will not apply) or their shares will be wholly owned by other Constituent Entities that are not subject to an IIR (and the UTPR will apply). There may be situations, however, where no Constituent Entity that controls the low-tax Constituent Entity is subject to an IIR but a foreign Constituent Entity owns a minority interest in the low-tax Constituent Entity and applies the IIR in respect of its (minority) share of the income of such low-tax Constituent Entity, as described in section 4.3. The UTPR applies under such circumstances, because the low-tax Constituent Entity is not controlled, directly or indirectly, by another Constituent Entity in another jurisdiction which applies an IIR.¹¹³

484. To avoid taxation of the same low-tax income both in the hands of the UTPR Taxpayers and of the Constituent Entity that applies the IIR (because of the minority interest it owns in the low-tax Constituent Entity), the top-up tax allocated under the UTPR excludes the portion of the top-up tax that has already been imposed under the IIR.¹¹⁴ This mechanism ensures that the IIR has priority over the UTPR, while avoiding multiple taxation of the same low-tax income as a result of the GloBE rules.

Application of IIR where controlling shareholder does not apply a force of attraction rule

485. There may also be other situations where a Parent (i.e., a Constituent Entity that is subject to an IIR rule) controls the low-tax Constituent Entity but does not own all the shares ultimately held within the MNE group and the Parent's jurisdiction does not have an effective force of attraction rule described in section 4.3. Under such circumstances, the UTPR applies on an exceptional basis to allocate the remaining amount of top-up tax even though the control test for the UTPR to apply is not met. Similarly to the mechanism described above, the top-up tax allocated under the UTPR excludes the portion of the top-up tax that has already been imposed under the IIR.

4.5.3. Calculation of the top-up tax

486. The UTPR uses the same mechanics as the IIR for determining the MNE's jurisdictional ETR and the amount of top-up tax allocable under the rule. This includes the same definition of covered taxes and the application of any substance based carve-out. Equally the exclusions to the definition of Constituent Entity (for example, in respect of government entities) would apply under the UTPR and no top-up tax

¹¹³ An example of this type of structure is illustrated in [Example 4.2.2A of the Annex].

¹¹⁴ See above section 3.8. on the Computation of the ETR and the top-up tax

would arise, or be allocable under the UTPR, in respect of these excluded entities. Equally the application of loss carry-forwards and excess taxes used to address timing differences apply in the same way to determine the ETR of each jurisdiction under both the IIR and UTPR.

487. Example 3.7.2A. illustrates the application of a local tax carry-forward rule. In that example, a subsidiary pays excess taxes of 40 in year 1 which creates a local tax carry forward in that amount (assuming that this subsidiary is the only Constituent Entity in the relevant jurisdiction). While the subsidiary paid less than the minimum rate on its GloBE tax base in the subsequent year, it can carry forward the excess tax paid to increase its tax expense in year 2 up to the minimum rate. Accordingly, there would be no top-up tax liability under either the IIR or the UTPR in relation to this subsidiary's profits in year 2. Similarly, the loss carry-forward mechanism described in section 3.7.2 would apply for the purpose of calculating the top-up tax under the UTPR. Slightly different mechanisms apply, however, in relation to the crediting of UTPR taxes paid on accelerated income, these differences between the UTPR and IIR tax credit are discussed above in Section 3.7.2.

488. Having the same mechanism to compute the top-up tax under the IIR and the UTPR improves coordination and reduces implementation and compliance costs ensuring that any adjustment does not result in over-taxation or in taxation in excess of economic profits. In addition, using the same top-up tax calculation mechanic under both the IIR and the UTPR aligns the expected outcomes under both rules, which allows the UTPR to operate as a meaningful backstop to the IIR. In order to operate as a meaningful backstop to the IIR, the UTPR needs to apply in situations where the IIR would have applied if it was introduced in the Parent jurisdiction. Failing to align the mechanics for computing the top-up tax under both the IIR and the UTPR would either lead to less effective or harsher outcomes under the UTPR than under the IIR. For instance, a rule that only applied to direct payments made to recipients located in jurisdictions that have a nominal CIT rate that is below the agreed minimum rate would be less effective than the UTPR. On the other hand, a rule that would fail to apply the same blending approach, the same substance based carve-out and mechanisms to address timing differences as provided under the IIR could be harsher than the UTPR.¹¹⁵

489. The UTPR uses the same calculation mechanic as the IIR to determine the corresponding amount of top-up tax allocable in relation to the profits in scope of the rule. In accordance with the methodology described in Section 3.8, the amount of top-up tax that is allocable under the UTPR is determined in respect of each Constituent Entity located in a jurisdiction where the MNE's jurisdictional ETR is below the minimum rate (the "low-tax Constituent Entity") The top-up tax attributed to a low-tax Constituent Entity under this mechanic is then allocated amongst the UTPR Taxpayers.¹¹⁶ Section 4.3.4 below describes the operation of the allocation keys while section 4.3.6 provides a definition of the UTPR taxpayer.

4.5.4. Allocation of the top-up tax

490. The top-up tax is allocated among entities that are subject to a UTPR in their jurisdiction. The allocation of the top-up tax does not entail taxation of the profit of one entity in the hands of another. Rather the allocation of top-up tax operates as a co-ordinated way to connect the deductible intragroup payments made in one jurisdiction with low-tax outcomes in another jurisdiction. To ensure a coordinated application of the rule, this allocation requires a common definition of its key components. This section focusses on the design and the mechanics of the allocation keys, and the definition of the factors taken into account for the computation of the allocation keys (i.e. intra-group payments).

¹¹⁵ This sentence has been added further to a suggestion from Sweden

¹¹⁶ A withholding tax paid in relation to a particular payment made by a UTPR Taxpayer is taken into account for the computation of the ETR of the jurisdiction where the recipient Constituent Entity is located and does not reduce the amount of top-up tax allocated to this taxpayer.

Overview – two-step approach

491. The top-up tax is allocated to a UTPR Taxpayer that is a member of the same MNE Group as the low-tax Constituent Entity as follows:

- First, if the UTPR Taxpayer makes any deductible payments to the low-tax Constituent Entity during the relevant period, the top-up tax that applies to the income of such Constituent Entity is allocated in proportion to the total of deductible payments made directly to the low-tax Constituent Entity by all UTPR Taxpayers;
- Second, if the UTPR Taxpayer has net intra-group expenditure, the remaining top-up tax is allocated in proportion to the total amount of net intra-group expenditure incurred by all UTPR Taxpayers.

Both allocation keys apply on a period by period basis. Section 4.3.7 describes the rules used to determine the timing in the recognition of these payments.

Purpose and design of the allocation keys

492. A two-step approach based on related party payments and expenditures is consistent with the hybrid function of the UTPR. The UTPR is designed to operate as a back-stop to the IIR while also providing jurisdictions with a tool to protect themselves from the effect of base eroding transactions.

Purpose and design of the first allocation key

493. The first allocation key allocates the top-up tax to entities that make direct payments to a low-tax Constituent Entity. This allocation key ensures that the UTPR allocates top-up tax in priority to those jurisdictions where there is a readily identifiable and direct connection between the payment and shifting of intra-group profit. An allocation key that prioritises adjustments in respect of deductible intra-group payments made directly to a low-tax Constituent Entity is designed to capture the most obvious and straight-forward intra-group profit stripping arrangements. Direct payments to a low-tax Constituent Entity are the easiest to identify, which limits the number of potential adjustments under the rule and makes the rule simpler from a compliance and administration perspective.

Purpose and design of the second allocation key

494. Adjustments made under the first allocation key may not result in an allocation of the full amount of top-up tax. In such a case, the remaining top-up tax, after the application of the first allocation key, is allocated to the UTPR Taxpayers under the second allocation key in proportion to their net intra-group expenditures.

495. The second allocation key fulfils part of the UTPR's function in providing a comprehensive back-stop to the IIR and seeks to neutralise any advantage an MNE group may obtain from structuring around the first allocation key. A rule that allocated the top-up tax only in proportion to direct payments made by UTPR Taxpayers could be circumvented by routing intercompany transactions through an entity that is not subject to the UTPR so that there are no direct payments made to any low-tax Constituent Entity from a UTPR Taxpayer. The second allocation key provides a relatively simple way to address these conduit structures by imposing a top-up tax on net related party expenditure without the need to trace the destination of all the payments made by UTPR Taxpayers within the MNE group.

496. The second allocation key is therefore, intended, in part to operate as a backstop to the first one by targeting intragroup funding structures that indirectly shift profit into low-tax jurisdictions. It further, however, operates as a simplified anti-conduit rule that uses a fungibility of money approach that effectively deems the amount of net profit shifted out of each UTPR Taxpayer as funding a proportionate share of the remaining low-tax profit on the MNE without having regard to the specificities of intra-group payment flows.

This proxy reflects the view of IF members that profit shifting risks are generally greater for those entities that have net related party expenditure. The second allocation key is generally expected to have the effect of pushing the taxing obligation into those entities that derive a more significant proportion of their income from third party sales. The design of this second allocation key seeks to strike a balance between an anti-profit shifting rule that is comprehensive and relatively simple to apply and one that addresses the profit shifting risks that arise in the context of MNEs with global supply chains. Importantly, this second allocation avoids the complexity associated with tracking flows of intragroup payments through chains of connected intragroup payments.

497. The second allocation key, when applied in combination with the first one, operates as an effective backstop to the IIR without triggering the risk of over-taxation since it can only result in an adjustment to the extent that a top-up tax was computed in the first place, as explained in section 4.3.3.

Mechanics of the allocation keys

Mechanics of the first allocation key based on direct intra-group payments

498. Perhaps the simplest way of shifting profit from a high-tax to a low-tax jurisdiction is to make an intra-group deductible payment from a high tax to a low-tax entity. The first allocation key, which allocates the top-up tax in proportion to deductible intra-group payments made directly by UTPR Taxpayers to such entities, therefore aims at neutralising one of the most obvious ways of shifting profits into such jurisdictions.

499. For the first allocation key, the payments that are taken into consideration are the payments made directly by a UTPR Taxpayer to a low-tax Constituent Entity (i.e. a Constituent Entity located in a jurisdiction where the MNE's jurisdictional ETR is below the agreed minimum rate). Each UTPR Taxpayer is allocated a portion of the top-up tax that is computed in relation to the income of each low-tax Constituent Entity on an entity-by-entity basis in accordance with the following formula:

$$\frac{\text{Direct intragroup payments from UTPR Taxpayer A to Low Tax Constituent Entity Z}}{\text{All direct intragroup payments from all UTPR Taxpayers of the group to Low Tax Constituent Entity Z}}$$

500. For the purpose of this formula:

- “Direct intragroup payments from UTPR Taxpayer A to low-tax Constituent Entity Z” is the amount of deductible intra-group payments made directly by UTPR Taxpayer A to the low-tax Constituent Entity Z; and
- “All direct intragroup payments from all UTPR Taxpayers of the group to low-tax Constituent Entity Z” is the sum of all deductible intra-group payments made directly by any UTPR Taxpayer in the group to that entity.

501. Example 4.3.4A. provides an illustration of the operation of the first allocation key.

Mechanics of the second allocation key based on net intra-group expenditure

502. The application of the first allocation key may not be enough to achieve the function of the UTPR as a backstop to the IIR. First, a low-tax Constituent Entity may not be in direct receipt of any payments received from UTPR Taxpayers, and in such circumstances, no top-up tax at all would be allocated to any UTPR Taxpayers under the first allocation key.¹¹⁷ Second, even when direct payments are made, the top-

¹¹⁷ See the section 4.3.6 on the Definition of UTPR Taxpayer below.

up tax allocated to UTPR Taxpayers that made direct payments may be limited by the operation of the caps described below and some top-up tax would then remain unallocated.¹¹⁸

503. For those situations where a top-up tax is identified but is not (fully) allocated under the first allocation key, a second allocation key applies after the first one and allocates any remaining top-up tax. This second allocation key allocates such remaining top-up tax to UTPR Taxpayers in proportion to their net intra-group expenditures. The UTPR Taxpayers with net related-party income are therefore excluded from this second allocation key.

504. For the second allocation key, all payments and receipts to and from other Constituent Entities (both domestic and foreign constituent entities) are taken into consideration in order to determine a UTPR Taxpayer's net intra-group expenditure. The payments taken into account for the first allocation key are included for the purpose of the second allocation key when they both apply. Including all deductible payments is simpler from a compliance and administration perspective.¹¹⁹ It also recognises that payments made to another UTPR Taxpayer (even if it is resident or established in the same jurisdiction) can be used as a conduit to fund the low-tax profits of an offshore entity. Each UTPR Taxpayer is allocated a portion of the total remaining top-up tax that was not allocated under the first allocation key, in accordance with the following formula:

$$\frac{\text{Net intragroup expenditure of UTPR Taxpayer A}}{\text{Sum of all net related party expenditure of UTPR Taxpayers}}$$

505. For the purpose of this formula:

- “Net intra-group expenditure of UTPR Taxpayer A” is the difference between: (i) the sum of all deductible intra-group payments made by UTPR Taxpayer A and (ii) the sum of all related party income derived by such UTPR Taxpayer from deductible intra-group payments made by other Constituent Entities of the MNE group, when such difference is positive; and
- “Sum of all net intra-group expenditure of UTPR Taxpayers” is the sum of all net intra-group expenditure of any UTPR Taxpayers.

506. Example 4.3.4B. provides an illustration of the operation of the second allocation key. Example 4.3.4C. provides an illustration of the operation of the second allocation key when one UTPR taxpayer has net related party income.

¹¹⁸ See the section below on maximum amount of top-up tax

¹¹⁹ The amount of top-up tax allocated under the first allocation key may be capped and the amount of top-up tax allocated under the second allocation key may not be capped. In this case, failing to include these payments in both allocation keys would potentially provide for a narrower allocation of top-up tax in relation to direct payments, which would not be consistent with the fact that these payments are given priority in allocating the top-up tax of the group.

No allocation of top-up tax to a low-tax Constituent Entity

Note for WP11 delegates

At the WP11 meetings of 22 and 23 July 2020, several delegates raised concerns about the restriction on allocating top-up tax to a low-tax Constituent Entity.

While delegates generally acknowledge that this restriction simplifies the application of the rule and is in line with the underlying policy of the UTPR some delegates were concerned that this limitation could affect the effectiveness of the UTPR as a whole. In particular some delegates were concerned about a jurisdiction not being able to apply the UTPR simply due to timing differences.

These concerns however need to be understood in the context of the design of the rule as a whole:

- Section 3.7 contains extensive rules to address timing differences. These provisions should significantly reduce or eliminate the circumstances in which a jurisdiction is treated as a low tax jurisdiction due to timing differences. Furthermore the simplification options discussed in section 3.10 may mean that minor and temporary jurisdictional ETRs below the minimum rate would not result in a jurisdiction being treated as low tax for GloBE purposes.
- The restriction on allocating top-up tax to a low tax jurisdiction does not affect the computation of the total amount of top-up tax allocable under the UTPR but only the way the tax is allocated across jurisdictions. It is therefore not obvious therefore that this restriction will undermine the effectiveness of the rule.
- Eliminating the restriction would result in allocating top-up tax away from high tax jurisdictions (where the profit shifting risks are greater) towards low tax jurisdictions, contrary to the stated purpose of the rule.
- Allocating top-up tax to low-tax jurisdictions may also undermine the effectiveness of the rule as a back-stop to the IIR if it results in top-up tax being allocated to a Constituent Entity that is unable to make an equivalent adjustment under its domestic UTPR mechanism.

The text in the section below has been modified in order to respond to the concerns raised by delegates.

507. Among those entities that are subject to a UTPR, the allocation of the top-up-tax is limited to those Constituent Entities located in jurisdictions where the MNE's jurisdictional ETR is at or above the agreed minimum rate. In other words, no top-up tax is allocated under the UTPR to low-tax Constituent Entities.¹²⁰ When a low-tax Constituent Entity is not allocated any top-up tax, both the direct payments made by and the net intra-group expenditure of such low-tax Constituent Entity are disregarded for the application of the allocation key under the UTPR. Example 4.3.4D. provides an illustration for this specific feature.

508. The MNE's jurisdictional ETR in a jurisdiction where it has suffered a loss for GloBE purposes is not computed (as it has no income in that jurisdiction). For the purpose of applying the UTPR, Constituent Entities that are located in a jurisdiction where the MNE has suffered losses are not considered as low-tax Constituent Entities and therefore may apply the UTPR, provided (i) the nominal tax rate of the covered taxes in their jurisdiction exceeds [x%] and (ii) a mechanism is applicable in that jurisdiction to impose an

¹²⁰ One of the simplification options discussed above in section 4.10.1 is to explore further the use of deferred tax assets/liabilities to compute the ETR. If these simplification options are further developed, the UTPR taxpayers would also be covered by such a mechanism. For instance, if a jurisdiction was considered to be a high-tax jurisdiction in application of these simplifications, the UTPR taxpayers located in such a jurisdiction would be allocated top-up tax.

incremental amount of tax on loss-making companies as a result of the application of the UTPR in that jurisdiction.¹²¹

509. The restriction on allocating top-up tax to Constituent Entities in low tax jurisdictions simplifies the application of the rule. In particular it prevents a cross-allocation of top-up tax between two low tax jurisdictions. The restriction on allocating top-up tax to a low tax jurisdiction does not affect the computation of the total amount of top-up tax allocable under the UTPR but only the way the tax is allocated across jurisdictions. The restriction prevents top-up tax being allocated away from high tax jurisdictions (where the profit shifting risks are greater) towards low tax jurisdictions, contrary to the purpose of the rule. Allocating top-up tax to low-tax jurisdictions could also undermine the effectiveness of the rule as a back-stop to the IIR if it resulted in top-up tax being allocated to a Constituent Entity that is unable to make an equivalent adjustment under its domestic UTPR mechanism.

510. Jurisdictions that introduced the UTPR may, for a given MNE Group and a given year, be a jurisdiction where an MNE's jurisdictional ETR is below the agreed minimum rate due to the operation of certain tax incentives or other specific features in the tax system that result in the MNEs' operations in that jurisdiction being subject to an ETR falling below the agreed minimum rate in a certain period. However, jurisdictions that wish to ensure that they can apply the UTPR in every year could ensure the jurisdictional ETR of every MNE operating in their jurisdictions is at least at the agreed minimum rate by introducing an annual domestic minimum tax on income with the same tax base and tax rate as the GloBE rules. Introducing such a minimum tax on income would make the exclusion ineffective for their jurisdiction.

Identification of intra-group payments

Overview

511. Both the amounts of payments and of net intra-group expenditure taken into account for the application of the UTPR are identified at the level of each UTPR Taxpayer. This section provides more details on the identification of the amounts of intra-group payments taken into account for the purpose of the allocation keys of the UTPR.

¹²¹ This text was originally in a footnote. It has been modified to reflect comments made by delegates during the WP11 meeting.

Definition of deductible payments

Note for WP11 delegates

As set out in [\[CTPA/CFA/WP11/NOE\(2020\)16/REV1\]](#) and discussed at the WP11 meetings of 22 and 23 July 2020 the deductible payments that are taken into account for the purpose of the allocation key under the UTPR are those that meet the general criteria of deductibility applicable in the UTPR jurisdiction. Specific limitations on deductibility, such as the potential application of an anti-avoidance rule in a particular jurisdiction, are not taken into account and do not affect the amount of payments taken into account for the purpose of the allocation keys. There are several reasons for that, clarified in the section below. The main reason relates to the significant complexity that can be avoided by not adjusting the amount of the intra-group payments to reflect actual deduction limitations. Referring to the general conditions of deductibility applicable in the UTPR jurisdiction instead of adjusting that amount to reflect potential deduction limitations is also consistent with the overall rationale of the rule, as clarified in the section below.

In their written comments to the previous version of this Chapter, delegates were concerned that the definition of deductible payments would result in allocating top-up tax to a jurisdiction that would not be able to impose an equivalent incremental tax liability (due to the operation of a specific deduction limitation in that jurisdiction). These concerns need to be weighed against other design elements of the rule. In particular the operation of a cap based on the domestic CIT rate of the UTPR taxpayer (described in section 4.3.4) should limit the over-allocation of top-up tax to a particular jurisdiction and (as described in section 4.3.7) jurisdictions will have some flexibility to implement the rule in such a way that a specific limitation on the denial of a deduction should not impact on the effectiveness of the rule.

On balance, the Secretariat considers that these changes allow for a simpler and more transparent way of identifying the relevant deductible intragroup payments to be taken into account in the determination of the allocation key without affecting significantly the effectiveness of the rule.

512. A consistent and coordinated application of the UTPR requires a common definition of which payments are to be taken into account in applying the allocation keys. Building on the definition of deductible payments used in the BEPS Action 2 Report, the definition of payments for the UTPR covers any expenditure that is paid or payable (including in respect of any future or contingent obligation to make a payment) during the relevant period. Payments are taken into account on an accrual basis.¹²² The definition includes all current expenditure and receipts including rents, royalties, interest and fees paid for services and would also include amounts included as inventory costs.

513. The definition of payment only includes, however, payments that are generally deductible under the tax laws of the payer jurisdiction. Payments that do not meet the general criteria for being deductible in the jurisdiction where the payer is located are disregarded. For this purpose, specific limitations on deductibility or the application of anti-abuse provisions are not taken into account. If a payment meets the general criteria for being deductible in the jurisdiction where the payer is located, then the full amount of this payment is used for the allocation key. This approach could result in a top-up tax being allocated to a UTPR taxpayer for the full amount of a payment that is otherwise subject to deduction limitations under other rules that are applicable in the relevant jurisdiction, such as interest limitation or anti-avoidance rules for instance.¹²³ Adjusting the allocation to reflect specific limitations on deductibility of certain payments

¹²² See paragraph 242 of BEPS Action 2 Report and 423-424 of BEPS Action 2 Report.

¹²³ The interaction with existing domestic rules is expected to be treated under domestic law, as clarified under section 4.3.7.

would not be consistent with the overall design of the UTPR. While the allocation keys are based on intragroup payments, they are intended to be readily comparable proxies for profit shifting rather than providing an accurate measure of the actual tax saved by each UTPR Taxpayer in respect of such payments. For example, the allocation keys are not adjusted for other factors that have a direct bearing on profit shifting such as the tax rate at which they were actually deducted. In addition, measuring the extent to which each payment effectively eroded the tax base of the UTPR Taxpayer would represent significant compliance and administration costs as well as increase the risk of disputes among jurisdictions.

Identification of intra-group payments and net intra-group expenditure

514. Intra-group payments are any deductible payments made by a Constituent Entity to another Constituent Entity of the MNE group.¹²⁴ The net intra-group expenditure of a Constituent Entity is the positive difference (if any) between: (i) the sum of all deductible intra-group payments made by such Constituent Entity to other Constituent Entities of the MNE Group and (ii) the gross amount of income derived by such Constituent Entity from deductible intra-group payments made by other Constituent Entities of the MNE Group.

515. Both the intra-group payments and the net intra-group expenditure of a Constituent Entity are identified on the basis of the information available in its financial books and records (adjusted for items that are not generally deductible under the laws of the payer jurisdiction).¹²⁵ For the purpose of the first allocation key, intra-group payments are identified on the basis of the financial books and records of the Constituent Entities located in the jurisdictions where the MNE's jurisdictional ETR is below the minimum rate.¹²⁶ In practice, these intra-group payments correspond to the related party revenues that these entities receive from UTPR Taxpayers. For the purpose of the second allocation key, the net intra-group expenditure of each UTPR Taxpayer is determined on the basis of income and expenses that are identified in each taxpayer's financial books and records.¹²⁷

Application of the UTPR to deemed payments made by or to permanent establishments

516. As explained in section 2.2.2, permanent establishments are treated as separate Constituent Entities for the purpose of the GloBE rules. Deemed or notional payments from a permanent establishment to its head office or from the head office to its permanent establishment that are recognised for tax purposes should be included in the definition of payments, provided they meet the general criteria for being

¹²⁴ Intra-group payments made by a Constituent Entity to another Constituent Entity in the same jurisdiction are disregarded if both Constituent Entities (possibly with other Constituent Entities located in the same jurisdiction) form a single UTPR Taxpayer under the domestic tax law of this UTPR jurisdiction. See below section 4.3.6 on the Definition of UTPR Taxpayer. [Footnote added further to a comment from the United States]

¹²⁵ Section 4.3.7 describes the rules used to determine the timing in the recognition of these payments.

¹²⁶ A reconciliation may be needed in the case where there are differences between entity-level accounts and consolidated accounts, or between payments recorded in the entity-level accounts of entities in different jurisdictions. This reconciliation process could be done as part of the self-assessment process described in Section 4.3.8, and involve the Ultimate Parent Entity as referred to in the section on Local filing of the relevant information.

¹²⁷ The Constituent Entities may not be held to the same extent by the same controlling entities. This, however, is not relevant for the identification of the amount of intra-group payments to be used in the allocation keys under the UTPR. Assuming the UTPR Taxpayer is wholly owned by an Ultimate Parent Jurisdiction that controls 80% of a low-tax Constituent Entity, for instance, the amounts of intra-group payments used for the allocation key are not adjusted to reflect the difference in the ownership of those entities.

deductible in the payer jurisdiction.¹²⁸ This applies to payments taken into account under either the first allocation key or the second allocation key.

Maximum amount of top-up tax under each allocation key (caps)

517. Overall (and even if further limitations apply as provided under this section), the sum of top-up taxes imposed on all UTPR Taxpayers within the MNE group (when aggregated with adjustments made in other jurisdictions under the IIR) will not exceed the total amount of top-up tax identified at the group level. More specifically, the sum of top-up taxes imposed within the MNE group in relation to low-tax Income of this MNE in a given jurisdiction cannot exceed the amount necessary to bring the MNE's ETR up to the minimum rate in such jurisdiction.

Note for WP11 Delegates – Caps

In response to the previous version of this Chapter delegates expressed a variety of views in relation to the operation of the UTPR and potential further limitations (or caps) that could apply to the allocation of top-up tax under the rule.

Overall cap

An overall cap on the total amount of top-up tax allocated under the UTPR in reference to intra-group revenue of the low-tax Constituent Entities was discussed at the WP11 meeting on 22 July. The outcome of this discussion is summarised in the box for delegates in section 4.3.5. and the text of the Chapter has been further amended to reflect the comments made by delegates on that overall cap.

Possibility of a cap in respect of the first allocation key

The majority of delegates that provided written comments expressed support for applying a cap on the top-up tax allocated under the first allocation key. Most of these delegates considered that the adjustment in respect of the first allocation key should be limited so that it did not result in a higher tax cost than the domestic CIT rate multiplied by the gross amount of related party payments. A few delegates expressed support caps at other levels (e.g. at the minimum rate or based on net related party expenditure). It is now suggested below that the domestic CIT rate would apply. While this option may be more burdensome from a compliance and administration perspective (because of the need to identify such domestic rates), it is expected that this would still be workable, while providing the jurisdictions with a more effective tool to address the potential base eroding transactions that involve Constituent Entities located in their jurisdictions.

Top-up tax allocated under the second allocation key

There was also a mix of views on the need for a cap under the second allocation key. One delegate suggested that the top-up tax allocated under the second allocation key could be limited to the domestic CIT rate multiplied by the net related party expenditure taken into account for that allocation key. Other delegates considered that the operation of the second allocation should not be limited and that no cap should apply. It was pointed out, however, that no cap could, in theory, result in an allocation of top-up tax that was in excess of the Constituent Entity's gross income.

Therefore, in order to bring some measure of proportionality to the rule, while ensuring that it remains an effective backstop to the IIR and consistent with the fact that the UTPR is expected to take the form

¹²⁸ If the profit allocation between the head office and its permanent establishment does not rely on deemed payments, and no such deemed payments are recognised for tax purposes, then no deemed payments are recognised between the head office and its permanent establishment for the purpose of the UTPR.

of a denial of a deduction (or an equivalent adjustment) under the laws of the payer jurisdiction, the Secretariat has suggested that it at the total amount of top-up tax that can be allocated to a jurisdiction (under both keys) is capped at the domestic CIT rate on all intra-group payments made by Constituent Entities located in the UTPR jurisdiction.

Cap on the allocated amount of top-up tax under the first allocation key

518. The first allocation key allocates the amount of top-up tax between UTPR Taxpayers in proportion to the amount of direct payments made to low-tax Constituent Entities. The total amount of top-up tax that can be allocated in respect of direct payments cannot, however, exceed the domestic CIT rate applicable in the jurisdiction of the UTPR Taxpayer¹²⁹ multiplied by the amount of the deductible direct payments that are taken into account to apply the rule (numerator of the first allocation key).

Cap on the allocated amount of top-up tax under the second allocation key

519. The second allocation key allocates the amount of top-up tax between UTPR Taxpayers in proportion to their net related party expenditure. The total amount of top-up tax that can be allocated in respect of net related party expenditure cannot, however, exceed the domestic CIT rate applicable in the jurisdiction of the UTPR Taxpayer¹³⁰ multiplied by the amount of the deductible intragroup payments that are taken into account to apply the rule. These payments are all intragroup payments made by UTPR Taxpayers, except those that were already taken into account for computing the cap under the first allocation key.

4.5.5. Maximum amount of top-up tax that can be allocated under UTPR

Note for WP11 delegates

This section addresses the overall cap mechanism that was discussed in the last version of the UTPR Chapter [[CTPA/CFA/WP11/NOE\(2020\)16/REV1](#)] and discussed at the WP11 meeting held on 22 July.

As discussed at that meeting, that overall cap was in line with direction provided by the Steering Group at their meeting on 15 July 2020 and is intended to address potentially economically distortive outcomes that could arise under the UTPR when an MNE has a significant amount of low-tax domestic profits in a jurisdiction and begins to sell products or services offshore.

At the meeting on 22 July, some delegates expressed concerns about limiting the operation of the UTPR in this way. The primary concern of these delegates was that the limitation may impact on the effectiveness of the rule as a back-stop to the IIR. The majority of the other delegates who spoke at the meeting said that they considered the cap should be confined to profits arising in the Ultimate Parent Jurisdiction.

- In response to those comments, it is now suggested that the overall cap applies in relation to the profits made in the Ultimate Parent Jurisdiction only. Limiting the application of the cap in

¹²⁹ The domestic CIT rate applicable in the jurisdiction of the UTPR taxpayer is the combined rate of the relevant UTPR jurisdiction's covered taxes and also includes sub-national taxes (see section 4.2). Footnote added further to a suggestion from Canada

¹³⁰ The domestic CIT rate applicable in the jurisdiction of the UTPR taxpayer is the combined rate of the relevant UTPR jurisdiction's covered taxes and also includes sub-national taxes (see section 4.2). Footnote added further to a suggestion from Canada

the Ultimate Parent Jurisdiction further ensures that an MNE cannot derive a competitive advantage in being headquartered in a jurisdiction that did not introduce the IIR, since the income made in the subsidiary jurisdictions is affected to the same extent under the IIR and the UTPR. If the overall cap was applied on the income of the subsidiary jurisdictions, the MNE that is subject to an IIR in its headquarter jurisdiction would have an incentive to invert in a jurisdiction that did not introduce the IIR in order to apply the UTPR to the low-tax income of its subsidiaries.

- In addition, a section has been added below to clarify the effect of the cap on the UTPR and on its effectiveness in performing its dual function of operating as a backstop to the IIR while providing jurisdictions with a tool to protect themselves from the effect of base eroding transactions.

Delegates also made suggestions as to how the formula for the cap could be simplified. In adopting delegate suggestions, the formula has been split into two parts. The first imposes an overall jurisdictional limitation. Since the UTPR applies on an entity-by-entity basis, the cap needs to be allocated across the low-tax Constituent Entities located in the same jurisdiction. The second formula allocates the cap to each Constituent Entity in proportion to its adjusted GloBE income. While the formula has been split into two formulas in the section below, the outcome is the same as the one presented in the UTPR Chapter that was discussed at the 22 July meeting of WP11.

Circumstances under which the cap applies

520. As described above in section 4.3.2, the low-tax Constituent Entities located in the subsidiary jurisdictions can be covered either by the IIR (in priority) or the UTPR (as a secondary mechanism). The low-tax income of the Constituent Entities located in the Ultimate Parent jurisdiction, however, cannot be subject to any IIR, and only the UTPR can apply in respect of such low-tax income.¹³¹ Under the UTPR, a cap applies when such low-tax income exceeds the total amount of intragroup payments received by all Constituent Entities located in the Ultimate Parent jurisdiction.

521. If the MNE's ETR is below the agreed minimum rate in the Ultimate Parent Jurisdiction, the total amount of top-up tax to be allocated ("allocable top-up tax") in respect of that Jurisdiction is limited by reference to the foreign intra-group revenue of all Constituent Entities located in such Jurisdiction. The basis for computing the top-up tax allocable in respect of low-tax outcomes arising in the Ultimate Parent Jurisdiction is therefore the minimum of:

- the GloBE income of the Constituent Entities located in the Ultimate Parent Jurisdiction, computed in accordance with the rules described in Chapter 4, and
- the total amount of foreign intragroup revenue of all Constituent Entities located in that jurisdiction.

Calculation of the limited amount of top-up tax when the cap applies¹³²

522. When the GloBE income of the Constituent Entities located in the Ultimate Parent Jurisdiction that is computed in accordance with the rules described in Chapter 4 exceeds the total amount of foreign

¹³¹ As explained above, a domestic minimum tax on income, however, could be introduced in the ultimate parent jurisdiction. Such a domestic minimum tax on income would aim at ensuring that the MNE's jurisdictional ETR in the ultimate parent jurisdiction is at least equal to the agreed minimum rate and would prevent the application of the UTPR in other jurisdictions in relation to profits made in the ultimate parent jurisdiction.

¹³² Section reorganised further to a suggestion from New Zealand and the United States

intragroup revenue of all Constituent Entities located in that jurisdiction, the maximum top-up tax allocable in respect of the Ultimate Parent Jurisdiction is computed as per the following formula:

Top up Tax Percentage x Foreign intragroup revenue of all LTCE in the Ultimate Parent Jurisdiction

523. For the purpose of this formula:

- “Foreign intragroup revenue of all LTCE in the Ultimate Parent Jurisdiction” is the sum of intra-group revenue received from any foreign Constituent Entity (including UTPR Taxpayers and other Constituent Entities) by all low-tax Constituent Entities located in the Ultimate Parent jurisdiction (see further details below); and
- “Top-up Tax Percentage” means the difference between the minimum ETR and the ETR as calculated for that jurisdiction in the relevant period under the Globe Rules after adjusting for any excess taxes in that jurisdiction (same as for the general case described above).

524. For the purposes of determining the amount of Foreign intra-group revenue of all low-tax Constituent Entities, all foreign intragroup sources of revenue would be taken into account, regardless of whether the payer was a UTPR Taxpayer or not. The Foreign Intragroup revenue is identified in accordance with the rules described Section 4.3.4 on the identification of intragroup payments.¹³³ This revenue would not include, however, domestic revenue (both intragroup and third party) or foreign third party sources of revenue. In order to avoid MNEs structuring their intragroup transactions to maximise the effect of this limitation, the rule could contain an anti-avoidance feature that treated an MNE that made direct sales from a low-tax jurisdiction to customers using related party agency structures including commissionaire arrangements (rather than buy-sell structures) as making those sales through a buy/sell company (and thereby recognising a payment to a low-tax Constituent Entity, which would increase the overall limitation). Example 4.3.5A. provides an illustration of the operation of this limitation.

525. When such a cap applies, the maximum amount of top-up tax is computed on an entity-by-entity basis, similarly to what is described above under the general case. Therefore, when the cap applies, the Adjusted GloBE income of each low-tax Constituent Entity subject to the UTPR is further adjusted, in accordance with the following formula:

$$\frac{\text{Adjusted GloBE income of LTCE A}}{\text{Adjusted GloBE income of all LTCE}} \times \text{Foreign intragroup revenue of all LTCE}$$

526. For the purpose of this formula:

- “Adjusted GloBE income LTCE A” is the Adjusted GloBE income of a given low-tax Constituent Entity (A)
- “Adjusted GloBE income of all LTCE” is the sum of all Adjusted GloBE income of all low-tax Constituent Entities in the Ultimate Parent jurisdiction, irrespective of the source of such income; and
- “Foreign intragroup revenue of all LTCE” is the sum of intra-group revenue received from any foreign Constituent Entity (including UTPR Taxpayers and other Constituent Entities) by all low-tax Constituent Entities located in the Ultimate Parent jurisdiction (see further details above).

527. The amount of top-up tax that is allocable under the UTPR in respect of a low-tax Constituent Entity would then be equal to:

Adjusted GloBE Income of low tax Constituent Entity A after limitation x Top up Tax Percentage

528. For the purpose of this formula:

¹³³ This sentence was added further to a suggestion from Australia

- “Adjusted GloBE Income of low tax Constituent Entity A after limitation” is the Adjusted GloBE income of a given low-tax Constituent Entity (A) after it has been further adjusted as per the mechanism described above; and
- “Top-up Tax Percentage” means the difference between the minimum ETR and the ETR as calculated for that jurisdiction in the relevant period under the Globe Rules after adjusting for any excess taxes in that jurisdiction (same as for the general case described above).

Impact of the cap on the UTPR

529. The UTPR is designed to operate as a back-stop to the IIR while also providing jurisdictions with a tool to protect themselves from the effect of base eroding transactions. This cap on the amount of tax that can be allocated in respect of the jurisdiction of the Ultimate Parent strikes an appropriate balance between these two functions.

530. First, this cap does not affect the ability of the UTPR to operate as a backstop to the IIR because it only applies in respect of low-tax income of Constituent Entities that are located in the Ultimate Parent Jurisdiction. The UTPR still mirrors the outcomes of the IIR in respect of low-tax outcomes arising in subsidiary jurisdictions. Therefore, the cap still reduces the incentives for tax driven inversions. In addition, as the IIR would not have applied to the profits made in the Ultimate Parent jurisdiction, applying a cap to these low-tax profits under the UTPR does not provide for a better outcome than what applies under the IIR.

531. Second, this cap does not affect the UTPR as providing jurisdictions with a tool to protect themselves from the effect of base eroding transactions. If the MNE’s ETR in the Ultimate Parent Jurisdiction is below the agreed minimum rate, three scenarios could occur:

532. If the low-tax Constituent Entities in the Ultimate Parent jurisdiction have not received any intra-group revenue from foreign Constituent Entities, the cap would result in the UTPR not applying at all. Indeed, the intragroup revenue would be zero and no top-up tax would be allocated, even if the MNE group has made low-tax profits in that jurisdiction

533. If the amount of all foreign intragroup revenue received by the low-tax Constituent Entities in the Ultimate Parent jurisdiction was lower than the amount of their profits, this cap would limit the amount of top-up tax allocated under the UTPR

534. Finally, if the Foreign intra-group revenue of all low-tax Constituent Entities located in the Ultimate Parent jurisdiction exceeded the amount of Adjusted GloBE income made by such low-tax Constituent Entities, then this cap would not apply.

535. In the first and second scenarios (where there is either no foreign intragroup revenue in the parent jurisdiction or when such revenue does not exceed the amount of low-tax income of Constituent Entities located in the Ultimate Parent jurisdiction), the cap limits the effect of the UTPR to the gross amount of the foreign intragroup revenue. However, the potential base eroding transactions that could be used in the group to fund low-tax profits in the Ultimate Parent Jurisdiction are still subject to an adjustment under the UTPR. In the third scenario (where the foreign intragroup revenue exceeds the amount of low-tax income of Constituent Entities located in the Ultimate Parent jurisdiction), the cap has no effect at all. In this case, the MNE does not derive any competitive advantage from a GloBE perspective in being headquartered in a jurisdiction that is low-tax and that did not introduce the IIR.

4.5.6. Definition of UTPR taxpayer

536. Only the Constituent entities of the group that are subject to a UTPR in the jurisdiction where they are located are (required and) eligible to apply the rule (“UTPR Taxpayers”). Therefore, the top-up tax is allocated only among Constituent Entities that are subject to a UTPR in the jurisdiction where they are

located. Constituent Entities that are not subject to a UTPR in the jurisdiction where they are located are not allocated any top-up tax.¹³⁴

537. Allocating the top-up tax to entities that are not subject to a UTPR would significantly reduce the effectiveness of the rule, because the top-up tax allocated to those entities would not be collected. Therefore, Constituent Entities that are not subject to a UTPR in the jurisdiction where they are located are not allocated any top-up tax in respect of their own deductible payments. Consequently, both the payments made by (and the net intra-group expenditure of) Constituent Entities that are not subject to a UTPR in the jurisdiction where they are located are disregarded for the computations of the allocation keys.

538. A UTPR Taxpayer may consist of only one Constituent Entity or several Constituent Entities that are located in the same jurisdiction. Several Constituent Entities can form only one UTPR Taxpayer, for instance, if they belong to a tax consolidated group under the tax laws of that jurisdiction. Combining several Constituent Entities into a single UTPR Taxpayer has the effect of aggregating the amounts of intra-group payments that these Constituent Entities made to or received from any other Constituent Entities. In addition, this also results in disregarding the intragroup payments made between the Constituent Entities that form the same UTPR Taxpayer. Combining these Constituent Entities should not affect the total amount of top-up tax that is allocable to the UTPR Taxpayers. This should also not affect the top-up tax that these Constituent Entities would be allocated under the first allocation key. This could, however, affect the amount of top-up tax that they would be allocated under the second allocation key if, for instance the only intragroup payments that these entities were involved in were intragroup payments that are between them and that would be disregarded. The possibility to combine or not several Constituent Entities in a given jurisdiction to form one single UTPR Taxpayer depends on the domestic law of this jurisdiction.¹³⁵

4.5.7. Adjustment to be made under the UTPR

Domestic law mechanism

539. The rules set out above describe a coordinated mechanism which allocates top-up tax among the UTPR Taxpayers of the MNE Group. This allocation provides UTPR jurisdictions with the basis for calculating the amount of the adjustment to be made under the UTPR in these jurisdictions. The GloBE rules do not, however, prescribe the mechanism by which this adjustment must be made. This is a matter of domestic law implementation that is left to the jurisdictions that choose to adopt the UTPR. The adjustment could be through a limitation or a denial of a deduction for payments made to related parties or could be in the form of an additional tax. The form in which the adjustment is made will depend on the existing design of the domestic tax system and should be co-ordinated with other domestic law provisions and a jurisdiction's international obligations including those under tax treaties. For example, a jurisdiction that provides an allowance for corporate equity could choose to reduce that allowance to reflect an allocation of top-up tax. Another jurisdiction may require a taxpayer to make an adjustment under the UTPR by including an additional amount of deemed income representing a reversal of related party expenses incurred in current or prior periods.

540. In certain cases, the jurisdiction may allow the adjustment to be made by a taxpayer other than the UTPR Taxpayer that is allocated the top-up tax. For example, taxpayers in a UTPR jurisdiction may be consolidated for tax purposes or form part of a local tax group that allows members of the group to share the benefit of expenditure, credits or taxes paid. For such jurisdictions, the most straight-forward way of making the adjustment could be at the level of the local tax consolidated group rather than on an entity

¹³⁴ The rules for determining the location of a Constituent Entity are set out in Chapter 4.

¹³⁵ Paragraph added further to a comment from the United States

by entity basis.¹³⁶ In every case, however, the adjustment should result in the imposition of additional tax in the jurisdiction that is calculated by reference to intragroup payments (as provided for under the allocation key) and the adjustment should take effect within the same period that the top-up tax is allocated. In the event that it is not possible to make a full adjustment in that period then the adjustment should be made in the following period or as soon as reasonably practicable (see below section on the timing of the UTPR adjustment. The domestic design of the UTPR should ensure that the rules operate as an effective backstop to the IIR by imposing an additional tax that is incremental to the tax that the taxpayer would otherwise have paid under the ordinary domestic rules for calculating taxable income.

Extent of the denial of a deduction or deduction limitation

541. If the UTPR adjustment takes the form of a denial of a deduction (or a limitation of the deduction of intragroup payments), the extent to which it applies depends on the top-up tax allocated to a UTPR Taxpayer. The amount of deduction that needs to be denied is obtained by dividing the amount of top-up tax allocated to the UTPR Taxpayer by the CIT rate to which this entity is subject. For instance, if a UTPR Taxpayer¹³⁷ is allocated a top-up tax of 10 and is subject a 25% CIT rate, denying this entity the deduction of a payment of 40 (= 10 / 25%) results in the same incremental tax cost (40 x 25% = 10).¹³⁸

542. The maximum top-up tax allocated to an entity will de facto be capped if the UTPR operates as a denial of a deduction. The denial of a deduction results in an incremental tax burden on the payer that is equal to the CIT rate on the total amount of expenses that are treated as non-deductible under the rule. However, a jurisdiction can introduce a carry-forward mechanism that would ensure that the tax liability is carried forward if the top-up tax allocated to the payer did not result in an adjustment in the current year. See below the section on the Timing of the UTPR adjustment.

Information requirement

543. Most of the information necessary to apply the UTPR relates to foreign entities and foreign transactions from the perspective of the jurisdiction applying the UTPR and may not be directly available in the tax return of the UTPR Taxpayer or to the tax administration. Therefore, it is necessary to ensure that the UTPR Taxpayers and the MNE will provide the information necessary to compute and allocate the top-up tax.¹³⁹ Section 4.3.8 below provides further details about standardised mechanisms that can be contemplated to obtain such information from the taxpayer.¹⁴⁰

¹³⁶ Alternatively, under the domestic law of a UTPR Jurisdiction, the tax consolidated group itself could be the UTPR Taxpayer. Under such circumstances, the payments made by Constituent Entities would be aggregated for the purpose of applying the UTPR and the payments that occurred within the tax consolidated group would be disregarded for the application of the UTPR. See section 4.3.6 on the Definition of UTPR Taxpayer

¹³⁷ [Clarification further to a suggestion from Canada]

¹³⁸ The UTPR could also take the form of an additional tax. An additional tax could be achieved either by collecting the top-up tax directly or, for instance, by recognising an additional taxable income at the level of the UTPR Taxpayer.

¹³⁹ Simplification mechanisms to provide such information in a standardised manner across jurisdictions that apply the UTPR are described in section 4.3.8.

¹⁴⁰ Each jurisdiction could design an appropriate mechanism (e.g. penalties) under its own domestic law to ensure it is provided with the relevant information.

Timing of the UTPR adjustment

544. The UTPR is calculated based on the intra-group payments made during the relevant period. Under the first allocation key, the allocation is determined based on the total intra-group payments received by the low-tax Constituent Entity in the period for which top-up tax has been allocated. Under the second allocation key, the allocation is determined based on the net intra-group expenditure for the accounting period of the UTPR Taxpayer that ends during the period for which top-up tax has been allocated.

545. Absent an MNE having staggered year-ends for its Constituent Entities, the UTPR adjustment could be made in the same year as when the jurisdictional ETR of the MNE is below the agreed minimum rate in the relevant low-tax Jurisdiction. As mentioned above (section 4.3.7, sub-section on Domestic law mechanism), it is acknowledged that, if the top-up tax allocated to a UTPR Taxpayer cannot be imposed in the year of adjustment (for example, because the taxpayer does not have a sufficient amount of deductible related party expenses to support the adjustment) the adjustment could be carried over and imposed in a subsequent year provided the rule is likely to results in an incremental tax liability within a reasonable period of time [2 to 3 years].¹⁴¹ Under such circumstances, the UTPR Taxpayer should not suffer any penalties for not being imposed the top-up tax in the previous years.

4.5.8. Compliance and administration of the UTPR

Overview

546. The UTPR will apply as a backstop to the IIR. This means the UTPR will not apply to the low-tax income of a Constituent Entity where that entity is owned directly or indirectly by another Constituent Entity that applies the IIR to those low-tax Profits.¹⁴² To simplify both the compliance with the UTPR and the administration of the rule in instances where the UTPR should not apply, the taxpayer would be offered the possibility to certify that such an IIR applies and/or that the structure of the MNE it belongs to does not leave any low-tax profits that could be subject to the UTPR.¹⁴³ This section describes the content of the relevant certifications that the taxpayer would be expected to provide to the tax administration for that purpose.

547. On the other hand, when the UTPR is applied, it is likely that the operation of the rule may need to be coordinated with the UTPRs in several other jurisdictions where the MNE operates. This co-ordination is necessary to ensure that the total amount of the top-up taxes does not exceed the amount necessary to bring the aggregate tax in respect of UTPR adjustments up to the agreed minimum rate. As explained above, the top-up tax computed and then allocated to a given UTPR Taxpayer depends on the amount of profits made in such jurisdictions, the tax paid on such profits and the total volume of intra-group payments that are potentially subject to adjustment under the UTPR.¹⁴⁴ Both from a compliance and administration perspective, there will be benefits in applying a coordinated approach. Most of the information required to identify these amounts and to apply the rule will be the same for each jurisdiction applying the UTPR. In addition, the consistent application of the UTPR in each jurisdiction is critical to ensure that it does not result in the MNE being subject to an aggregate tax burden that is above the minimum rate. To simplify both the compliance with the UTPR and the administration of the rule, the taxpayer would provide this information in a standardised format to the tax administration in the jurisdictions where the UTPR applies.

¹⁴¹ Changes to this paragraph made further to comment from France

¹⁴² See above section 4.3.2 on the priority of the IIR over the UTPR

¹⁴³ Such an IIR would need to be designed in accordance with the GloBE rules.

¹⁴⁴ Addition to that sentence made further to a comment from Canada

This section further describes the content of standardised self-assessment returns that the UTPR Taxpayer would be expected to provide for that purpose.

Certification requirements in instances where the UTPR should not apply

548. There are several instances where the UTPR should not apply, either as a result of the prior application of an IIR rule or because the conditions required to apply the UTPR are not met. The basis for excluding the UTPR will depend on the structure of the MNE Group, the jurisdictions where it operates and its tax profile (e.g. the absence of low-tax profits). For example, the UTPR will not apply in any jurisdiction where the MNE operates if:

- the Ultimate Parent Entity of MNE Group is resident in a jurisdiction where an IIR applies and the MNE's jurisdictional ETR in the parent jurisdiction is at or above the agreed minimum rate;
- the MNE's jurisdictional ETR is at or above the agreed minimum rate in every jurisdiction where its Constituent Entities are located; or
- the nature of the intra-group payments of the UTPR taxpayer cannot lead to any top-up tax being allocated to that taxpayer.

549. The content of the certification required to avoid the application of the UTPR in each jurisdiction are further described below for each of those instances. Most of the information necessary to apply the UTPR relates to foreign entities and foreign transactions from the perspective of the jurisdiction applying the UTPR and may not be directly available to the Constituent Entities although they can be prepared at the Ultimate Parent level. Therefore, these certifications could be provided by the Constituent Entity itself or by the MNE's Ultimate Parent entity.¹⁴⁵

550. The type of information contained in the certifications is the same for all UTPRs to which the UTPR Taxpayers of the MNE group are subject. Therefore, the compliance with the rule and its administration can be simplified by requiring those taxpayers to provide such certification under a single format. The format and content of the certificate would be developed as part of the work on implementation.

Certification that no adjustment required under UTPR due to prior application of IIR

551. If all members of the group are parented in a jurisdiction where an IIR applies, the IIR mechanism ensures that the MNE group is liable for a top-up tax if there are low-tax profits made in the jurisdictions where it operates (except from the parent jurisdiction). For this exception from the UTPR to apply, the IIR should be designed in accordance with the principles described in this report, which is further discussed in Chapter 6. As a matter of simplification, it is contemplated that part of the work on implementation could include compiling and publishing a list of the IIRs that have been designed in accordance with the principles described in this report.

552. As discussed in section 4.3.1, an applicable IIR would not cover the profits made in the parent jurisdiction. Therefore, to be exempted from the application of the UTPR, the taxpayer would also need to certify that the ETR in the parent jurisdiction is at or above the agreed minimum rate. Such certification could be based on the simplifications that are discussed in section 3.10 and that will be further developed as part of the work on implementation.

Certification that no adjustment required because ETR is at or above the agreed minimum rate

553. If the MNE's jurisdictional ETR is at or above the agreed minimum rate in every jurisdiction where its Constituent Entities are located, neither the IIR nor the UTPR apply. Therefore, if the taxpayer certifies

¹⁴⁵ See below the section about the local filing of the relevant information.

that this is the case, the UTPR should not apply, even in the absence of any applicable IIR within the group. For that purpose, the certification will also incorporate the simplifications that are discussed in section 3.10 and that will be further developed as part of the work on implementation.

Certification that intra-group payments cannot result in allocation of top-up tax

554. The nature of the intra-group payments of a given UTPR Taxpayer does not lead to any top-up tax being allocated to that taxpayer when (i) it has not made any intra-group payments to entities located in jurisdictions where the MNE's jurisdictional ETR is below the agreed minimum rate and (ii) it has net related party income (and not net related party expenses) for the purpose of applying the rule. Under such circumstances, the top-up tax that may be due because of low-tax profits arising in the MNE group would be allocated to other taxpayers. Certifying that this is the case is likely to operate at the Constituent Entity's level and involves the jurisdiction where this Constituent Entity is located only. It would not avoid the application of the UTPR in other jurisdictions where the MNE operates. However, the information necessary for this certification would be required in other jurisdictions as it affects the operation of the allocation keys.

Standardised self-assessment return to apply the UTPR

555. The information required to apply the UTPR will need to be provided by the taxpayer to the relevant tax administrations. As most of the information required to apply the UTPR in each jurisdiction is the same, a standardised self-assessment return that the MNE would prepare and use in order to comply with the UTPR could be developed as part of the work on implementation. These standardised self-assessment returns could be provided by the UTPR Taxpayer itself or by the MNE's parent entity under the same format.¹⁴⁶ A number of benefits for MNEs and tax administrations in using such standardised information have been identified:

- It would reduce the burden on MNEs which would be able to provide the same documentation in each jurisdiction where they operate
- It would facilitate a consistent application of the rule
- It would facilitate the review by tax administrations that would gain experience in working with standardised templates
- It would facilitate the multilateral working by tax administrations
- It would be possible to develop guidance to support tax administrations and MNEs in completing and using standardised templates.

556. The format and content of the forms that could be part of the standardised self-assessment return will be developed as part of the work on implementation, but this information is likely to include, for each period:

¹⁴⁶ See below the section about the local filing of the relevant information.

- The total amount of top-up tax arising in that period for jurisdictions where the MNE's jurisdictional ETR is below the agreed minimum rate, which would be computed based on the net income and taxes paid in each jurisdiction where the MNE operates;
- The total amount of intra-group payments made by each UTPR Taxpayer to each low-tax Constituent Entity;
- The total amount of top-up tax imposed in the year as a result of the first allocation key¹⁴⁷
- If there is top-up tax remaining after this first allocation, the net intra-group expenditure of each UTPR Taxpayer.

557. Annex 4.3.8A. provides an example of an information template that is comprised of four tables intended to capture most of the information that could be required in order to apply the UTPR.

Local filing of the relevant information

558. Requiring each UTPR Taxpayer to provide the certifications or standardised self-assessment returns described previously implies that it is able to collect such information either from its Ultimate Parent Entity or from other group entities. However, the UTPR Taxpayer may not be in the best position to collect such information. The Ultimate Parent Entity would be in a better position to collect such information from all the group entities and may collect some of this information for consolidation purposes already. Although the UTPR Taxpayer will be required to provide the self-assessment return or certifications, the Ultimate Parent Entity could in practice prepare these documents and provide them to each tax administration in jurisdictions where it has a Constituent Entity, on behalf of its Constituent Entity. This could be compared with the approach currently adopted with respect to an MNE's master file which (assuming requirements correspond with the BEPS Action 13 recommendations) may be prepared centrally but is filed separately in each jurisdiction where required. In order to facilitate administration the local UTPR Taxpayer would, in any event, remain jointly responsible for providing the local tax administration with the information needed in order to apply the rule including the determination of the top-up tax allocated to that UTPR Taxpayer.¹⁴⁸

4.6. Application of the special rules to out of scope entities

4.6.1. Associates and joint ventures

Note for WP11 Delegates

The document [CTPA/CFA/WP11/NOE\(2020\)15/REV1](#), which was discussed by WP11 delegates at their virtual meeting on July 17, 2020, included proposals for treating joint ventures as Constituent Entities for purposes of the GloBE rules. While this would have been a departure from how such entities are currently treated under CbCR, the reason for this including them within the scope of the GloBE rules was that joint ventures represented a risk of leakage under the GloBE rules due to the fact that their owners always account for them under the equity method.

While acknowledging the risk of leakage, some delegates noted that treating joint ventures as Constituent Entities of an MNE Group could result in significant additional complexity. For example, if the joint venture was an investment amongst several MNE Groups, then the ETR calculation would need to be applied to the JV entity several times under the different income inclusion rules applying in respect of each MNE Group. This could complicate the application of the rules in respect of joint

¹⁴⁷ A record should also be kept of whether any top-up tax allocated but not imposed is imposed in a later year

¹⁴⁸ Changes to that paragraph made further to a comment from France

ventures and potentially result in over- or under-taxation depending on blending outcomes. These type of complications suggest that simply treating joint ventures as Constituent Entities may not ultimately result in a workable rule.

Subsequently Section 4.2.4 of the document [CTPA/CFA/WP11/NOE\(2020\)17/REV1](#), discussed by WP11 delegates at their meeting on July 30, 2020, set out design options for the development of rules that would capture investments in Associate Entities held by MNE Groups. The proposal suggested in the note was that a simplified version of the income inclusion rule could be applied with respect to associate entities of the MNE Group that would be based on the equity method of accounting.

In light of delegate comments at the WP11 meetings on July 17 and 30th, the Secretariat has suggested the following compromise proposal for addressing the treatment of joint venture interests held by an MNE Group under the GloBE rules:

- (a) Joint Venture Entities would not be treated as Constituent Entities of an MNE Group; and
- (b) Instead, an MNE Group would be required to apply a simplified version of the income inclusion rule to its investments in both joint ventures and associate entities.

This approach avoids departing from the current treatment of joint ventures under CbCR or the need to adopt separate rules to deal with the calculation of an ETR in respect of joint ventures. It also aligns the treatment joint ventures and associate entities which are both accounted under the equity method for financial accounting purposes.

Question for WP11 Delegates

Do delegates agree with compromise proposal for addressing the treatment of joint venture interests held by an MNE Group under the GloBE rules?

559. The income inclusion rule applies to the income of Constituent Entities directly or indirectly owned by the Parent applying the rule. The MNE Group's share of the income of Associate Entities and Joint Venture Entities (JVs) in which it has an equity interest is included in the group's financial accounting income under the equity method but is excluded from the GloBE tax base as a permanent difference.

560. Excluding the MNE Group's income from Associate Entities and JVs, however, creates a risk of leakage and unfairness. An MNE Group could often arrange to acquire its minority interest in another MNE Group through an entity whose income is not subject to an IIR rule (including an IIR rule applicable under the split-ownership rules). Moreover, an interest in a Joint Venture represents a serious risk of leakage under the GloBE rules because the owner's share of the JV's income is excluded from the owner's income. If an Associate Entity or JV is a Parent that applies the IIR, the income of its subsidiaries will be subject to the GloBE rules. However, in many cases, a JV will be a stand-alone entity or will not have foreign subsidiaries. Thus, the income of the entity itself will escape taxation under the GloBE rules absent a special rule to deal with interests in these entities. Finally, while the difference between control and joint control may have some significance for financial accounting purposes, it does not seem appropriate for taxation or full exemption under the GloBE rules should turn on that distinction.

Not possible to require MNE Group to apply IIR on standalone basis

561. It would be very challenging, however, to apply the full set of IIR rules to the income of Associate Entities and JVs for a variety of reasons. The MNE Group would need to get detailed information about the income and covered taxes reported in the tax returns of the entity in which it directly holds an equity interest and the subsidiaries of that entity in order to compute jurisdictional ETRs. It would also need the information necessary to compute any carve-out for the jurisdictions in which those entities are tax resident. Because the MNE Group jointly controls a JV and has significant influence over an Associate Entity, it may be able to secure relatively detailed financial information on the Associate Entity or JV operations.

However, this information is not contained in its own financial accounts and it may have difficulty getting the jurisdiction-by-jurisdiction information in the format and detail necessary to incorporate that information into its own GloBE computations. Moreover, it may not be appropriate to include all the income of the Associate Entity or JV in the MNE Group's ETR computations for a jurisdiction because the minority interest could significantly affect the MNE Group's ETR in the jurisdiction. Rather, it would be more appropriate to only include the MNE Group's share of the income and covered taxes attributable to the interest in the Associate Entity or JV in its ETR computations.

Simplified IIR

562. Accordingly, a simplified income inclusion rule (the Simplified IIR) is necessary for income attributable to interests in Associate Entities and JVs. Generally, the Simplified IIR applies to the income of an MNE Group attributable to ownership interests in entities or arrangements that are reported under the equity method. The rule does not apply, however, in the case of an entity or arrangement in which the MNE Group has a direct ownership interest and that:

- a. is organised in a jurisdiction that has adopted the GloBE rules; and
- b. has an ETR above the minimum rate (or that is subject to a domestic minimum tax described in section 4.9).

The second requirement is necessary because often substantially all of the income of a JV will be derived from operations in the JV's tax jurisdiction, rather than through foreign subsidiaries. Without the second requirement, the income of a JV would escape the GloBE rules if it were organised in a low-tax jurisdiction that nonetheless had adopted the GloBE rules.

563. The simplified IIR determines the ETR for the interest in each Associate Entity or JV as a whole. Specifically, it determines the ETR for the income attributable to each entity based on the MNE Group's equity method income attributable to each investment in the entity and the MNE Group's proportionate share of the income taxes accrued by the Associate Entity or JV and its subsidiaries, if any, for the year. This computation departs from the general IIR in three respects.

564. First, the ETR computation under the simplified IIR is effectively based on worldwide blending of the income and taxes of the Associate Entity or JV and all subsidiaries of that entity. In many cases, the Associate Entity or JV will not own foreign subsidiaries and the simplified IIR will not result in cross-jurisdictional blending. In other cases, however, it would be extremely complex and burdensome to apply jurisdictional blending in the context of the Simplified IIR.

565. Second, the income taxes are determined based on the financial accounting rules, including deferred tax accounting. This simplification eliminates the need to determine the amount of cash taxes paid by each Associate Entity or JV and its subsidiaries. It also eliminates the need for the local tax carry-forward and IIR tax credits.

566. Third, the simplified IIR only takes into account taxes that are treated as income taxes for financial accounting purposes. This simplification means that the MNE Group does not have to re-compute the income and taxes of each subsidiary to determine the ETR. The applicable accounting principles are the accounting principles used to determine the amount of the MNE Group's income reported under the equity method.

567. If the ETR computed for an Associate Entity or JV is below the minimum rate, the MNE Group's equity method income attributable to the ownership interest in the entity is multiplied by the top-up tax percentage (the difference between the minimum rate and the ETR) to determine the top-up tax attributable to that ownership interest.

568. The Simplified IIR computes the tax liability for purposes of computing the ETR based on deferred tax accounting and worldwide blending. Therefore, carry-forwards generally are not necessary and indeed

would be duplicative. However, a loss carry-forward or similar adjustment is needed for Associate Entities and JVs organised in jurisdictions that do not have an income tax or that have an income tax rate below the minimum ETR. Therefore, the Simplified IIR could allow for a loss carry-forward in respect of an Associate Entity or JV that is organised in jurisdiction that does not impose an income tax on the entity's income annually. In the case of an entity organised in a jurisdiction that has a tax rate below the minimum, the deferred tax asset arising in connection with a loss is determined for purposes of the Simplified IIR based on the minimum tax rate.

569. Finally, the Simplified IIR does not allow a carve-out for a routine return. This simplification is appropriate because, because the simplified IIR is a stand-alone tax imposed on an equity investment which simply measures the overall return on that investment and (expected) the tax liability on that return. It is also expected that, in practice, the MNE Group may have significant difficulty of getting and auditing the relevant information to apply the carve-out.

4.6.2. Orphan entities

Note for WP11 delegates – Orphan Entities

Comments were received from delegates and summarised in the latest version of the UTPR Chapter that was circulated to WP11 Delegates [[CTPA/CFA/WP11/NOE\(2020\)16/REV1](#)]. This last paper provided that the Secretariat would prepare a draft rule that would be circulated to delegates in the next version of this Chapter. The draft rule was designed on the basis of delegates comments and is provided below.

570. The GloBE rules apply only in respect of low-tax Constituent Entities that are members of the same MNE Group as the taxpayer. Some entities or arrangements may not meet the criteria for being part of the MNE Group (and, therefore, are not “Constituent Entities”) as defined in Chapter 3, even though they may be controlled by the same shareholder or group of shareholders as the Constituent Entities. The most common situation where this could arise is where the underlying shareholder or group of shareholders of the MNE Group and the entity or arrangement consists of a fund or foundation or a group of connected individuals (such as a family) that does not, itself, form part of the MNE Group.

571. These entities or arrangements (“Orphan Entities”) could be used to extract profit from the MNE Group for the benefit of the controlling shareholders, giving rise to a BEPS risk. Including the profits made by Orphan Entities in the scope of application of the UTPR mitigates this risk. Defining the circumstances under which these profits are included in the scope of application of the UTPR further aims at limiting compliance and administration costs when this risk is the most acute.

572. The BEPS risks posed by these Orphan Entity structures is likely to be most significant when (i) such an Orphan Entity is connected with some or all the Constituent Entities of the MNE Group and (ii) it derives a significant revenue or a significant portion of their revenues from payments that are made directly by Constituent Entities. Therefore, as an exception to the general definition of the scope of the MNE Group, the Orphan Entity rule would treat an entity or arrangement as a Constituent Entity for the purposes of the UTPR, if the entity is a connected person and it derives more than a certain amount or a certain percentage of its annual turnover from deductible intra-group payments that were made directly by Constituent Entities of the MNE Group

*Connected persons***Definition of Connected Persons**

“Two persons shall be “connected persons” if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

In any case, a person or enterprise shall be considered to be connected to another person if:

- (a) one possesses directly or indirectly more than 50 per cent of the beneficial interests in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) or
- (b) if another person possesses directly or indirectly more than 50 per cent of the beneficial interests (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) in each person.”.

573. The definition of connected persons is based on the approach taken in the definition of “closely related” persons and enterprises in Article 5(8) and 5(9) respectively of the OECD and UN Model Tax Conventions, for the purposes of applying the independent agent and anti-fragmentation provisions in those Articles¹⁴⁹. The test is the same as used for the Subject to Tax rule in Section 5.2 below and is similar to the control test used in consolidated accounting.

De facto control test

574. The first part of the definition sets out the general definition of “connected persons”. It provides that there is a connection persons where there is a *de facto* control relationship between them. In line with similar requirements set out in accounting standards, a *de facto* control test looks to the facts and circumstances between the parties in the context of its other arrangements and seeks to determine whether the person has sufficient power over the entity to affect that person’s investment return in that entity.

575. Factors that are relevant to the application of the *de facto* control test include the size of the person’s shareholding relative to the size and dispersion of other shareholders, other potential voting rights held by that person through instruments such as options, warrants or convertible notes and rights arising from other contractual arrangements such as lending arrangements that provide the lender with *de facto* control over the business. This *de facto* control test means that an investor without a majority stake in a company could still be a controlling person if there are arrangements in place that provide that person with the ability to acquire a majority stake or the other shareholdings are widely dispersed and the investor holds significantly more voting rights than any other shareholder. The *de facto* test ensures that, in practice, a controlling investor in a company cannot sever that connection by putting in place arrangements designed to retain control but shift ownership of the equity into the hands of others. The *connected persons* test also extends to situations where a person has joint control over the parties involved in the transaction. For example, a joint venturer owns 50% of the equity interests of a joint venture. The joint venture company makes a payment to another company that is controlled by the joint venturer. In this case, both companies

¹⁴⁹ It is noteworthy that the same approach – a two component rule with a *de facto* control test and deemed control above a 50 per cent participation level – is also adopted in paragraph 6 of the alternative fees for technical services article provided for in paragraph 26 of the Commentary on Article 12A of the 2017 UN Model Tax Convention. A similar control test could also be applied in the context of rules for addressing the profit shifting risks raised by orphan entities in the context of the undertaxed payment rule depending on the outcome of those discussions in WP11. See [CTPA/CFA/WP11/NOE\(2020\)16](#) – Section 5.4.

are considered to be connected persons for purposes of the Orphan Entity rule because they are controlled by the same person, even if one of those companies is not unilaterally controlled.

Group of persons

576. The definition set above states that two persons are connected if both of them are controlled by the same person or persons. The term “persons” refers to an identifiable group of persons that have entered into an agreement in respect of the equity of the company or that habitually act together to exercise control over the entity. A control agreement is an agreement concerning the ownership or exercise of voting or equity interests that can be expected to have a material impact on the value of those interests. It would include, for example, shares held by different funds but under the control of a common manager. Persons who habitually act together to control an entity would include members of a family that hold a controlling stake in a company. The definition does not, however, seek to capture those situations where there is simply a set of otherwise independent shareholders that, in aggregate, hold a majority of the equity interests of two different companies.

577. The group of persons requirement means that a controlling shareholder cannot lose control of its equity holding in a company by transferring ownership to or among members of the shareholder’s family. It also ensures that an entity that is spun-out of the MNE Group to a group of controlling shareholders will generally remain under common control even if that entity is no longer consolidated.

Deemed control test

578. The second part of the definition provides that the connection requirements are automatically met in certain circumstances. Under that second part, a person is considered to be connected to another person if either one possesses directly or indirectly more than 50 per cent of the beneficial interests in the other or if a third person possesses directly or indirectly more than 50 per cent of the beneficial interests in both. A person is therefore deemed to be connected to another person where the first person holds directly or indirectly more than 50 per cent of the aggregate vote and value of a company’s shares or of the beneficial equity interest in that company. The deemed control test means that a majority shareholder does not fall outside the scope of the rule simply because there are arrangements in place that mean that the de facto control test does not apply. For example, there may be legal or regulatory requirements in a jurisdiction that prevent a majority shareholder from fully exercising its rights over the subsidiary. While the majority holder may consider that it does not have de facto control over the entity it will be treated as a controlling shareholder by virtue of its majority stake in the subsidiary.

Revenue test

579. The amount or share of the annual revenue of an orphan entity that is derived from deductible intra-group payments made by Constituent Entities would be determined on the basis of the financial accounts of such an Orphan Entity, with the same methodology as the one that applies under the UTPR.

Application of the UTPR to Orphan Entities

580. An Orphan Entity is included in the scope of the UTPR if treating such an entity as an Orphan Entity would result in an increase in the total amount of top-up tax can be collected under the UTPR. Therefore, an Orphan Entity is included only if including its income and covered taxes under the methodology described in Chapter 4 results in either:

- adding a new jurisdiction to the scope of jurisdictions for which the MNE Group computes its ETR (in the absence of any Constituent Entity being located in the same jurisdiction as the Orphan Entity) and the MNE’s ETR in that jurisdiction being below the minimum rate as a result of taking into account the income and covered taxes of the Orphan Entity, or

- the MNE's ETR in the jurisdiction where the Orphan Entity is located becoming or remaining below the minimum rate after taking into account the income and covered taxes of the Orphan Entity.

581. In accordance with the methodology described in section 3.8, the income and covered taxes of the Orphan Entity are taken into account to compute a (revised) top-up tax percentage for the jurisdiction where it is located. Subsequently, this top-up tax percentage is applied to the Adjusted GloBE income of the Orphan Entity in order to determine the amount of top-up tax attributed to the Orphan Entity. Such top-up tax is then allocated to UTPR Taxpayers in accordance with the methodology described in section 4.3.4. For that purpose, the payments that such an Orphan Entity receives from or makes to Constituent Entities are taken into account to allocate the top-up tax. If the Orphan Entity is located in the Ultimate Parent Jurisdiction, the overall cap provided in section 4.3.5 applies by including the intragroup revenue of such an Orphan Entity. The data that relates to the computation of the income and the covered taxes of the Orphan Entity as well as the amounts and structure of intra-group payments involving the Orphan Entity are subject to the same filing and documentation requirements as those that are provide for any Constituent Entity that is located in a low-tax jurisdiction for the purpose of applying the UTPR.

582. An Orphan Entity that would be located in a jurisdiction that introduced the UTPR, however, would not be allocated any top-up tax. This results from the condition described previously under which an Orphan Entity is included in the scope of the UTPR on the condition that the MNE's ETR in the jurisdiction where the Orphan Entity is located is below the minimum rate after taking into account the income and covered taxes of the Orphan Entity.

5 Subject to tax rule

5.1. Overview and summary

583. The GloBE rules are designed to ensure large multinational enterprises (MNEs) pay a minimum level of tax on their income globally. The subject to tax rule complements these rules, but focuses on the bilateral context of tax treaties and the ability of source jurisdictions to protect themselves from the risks posed by BEPS structures which take advantage of low tax outcomes in the other contracting jurisdiction.

584. The subject to tax rule is not premised on concerns (such as those addressed under Pillar 1, or underlying the inclusion of the Article 12A technical service fees provision in the 2017 UN Model) that the current allocation of taxing rights between jurisdictions needs to be revisited. Rather, the subject to tax rule reflects the concern that source countries are vulnerable to having their tax base eroded through certain deductible payments that are subject to no or low rates of taxation in the state of residence, and that the retention of properly targeted and limited source taxation rights could be a supporting element in preventing certain payments that give rise to greater base erosion concerns being used as a mechanism for profit shifting.

585. As with other elements of Pillar 2, Inclusive Framework members acknowledge the importance of developing rules that meet this objective while minimising burdens for both tax administrations and taxpayers and avoiding double taxation or taxation in excess of economic profit.

586. Drawing all of this together, the subject to tax rule will incorporate the following design components:

- a. **Applied to payments.** The subject to tax rule is a standalone treaty rule and, consistent with the way bilateral tax treaties operate, will apply to payments between residents of two contracting states. This payments-based approach means that the rule will not apply jurisdictional or entity blending, but will instead operate by reference to the tax applicable to an item of income. Consistent with the scope of application of the GloBE proposal, however, it will not apply to payments made to or by individuals.
- b. **Applied between connected persons.** The rule will apply to payments between connected persons. The definition of connected persons is based on the definition of “closely related” persons in Article 5(8) and 5(9) respectively of the OECD and UN Model Tax Conventions. Under this test, two persons are treated as “connected” if one has control of the other or both are under the control of the same person or persons. While the test is based on a de facto control relationship, these control requirements are automatically met where one person possesses directly or indirectly more than 50 per cent of the beneficial interests in the other or if a third person possesses directly or indirectly more than 50 per cent of the beneficial interests in both.
- c. **Covered payments.** The rule will apply to a defined set of payments giving rise to base erosion concerns.
- d. **Excluded entities.** Consistent with the scope of application of the GloBE, the subject to tax rule will not apply to certain entities that are outside the scope of the income inclusion and undertaxed payments rules (where certain conditions are met). The entities that are currently

envisaged as being excluded from those rules are: investment funds; pension funds; sovereign wealth funds; government bodies; international organisations, and non-profit organisations.

- e. **Materiality threshold.** In order to ensure that the subject to tax rule is focused on those structures that pose the most material profit shifting risks, it will be subject to a materiality threshold.
- f. **Adjusted nominal rate trigger.** The rule will be triggered when a payment is subject to a nominal tax rate in the payee jurisdiction that is below the minimum rate, after adjusting for certain permanent changes in the tax base that are directly linked to the payment or the entity receiving it. This approach is consistent with the design of a payments-based rule; applying an effective tax rate test to each payment would be prohibitively complex to administer and comply with.
- g. **Using a top-up approach.** The effect of the rule will be to allow the payer jurisdiction to apply a top-up tax to bring the tax on the payment up to an agreed minimum rate and that interacts in a coordinated manner with any existing withholding rate in the treaty. Because the rule applies to the gross amount of the payment, the top-up tax will be limited to avoid excessive taxation.

587. The first five of these components frame the scope of the standalone treaty rule; and the last two determine the conditions under which it applies and the effect of its application.

5.2. Scope

588. Consistent with the nature of bilateral tax treaties, the subject to tax rule will apply at the entity (person resident in a contracting jurisdiction) level and to individual payments (items of income). Consistent with the overall design of Pillar 2 the subject to tax rule will only apply to payments between parties that are under common control and will not apply to payments made to (or by) residents who are individuals.

Note for Delegates

During the joint meeting of WP1 and WP1 held on 28 July 28 2020, delegates expressed a range of views on the degree of connection that would be required between the payer and payee before the subject to tax rule could be applied. Some delegates supported limiting the rule to payments between persons that were under common control while others expressed a preference for a lower threshold (such as 25% common ownership). Other delegates argued that no connected persons test was required and that the rule should apply to all covered payments.

The changes made to this Section are based on the comments made by delegates at the July meeting. This section provides further explanation for the policy and practical reasons for confining the application of the rule to connected payments. It further explains the design of the connected persons test, particularly in those cases where the payment is between parties that have less than 50% common ownership and the de facto control test applies.

Question for delegates

Do delegates agree with the changes made to section 2.2.1?

5.2.1. Connected persons requirement

589. The subject to tax rule is based on the rationale that a source jurisdiction which has ceded taxing rights in the context of an income tax treaty should be able to bring them back where, against expectations, the income that benefits from treaty protection is not taxed or is taxed at below the minimum rate in the

other contracting state. The subject to tax rule is designed to protect the tax base of source countries by targeting arrangements that use certain types deductible intra-group payments as a mechanism to shift profits from source countries to jurisdictions where those payments are subject to no or low rates of nominal taxation.

590. Limiting the scope of the rule to payments between connected persons is in line with the policy and purpose of the subject to tax rule. A connected persons requirement ensures that the rule focuses on those cross-border tax planning arrangements that are designed to shift an amount from the source state into a low-tax offshore structure without a corresponding change in the ownership of the underlying profit. The fact that the ownership of the underlying profit does not change as a result of the payment justifies restoring taxing rights to the source state in respect of such low-taxed payments. A subject to tax rule that applied to all covered payments, regardless of the payer's connection with the payee, would push the policy of the rule, contrary to its agreed purpose, away from targeting BEPS risks and towards a simple re-allocation of taxing rights in respect of certain listed payments.

591. Limiting the subject to tax rule to payments between connected persons limits the scope of the rule to those transactions, which IF members consider raise the most significant BEPS risks. A connected person requirement ensures that there is a sufficient degree of common control between the payer and the payee such that the parties have both the ability to engineer the type of low-tax outcomes covered by the rule and sufficient economic connection to benefit from such profit shifting.

592. On the other hand, expanding the rule to cover all covered payments, regardless of the degree of connection between the parties, could result the over-taxation of transactions that do not raise any BEPS concerns. Absent concerns about treaty abuse,¹⁵⁰ payments made by a third party customer for the acquisition of services would not, in isolation, be considered profit-shifting from the payer to the payee jurisdiction in the sense contemplated by the subject to tax rule, even if those payments benefitted from low rates of taxation under the domestic laws of the payer jurisdiction. On these facts the payment of services fee to an unrelated party is not the shifting of profit but expenditure incurred in determining the amount of that profit. Limiting the subject to tax rule to payments between connected persons guards against the real risk that the imposition of gross-basis taxation may make the supply of those services uneconomic, thereby distorting pricing and purchasing decisions to the determinant of the payer.

593. The connected persons test is consistent with other design features of the rule such as the definition of covered payments, which focuses on certain categories of transactions involving an intragroup transfer of risk, assets or capital and which are difficult to price from a transfer pricing perspective. It is also in line with the operation of the other GloBE rules such as those applied to Orphan Entities.

Practical and administrative concerns

594. A subject to tax rule that did not incorporate a connected persons requirement could be difficult to apply and could lead to volatile and unpredictable outcomes for taxpayers due to the fact that the payer may not have the information necessary to determine whether (and to what extent) the rule will apply and would not have the ability to control its liability for any withholding tax under the rule.

¹⁵⁰ An MNE Group may arrange to provide services to its customers through a subsidiary that is resident in a contracting state which has a tax treaty with the state where that customer is located (the source state). Where a principal purpose of that arrangement is to take advantage of the tax treaty between the two jurisdictions then, under the measures agreed in Action 5, the source state will not be required to extend treaty benefits to any covered payment made under that arrangement.

Information requirements

595. In order to comply with the subject to tax rule the payer needs to know, prior to making the payment, whether the payment is subject to tax above the minimum rate in the hands of the counterparty. While in certain cases it may be relatively simple for a payer to know whether the payee is subject to a nominal rate of tax on a payment, there are likely to be a number of situations where the nominal rate of taxation on a payment is not obvious.¹⁵¹ The information requirements are more significant in the case of payments to unrelated parties where it may be difficult for the payer to obtain the information necessary to comply with the rule but also because the compliance and economic incentives of the payer and payee may not be aligned.

596. It may be possible to address some of these concerns by incorporating information exchange requirements into the arrangement between the parties. For example, the payee could be required to communicate to the payer, whenever a payment was made, whether that payment was subject to tax at above the minimum rate. This would involve an information exchange mechanism that does not currently exist for most service contracts and, it is not clear to what extent the payer can or should, be able to rely on information provided by a payee located in a different jurisdiction. An alternative would be for the payer to withhold on all payments and require the payee to file for a refund. However this would impose a significant additional tax burden on cross-border supplies of services and would be contrary to the policy behind the subject to tax rule which focuses on defined transactions that give rise to a significant mismatch in tax treatment.

Inability of payer to control risk

597. While, as discussed further below, there may be a number of domestic mechanisms that the source state could use to levy the tax provided for under the subject to tax rule, in most cases it is expected that the compliance and payment obligations are likely to fall, at least in part, on the local payer. Furthermore in situations where the parties are independent persons acting at arms-length with divergent economic interests, then the payee may seek to shift the additional cost of tax payable in the source state onto the payer in the form of a tax indemnity or gross-up. This is commonly the case, for example, in relation to third-party lending transactions. Therefore, particularly in the case of payments between unconnected parties, the economic and compliance burden of the tax falls on the local payer.

598. The risk of the payer being exposed to unexpected liabilities pursuant to the operation of the subject to tax rule will be exacerbated in cases where the payer and payee have divergent interests and are not under common control. For example, the payer would not necessarily know (or expect to be notified) that the underlying IP licensed from a third party has been shifted into a low tax preferential regime. The payer could not protect itself from the resulting change in the tax treatment of license payments without inserting onerous provisions into the service agreement that restricted the counterparty's right to manage its own IP.

¹⁵¹ There are a number of reasons why a payment could be subject to no or little tax in the counterparty jurisdiction. The payment may have a different character under the laws of the payee jurisdiction which means that it is not treated as income for tax purposes. The payee could have a special tax status or be eligible for special tax treatment in respect of the payments (e.g. because the payment is subject to tax under a preferential tax regime). The payee jurisdiction may impose tax at progressive rates and the payee may be eligible for an exclusion or lower rate on small amounts of income or the payee may be eligible for a lower rate of tax on income from certain sources or based on the way the payment is treated (i.e. whether it is remitted to the jurisdiction of the payer).

5.2.2. Definition of Connected Persons

Connected Persons

“Two persons shall be “connected persons” if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

In any case, a person or enterprise shall be considered to be connected to another person if:

- (a) one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) or
- (b) if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) in each person.”.

599. The definition of connected persons adopts (with the necessary adaptations) the approach taken in the definition of “closely related” persons and enterprises in Article 5(8) and 5(9) respectively of the OECD and UN Model Tax Conventions, for the purposes of applying the independent agent and anti-fragmentation provisions in those Articles¹⁵². This rule is based on a *de facto* control test but includes a back-up rule that deems there to be control where there is a direct or indirect participation of 50 per cent or more. This test is the same as control test used for Orphan Entities in Section 4.4.2 above which, in turn, is similar to the control test used in consolidated accounting.

600. As set out in Section 4.4.2, the connected persons test looks to the facts and circumstances between the parties in the context of its other arrangements and seeks to determine whether the person has sufficient power over the entity to affect that person’s investment return in that entity. The test takes into account a broad range of factors affecting control which ensure that, in practice, a controlling investor in a company cannot sever a connection with an entity by putting in place arrangements that are designed to retain control but shift ownership of the equity into the hands of others. The connected persons test also extends to joint venture interests. The connected persons test applies to groups of controlling persons. The controlling persons requirement means that shares in an entity that are held by members of the shareholder’s family or received as part of a spin-off of a business to controlling shareholders will generally remain under common control even if that entity is no longer consolidated with the group. The *de facto* test is supplemented by a deeming rule that treats one person as connected to another where the first person holds directly or indirectly more than 50 per cent of the beneficial interest in the second person. The deemed control test means that a majority shareholder does not fall outside the scope of the rule simply because it is de-consolidated for other reasons. Together these three elements of the connected persons test (*de facto* control, groups of persons and deeming rules) ensure that two parties to arrangement that have a significant economic connection and the ability to structure arrangements between them to the advantage of one or the other are likely to fall within the scope of the connected persons test.

¹⁵² It is noteworthy that the same approach – a two component rule with a *de facto* control test and deemed control above a 50 per cent participation level – is also adopted in paragraph 6 of the alternative fees for technical services article provided for in paragraph 26 of the Commentary on Article 12A of the 2017 UN Model Tax Convention. A similar control test could also be applied in the context of rules for addressing the profit shifting risks raised by orphan entities in the context of the undertaxed payment rule depending on the outcome of those discussions in WP11. See [CTPA/CFA/WP11/NOE\(2020\)16](#) – Section 5.4.

5.2.3. Categories of covered payments

601. The subject to tax rule will apply to a defined list of payments that present a greater risk of base erosion. This list will consist of interest¹⁵³, royalties and a defined subset of payments for services (“high-risk services payments”). The list is designed to capture payments that present the most obvious and serious ongoing BEPS risks, because they exhibit features such as being susceptible to transfer pricing abuse or uncertainty and arise in respect of transferable risk, ownership of assets, or capital. The rule will include a definitive list of the categories of payment to which it will apply.

Interest and royalties

The subject to tax rule will apply to payments of interest and royalties.

Note for WP1 delegates

During the 28 July 2020 joint WP1 and WP11 meeting, delegates expressed different views on the approach to defining “interest” and “royalties” for the purposes of the subject to tax rule. Some thought that the best approach was to adopt a uniform definition following Articles 11(3) and 12(2) of the OECD Model. In their view, this approach has the attraction of uniformity of application and is more consistent with the blackletter list approach to defining covered high-value services payments; adopting existing treaty definitions could mean that a broader range of payments are covered by the rule as a result, for example, of a more expansive definition of “royalties” in a particular treaty. This approach would also avoid inconsistent outcomes, such as applying the rule to certain technical fees under one treaty (because these are included in the definition of “royalties” in that treaty) but not under another treaty providing an otherwise identical allocation of taxing rights (because it includes a separate technical fees provision).

Other delegates took the view that such differing outcomes were inherent in the bilateral nature of tax treaties and noted that countries often agreed modified definitions in their bilateral negotiations to adapt the provisions to their domestic law, for example by including items that would be “interest” according to the OECD Model in the definition of “dividends”. Adopting a uniform definition following the Model for the purposes of the subject to tax rule would mean having two different definitions in the treaty and could lead to the subject to tax rule inadvertently applying to payments otherwise categorised as “dividends” for the purposes of that treaty.

Secretariat comment

In the Secretariat's view, there are merits in adopting a uniform definition of interest and royalties for the purposes of the subject to tax rule. As noted above, this is more consistent with the design of a rule that applies to a defined set of payments: interest, royalties and a blackletter list of payments for high-risk services that are not low-value services. Adopting the definitions in the existing interest and royalty articles of bilaterally-negotiated tax treaties could, where these depart from the definitions in Articles 11(3) and 12(2) of the OECD Model, result in the extension of the rule to payments – such as payments for services that are low-return services – that is contrary to the intended scope of the subject to tax rule.

If the rule were to be implemented via the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), or a similar instrument, adopting the existing definitions in bilateral treaties would also require the drafting of compatibility clauses to identify

¹⁵³ Further consideration could be given to the treatment of interest payments on intra-group regulatory capital or other regulated financing instruments where the imposition of withholding taxes could give rise to a significant risk of over-taxation making such funding arrangements uneconomic on an after-tax basis.

those existing provisions. This is because the definitions of interest and royalties in existing treaties apply only for the purposes of the particular articles allocating taxing rights over those categories of income, which would have to be identified descriptively. Uniform definitions of interest and royalties, following Articles 11(3) and 12(2) of the OECD Model, on the other hand could simply be included in the text of the subject to tax rule and applied consistently to all covered tax agreements.

However, it would be possible to allow jurisdictions the option to reserve against one or both of the uniform definitions where, given the particularities of a covered tax agreement, adopting the uniform definition would produce outcomes that are at odds with the intended scope of the rule or are otherwise undesirable. Such reservations could apply to particular covered tax agreements and adopt a system of notifications to identify the precise provision in a covered tax agreement that will apply in place of the uniform definition.

Where no parties to a covered tax agreement made such a reservation, the uniform definitions would apply, making those uniform definitions the default approach. Where both parties to a covered tax agreement made the reservation and supporting notification, the existing definition(s) in the covered tax agreement would apply instead. Where only one party to a covered tax agreement made such a reservation and notification, it would be possible to have a rule binding both parties to that choice on the grounds that this simply preserves the bilaterally agreed position – for example, treating certain items of income that would be “interest” according to Article 11(3) of the OECD Model as “dividends” (and therefore outside the scope of the subject to tax rule). In many instances, where a covered tax agreement includes an expanded definition of, for example, “royalties”, this will be accompanied by an existing source jurisdiction taxing right at rates (e.g. 10 per cent) that are likely to be above the top-up rate provided for under the subject to tax rule. In such instances, a bilaterally-binding reservation preserving the existing definition would not disturb the existing bilaterally-agreed allocation of taxing rights.

Question for WP1 delegates

Do delegates agree that, by default, the subject to tax rule should adopt uniform definitions of “interest” and “royalties”, following Articles 11(3) and 12(2) of the OECD Model, but that jurisdictions should be given the option to instead preserve the existing definition(s) in particular tax treaties along the lines described above?

High-risk services payments

Note for WP1 delegates

During the discussions of this feature of the subject to tax rule in the Inclusive Framework, the Steering Group and the Working Parties, members and delegates have consistently expressed a range of differing perspective.

- Some are not persuaded that a subject to tax rule is necessary and, whilst indicating a willingness to accept a rule that was limited in its scope to payments of interest and royalties between connected persons, in recognition of the BEPS risks that can be associated with these types of payment, consider that a compromise which already goes beyond their preference.
- Others consider that a much broader category of payments, especially including those for knowledge-based technical services, management fees, and some capital gains, present material base-erosion risks and that a source jurisdiction should be able to re-assert limited taxing rights where an item of income or gain is not subject to a minimum level of taxation in the other jurisdiction. Some of these members would favour a rule that applied to all income covered by Articles 7

(business profits), 8 (international air and shipping), 10 (dividends), 11 (interest), 12 (royalties), 13 (capital gains) and 21 (other income) of the OECD Model.

In order to try and bridge these gaps and find an acceptable middle ground, the Secretariat produced a proposal that was discussed in the Steering Group during its June 2020 meeting and which the Steering Group agreed was a sound basis on which to pursue a compromise solution.

That proposal recognised that agreement could not be reached on either a narrow scope rule applying only to payments of interest and royalties or a broad scope rule covering an extensive range of services payments, capital gains and other types of income. This approach would extend to a larger set of payments, including payments for services, but focused on those payments exhibiting features that give rise to greater profit-shifting risks.

Extending the logic of applying the rule to payments of interest and royalties, the proposal identifies five categories of services payments for which similar BEPS concerns arise because the underlying production factors are mobile capital, ownership of assets, and assumption of risks. These “high-risk” services are included on a definitive blackletter list of services payments to which, in addition to payments of interest and royalties, the rule would apply. And, building on the principles underlying existing transfer pricing safe-harbours (including those in the OECD Transfer Pricing Guidelines and the UN Transfer Pricing Manual), the proposal incorporates an exclusion for listed services payments where they generate a low-return (“low-return” services). These twin features focus the scope of the rule on payments presenting greater risks of BEPS, but also broaden its scope to include a range of services payments.

When this feature of the subject to tax rule was discussed in the joint WP1 and WP11 meeting on 28 July 2020, delegates continued to express differing preferences on the scope of payments that should be covered by the rule. But a number of delegates indicated a willingness to accept a scope that, in addition to interest and royalties, would also apply to certain high-risk services payments along the lines described above. And, while some delegates would prefer a narrower list (excluding, for example, insurance/reinsurance and asset rental payments) and others a broader list (including, for example, management fees and knowledge-based technical services), delegates broadly agreed that the “high risk” and “low return” concepts articulated in the Secretariat proposal provided a coherent basis on which to evaluate the content of a list of covered payments focusing on material BEPS risks. A number of delegates signalled clearly that, although they were willing to agree a compromise on this basis, they would be opposed to a broadening of the category of covered payments that is not consistent with these principles.

Delegates also raised a series of questions about the articulation between the principles outlined above and the precise categories of payments included on the list in the Secretariat proposal, and sought greater clarity about precisely which types of payments were covered by each of these categories. This section has therefore been revised to clarify in the text:

- that the rule only applies to services payments that fit within categories (a) to (e) of the list (where these are not low-return services payments); and
- the type of payments covered by the list, with more detailed descriptions of what each category is intended to cover and illustrations of typical scenarios of intra-group transactions that would involve these categories of payments and give rise to BEPS concerns;

A number of delegates specifically stated that the subject to tax rule should apply to management fees or payments for knowledge-based technical services. While there is no standard definition of what constitutes this type of fee or service, these terms usually refer to what are typically considered overhead costs such as: accounting, human resources activities, IT services, legal services, etc; or payments for the periodic supply of technical services, consulting services, engineering services,

training services, etc. The value of these types of services is usually mainly derived from the skills and the functions that are performed by the service provider to the benefit of the payer. Because functions are less mobile production factors than assets and risks, as explained above, this type of services is not considered a “high-risk services payment” on the principles articulated above. And, because their value mainly derives from the functions performed, these services are often compensated on the basis of the costs incurred plus a mark-up (cost plus method) from a transfer pricing standpoint. Therefore, even if they were expressly included on the list, most of these services could be excluded from the scope of the rule because of the exclusion for low-return services. Including them without applying the exclusion for low-return services would bear the risk of over taxation because the rule applies on the gross amount of the payments, while these services would not generate a high margin for the service providers.

Some “management fees” or “technical services fees”, however, would be covered by the list of high-risk services payments. This would be the case, for instance, for:

- intra-group services that would be rendered in combination with the license of a trademark, which could be compensated by a single franchise fee;
- an intermediary service that is performed by the headquarters in order to purchase goods or services on behalf of its affiliates;
- training services rendered in addition to the license of technology or know-how; and
- brokerage services.

Provided these services cannot benefit from the “low-return” exclusion, they would be in the scope of the rule.

Question for WP1 delegates

Do delegates agree that:

- a) the changes made to this section now make clear that the services payments covered by the subject to tax rule are only those listed in categories (a) to (e), and better elaborate what is covered by those categories and how this fits with the “high risk” principle?
- b) for the reasons discussed above in this box, a scope that extends beyond interest and royalties to include services in line with the “high risk” and “low return” concepts provides a coherent basis for compromise on the covered payments feature of the subject to tax rule?

602. Service payments are considered to present a greater BEPS risk if the value of the service is primarily based on mobile factors such as capital, assets, or risks that are owned or assumed by the service provider. Conversely, payments for services present a lower risk from a BEPS perspective where their value is primarily linked to functions performed by the service provider. Whilst the latter type of services may, in certain cases, be equally difficult to price from a transfer pricing perspective they might not be expected to give rise to the same base-eroding opportunities as services that are primarily based on the provision of capital, assets or risk. This is because the functions performed by personnel are less mobile than the ownership or assumption of capital, assets and risk and therefore less susceptible to BEPS strategies.

603. In addition to payments of interest and royalties, the subject to tax rule will therefore apply to the following high-risk services payments:

- (a) A franchise fee or other payment for the use of or right to use intangibles in combination with services;
- (b) Insurance or reinsurance premium;
- (c) A guarantee, brokerage or financing fee;
- (d) Rent or any other payment for the use of right to use moveable property;

- (e) An amount paid to or retained by the payee that is consideration for the supply of marketing, procurement, agency or other intermediary services.

604. These high-risk services payments were identified by applying the principles set out above and aim at providing jurisdictions with a tool to deal with arrangements that are designed to shift profit to low tax structures within the group that have previously identified by their tax administrations. Each of these categories of payment is described in further detail below.

605. None of these categories apply to payments for services rendered by a permanent establishment in the source state or for the use of an asset that forms part of the business property of a permanent establishment in the source state. This is because the source state has an existing and prior taxing right over the profits of the permanent establishment under Article 7.

606. A payment for a service that does not fall in the categories (a) to (e) listed above would not be covered by the subject to tax rule. In addition, the subject to tax rule will not apply to high-risk services payments falling within those categories where the payment generates a low return (See below section on the Exclusion of low-return services).

607. Defining the scope of covered payments by reference to the components that generate the value of the service and the pricing method ensures that the subject to tax rule targets relevant high-risk payments for services that are likely to present BEPS risk offers a number of advantages:

- it is relatively simple and draws upon basic transfer pricing concepts;
- the inclusion of services the value of which derives from a significant asset is in line with the inclusion of royalties in the scope of covered payments;
- the inclusion of services the value of which derives from a significant risk is in line with the fact that the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised;
- the exclusion for low-return services that are compensated on a cost-plus basis limits the risk of taxation in excess of economic profits if the rule applies as a withholding tax on the gross amount of the payment made;
- the exclusion for low-return services is in line with the simplified approach provided in Chapter 7 of the OECD Transfer Pricing Guidelines as available for low-value adding services;
- the exclusion for low-return services could leave the possibility for taxpayers and tax administrations to prove on an ex-post basis that the service did or did not generate a low-return on costs, which is likely to facilitate the administration of the rule.

(a) A franchise fee or other payment for the use of or right to use intangibles in combination with services

608. Under a franchise arrangement, one member of an MNE group may agree to provide a combination of services and intangibles to an associated enterprise in exchange for a single fee (a “franchise fee”).¹⁵⁴ The franchisor may have developed intangible assets (e.g. trademark, know-how) that it licenses to the franchisee together with additional services in return for a fee, such as a percentage of the franchisee’s revenue.

¹⁵⁴ See Paragraph 6.100 of the OECD Transfer Pricing Guidelines: “One situation where transactions involving transfers of intangibles or rights in intangibles may be combined with other transactions involves a business franchise arrangement. Under such an arrangement, one member of an MNE group may agree to provide a combination of services and intangibles to an associated enterprise in exchange for a single fee.”

609. Other similar arrangements could give rise to payments for the “use or right to use intangibles in combination with services”. Such payments could, for instance, be made for the right to use a technology owned by a connected person that provides services to the payer based on the use of that technology. Another example is a payment for the use of software where the provider also provides ancillary support such as technical support, customisation and maintenance which is performed by the same connected person. The payer could pay a single fee for both the use of the software and the related services.

610. One of the underlying components of these payments may be a royalty for an intangible asset that is licensed through the arrangement. If related intragroup services can be rendered by a connected person that benefits from a low-tax regime, an MNE group could organise its structure so that the ownership of such an intangible asset is transferred to such a low-tax connected person, which would then license the asset and render combined services in exchange for a single fee, which could generate a high return.

611. Where the payment is made under a mixed contract and includes a royalties¹⁵⁵ element, the contract may be able to be broken down into its constituent parts (i.e. royalty + payment for a service). In this case, the subject to tax rule will only apply to the constituent parts that are in scope of the rule.¹⁵⁶ Assuming that the payment can be broken down into a royalty and a payment for a service, the following will apply:

- Where the treaty allocates a source state taxing right over royalties, both the existing treaty provision and the subject to tax rule will apply to the royalty component and the source state will be permitted to tax the royalty element at the higher of the existing treaty rate or the top-up rate.
- The remainder of the payment (the services element) will be in the scope of the subject to tax rule if it is, viewed in isolation, itself a covered payment that is not a low-return services payment. This is consistent with the ordering rule described in section 2.3.1 below.

(b) Insurance or reinsurance premium

612. Insurance or reinsurance premiums are payments made in exchange for covering a risk that would otherwise be borne by the insured person. Through the insurance/reinsurance, the assumption of the insured risk is transferred to the insurer, so that if the risk materialises the insured person does not bear the financial consequences of that risk. Risks can therefore be transferred from one connected person to another through this arrangement. If the risk does not materialise, the insurance or reinsurance premium can generate a high return. Insurance or reinsurance services rendered by connected persons such as captive insurance tend to be more profitable than other insurance or reinsurance services. Furthermore, it can be hard to find comparable unrelated transactions to test whether the pricing of these transactions meets the arm’s length principle.

613. These premiums are generally not taxable in the source jurisdiction, unless they are attributable to a permanent establishment operating in that jurisdiction. In the situation where the insurance premium would form part of the taxable profits of a permanent establishment located in the source jurisdiction, these premiums would be taxable in the source jurisdiction and the subject to tax rule would not apply to them. The UN Model Tax Convention, for instance, provides that an insurance enterprise shall be deemed to have a permanent establishment in the state where it collects premiums or insures risks situated therein

¹⁵⁵ As defined in the relevant treaty.

¹⁵⁶ See Paragraph 6.100 of the OECD Transfer Pricing Guidelines in relation to the breakdown of the constituent parts of a business franchise arrangement: “If the services and intangibles made available under such an arrangement are sufficiently unique that reliable comparables cannot be identified for the entire service/intangible package, it may be necessary to segregate the various parts of the package of services and intangibles for separate transfer pricing consideration. It should be kept in mind, however, that the interactions between various intangibles and services may enhance the value of both.”

through a person.¹⁵⁷ An exception, however, is provided for reinsurance premiums. In this situation, the existence of a PE can be avoided by providing reinsurance services to local (possibly connected) insurers instead of insurance services directly to final customers. The subject to tax rule could apply to such reinsurance premiums if the insurer benefits from a low-tax regime in the jurisdiction where it is located.

(c) A guarantee, brokerage or financing fee

- Guarantee fee

614. A guarantee is a legally binding commitment of the guarantor to assume an obligation of the guaranteed debtor if the debtor defaults on that obligation. In an MNE group context, a related party guarantor may provide a guarantee on a loan taken out by a connected person from an unrelated lender. By providing an explicit guarantee the guarantor is exposed to additional risk as it is legally committed to pay if the borrower defaults. While the guarantor can suffer a loss in case the risk materialises, the guarantee fee can generate a high return if the borrower does not default on its obligation. The price to pay for the guarantee would also reflect the value added for such a borrower. A guarantee is not only supporting the credit rating of the borrower but could be acting both to increase the borrowing capacity and to reduce the interest rate on any existing borrowing capacity of the borrower. Provided the guarantor has the financial capacity to assume the risk in cases it materialises, such a guarantor could be located in a low-tax jurisdiction.

- Brokerage fees

615. A broker acts as an intermediary to facilitate a transaction, in exchange for a commission or a brokerage fee. An underlying component of this transaction is the access to and use of an intangible asset (for instance the client and the supplier list). When a broker acts on behalf of connected persons, the development of the client or supplier list consisting of connected persons may not have required significant efforts. The broker may have been transferred such an intangible asset and benefit from a low-tax regime.

616. It may be difficult to find reliable comparable transactions to the intragroup brokerage service that is rendered, which makes it difficult to test whether the pricing of the intragroup transactions meets the arm's length principle. When the brokerage fee is a percentage of the underlying transaction (and not based on the costs of the service provider), the transaction may also generate a high return.

- Financing fees

617. When a company borrows money, either through a loan or a bond, it usually incurs financing fees. These are fees paid by the borrower to the bankers, lawyers and anyone else involved in arranging the financing. If a connected person was involved in arranging the financing, it could also charge intragroup financing fees.

618. It may be difficult to find reliable comparable transactions to the financing fee, which makes it difficult to test whether the pricing of the intragroup transactions meets the arm's length principle. When the financing fee is a percentage of the underlying transaction (and not based on the costs of the service provider), the transaction may also generate a high return.

(d) Rent or any other payment for the use of right to use moveable property

619. This category covers leasing or rental payments for moveable property and would apply, for instance, where such moveable property is held by a connected person that benefits from a low-tax regime

¹⁵⁷ See Article 5(6) of the UN Model Tax Convention: "Notwithstanding the preceding provisions of this Article but subject to the provisions of paragraph 7, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person."

and is used by another connected person. The ownership of such moveable property can be transferred within the group while it may be hard to find reliable comparable transactions for the use of such moveable property when it is relatively unique and essential to the business of the lessor. For instance, a company operating in the extractives sector could transfer the ownership of a drilling rig to a low-tax affiliate which would lease this property to other connected persons and receive a rent. When the rent is not based on the costs of the low-tax affiliates, the transaction may generate a high return.

(e) An amount paid to or retained by the payee that is consideration for the supply of marketing, procurement, agency or other intermediary services.

620. This category is aimed at covering agency and intermediary services such as marketing agency, procurement or other centralised intermediary services when their value primarily derives from the use of an intangible asset, such as a client list or a supplier list where these services are not priced on the basis of the costs incurred by the service provider but, for instance, as a percentage of the turnover of the affiliate to which the service is rendered or as a percentage of the value of the services or products purchased centrally.

621. The payments covered by this category may either be paid to the intermediary (for instance in the case of a commission paid to a sales agent for the sales made to the customers that it introduced to the intragroup seller) or retained by the intermediary (for instance in the case of a procurement fee that is incorporated in the price of the products that are purchased on behalf of the other affiliates).¹⁵⁸ This difference in payment terms does not affect the characterisation of such payments as being covered by the subject to tax rule.

622. One of the underlying components of these payments is the access to and use of an intangible asset (e.g. client list or supplier list). If related intermediary functions can be rendered by a connected person that benefits from a low-tax regime, an MNE group could organise its structure so that the ownership of such an intangible asset is transferred to such a low-tax connected person, which would then be entitled to the intermediary fee, which could generate a high return.

623. Other marketing agency, procurement and other intermediary services may primarily derive their value from functions performed, for example for market research. These services would be expected to generate a low-return and would be covered by the exclusion for low-return services (see below).

Exclusion for low return services

624. Although payments for the listed categories of high-risk services payments, by their nature, present prima facie risks of base-erosion and profit-shifting, the subject to tax rule is designed to be targeted and to minimise administrative and compliance burdens. The rule will therefore provide an exclusion for payments falling within those categories where the payment generates a low return (low-return services). A payment is for low-return services where it is calculated by reference to the costs incurred by the payee in rendering the service¹⁵⁹ and the reward is calculated on a cost plus basis, where the margin is no higher than an agreed percentage.

625. When combined with the materiality threshold described later in this section, this exclusion will ensure that the subject to tax rule is focused on cross-border tax planning structures that take advantage

¹⁵⁸ See paragraph 7.15 of the OECD Transfer Pricing Guidelines.

¹⁵⁹ When the service provider is acting only as an agent or intermediary, the cost base will include only those costs incurred by the intermediary in performing its agency function. For example, the cost base of a company acting as a procurement agent and incurring costs for the purchase of goods on behalf of connected companies would not include the costs of those goods.

of particular low tax outcomes in the residence jurisdiction in order to shift material amounts of profit from the source to the residence jurisdiction.

626. The effect of the exclusion for low-return services is to focus the subject to tax rule only on those payments that generate a high return. Services that produce a low-return for the payee are the least likely to present a risk of base erosion for the payer jurisdiction. When the taxpayer demonstrates that payments for services are calculated on the basis of the costs incurred by the service provider, these services will be excluded from the subject to tax rule as long as the pricing is based on a mark-up on costs and a cost allocation basis that is reasonable and below a certain fixed percentage. This mark-up test will be applied independently of whether the transfer pricing method applied is a cost-plus method, or another method the result of which produces an equivalent mark-up on costs. This limitation is generally expected to exclude payments for services that had already been subjected to a transfer pricing benchmarking analysis and would be consistent with existing transfer pricing safe-harbours used by Inclusive Framework members.

Note for WP1 delegates

At the joint meeting of WP1 and WP11 held on 28 July 2020, delegates expressed the view that transfer pricing safe-harbours that could be used to inform the design of the exclusion for low-return services. Safe-harbours used in the transfer pricing context include:

- Section D2 of Chapter 7 of the [OECD Transfer Pricing Guidelines](#), which sets out a simplified mechanism for determining the arm's length charge for low value-adding intragroup services and applies a mark-up of 5% on costs.
- The US BEAT rules which apply an exception to "low-margin" services, defined as those for which the *median* comparable mark-up is less than or equal to 7% (the actual mark-up could be higher).
- The EU JTPF [guidelines on low-value adding services](#) provide that typically agreed mark ups fall within a range of 3-10%, often around 5% (§65.).
- The [UN Manual on TP](#) does not mandate an appropriate mark up (a benchmarking study is necessary) but one example (example 18) "assumes" that a mark up on costs of 10% is acceptable; and another example (example 19) uses a 7.5% mark up. A further example uses an 8% mark up for R&D activity.
- The UN Manual refers to [Australia's guidance](#), which considers that
 - o A transfer price not less than cost plus 5% of relevant costs but less than cost plus 7.5% of relevant costs would be accepted for non-core services.
 - o A transfer price of up to cost plus 10% of relevant costs would be accepted for non-core services under specific circumstances

Some delegates further suggested that Working Party 6 could be asked to consider an appropriate mark-up percentage for the purposes of the low-return services exclusion based on existing approaches.

Question for WP1 delegates

Do delegates agree that questions related to setting the mark-up for the purposes of the low-return services exclusion could be referred to Working Party 6 as part of the work on finalising the subject to tax rule?

5.2.4. Excluded entities

627. For the purposes of the income inclusion and undertaxed payments rules, and where certain conditions are met, it is proposed that the following entities will not be treated as constituent entities of an MNE Group (and will therefore be excluded from the scope of those rules: investment funds, pension funds, governmental entities (including sovereign wealth funds), international organisations, and non-profit organisations. Consistent with the exclusion of these entities from the scope of the income inclusion and undertaxed payments rules the same exclusion could apply for the purposes of the subject to tax rule.

628. These excluded entities all have a particular purpose and status under the laws of the jurisdiction in which they are created or established. This status is likely to result in the entity not being exposed to domestic income tax in order to preserve a specific intended policy outcome under the laws of that jurisdiction. The domestic tax outcome may, for example, be designed to ensure a single layer of taxation on vehicles used by investors (e.g. funds) or on retirement plans used by employees, or because the entity is carrying out governmental or quasi-governmental functions. The tax policy objectives of the domestic tax exemption for these types of entities are neither inconsistent with the tax policy objectives of the GloBE rules nor create a competitive distortion that would undermine the tax policy objectives of the GloBE proposal. Subjecting the income of such entities to tax under the GloBE rules would undermine the policy objectives that the domestic jurisdiction is seeking to achieve by granting the exemption without furthering the tax policy objectives of the GloBE rules.

629. Similar considerations apply in the context of bilateral tax treaties and this is recognised in the OECD Model and Commentaries.

- a. Paragraphs 22 to 48 of the Commentary on Article 1 address issues relating to collective investment vehicles and, recognising that under domestic law such arrangements may enjoy exemption from tax, be taxed on a reduced base (often reduced to nil) by being granted deductions for distributions to investors, or be taxed at special low rates, generally seek to clarify their entitlement to treaty benefits as persons who are liable to tax and the beneficial owners of their income.
- b. In 2017, Article 4(1) of the Model was revised to expressly include a “recognised pension fund”, which may be conditionally exempt from tax under domestic law, in the definition of a resident liable to tax and prima facie entitled to treaty benefits.
- c. Paragraphs 49 to 53 of the Commentary on Article 1, and paragraph 8.5 of the Commentary on Article 4, discuss the treaty entitlement of entities set-up and wholly-owned by a state or its political subdivisions, including sovereign wealth funds, and note that these entities often enjoy exemption from tax and paragraph 8.11 of the Commentary on Article 4 considers similar issues in relation to charities and other organisations that may be exempted from tax.

630. Many states include provisions in, or interpret and apply, their bilateral tax treaties to grant the benefit of exemptions from or reductions in source taxation of these entities, notwithstanding that they may be exempt in their state of residence, in recognition of the principles outlined above. Applying the subject to tax test to such entities would therefore run contrary to that policy objective.

631. Jurisdictions are, of course, free to determine their response to these issues in their bilateral negotiations and may, as is recognised in paragraph 8.12 of the Commentary on Article 4, take the view that entities that are exempt from tax under domestic law do not qualify as residents prima facie entitled to benefits or, as is recognised in paragraph 8.9 of the Commentary on Article 4, choose to omit the reference to a “recognised pension fund” in Article 4(1). In relation to the application of the principle of sovereign immunity to governmental entities, paragraph 52 of the Commentary on Article 1 notes that most states would not extend this to business activities carried on by such entities.

632. Consideration of these exclusions in the context of the subject to tax rule will be updated as the discussions develop further on sectoral carve-outs in relation to the broader GloBE rules, with the option to align the treatment of these entities.

5.2.5. Materiality threshold

Note for WP1 delegates

When the materiality threshold was discussed during the joint meeting of Working Parties 1 and 11 on 28 July, delegates expressed differing design preferences. Some favoured a threshold based on the size of the MNE group – whether or not aligned with the €750m GloBE threshold – and others a threshold based on a fixed €-value of covered payments made to connected persons in the other contracting jurisdiction. But an overriding concern was the administrability of such a threshold, with a number of delegates concerned that the materiality threshold in the Secretariat proposal added undue complexity to the subject to tax rule. This section of the report has therefore been redrafted to recognise that a materiality threshold is an important design component – essential for some delegates – but that alternative design options could be developed, balancing the twin objectives of focusing the subject to tax rule on material BEPS risks and producing an administratively simpler rule.

A number of delegates raised questions about the application of contingent withholding taxes at the point of payment and the associated risks of excessive withholding and delays in obtaining refunds. Some delegates suggested approaches to minimising and addressing these issues and these are discussed together in section 5.3 (operation and effect) below.

Question for WP1 delegates:

Do delegates agree with the changes to this section describing the role and purpose of a materiality threshold?

Delegates are invited to provide comments on this feature of the subject to tax rule and approaches to designing an administrable threshold, to assist the Secretariat in further refining this section of the Report.

633. Even if the limitations that may apply to the income inclusion and the undertaxed payments rules would not apply to the subject to tax rule, it would still be necessary to include a mechanism to ensure that the rule is properly focused on arrangements that present the most significant potential for BEPS. A materiality threshold provides taxpayers and tax authorities with certainty; minimising the related compliance costs and burdens for taxpayers and tax administrations alike and recognising that there are situations where the cost to a tax authority of making adjustments is not commensurate with the tax revenue at stake. The materiality threshold should therefore be designed to achieve this dual purpose. The design and operation of such a threshold would need to align with the purpose of the subject to tax rule, also recognising that the materiality test may need to reflect that what is a significant risk can vary between small and large jurisdictions.

634. Under this threshold test, the subject to tax rule would not apply where the total amount of covered payments the payer had made (or was expected to make) to any related parties in the other contracting state were below a certain threshold over the course of the payer's financial year. Building off a risk assessment concept, the threshold would be designed to measure whether the payer makes a sufficient amount of covered payments (as defined in section 5.2.2 above) during the relevant period to related parties in the other contracting jurisdiction to justify further intervention by the source state and allow an efficient allocation of a tax administration's resources to risk. The threshold would be intended to simplify the operation of the subject to tax rule by excluding from its scope those related party arrangements that

would not typically be expected to give rise to audit concerns. The materiality test would capture all covered payments and apply irrespective of the tax treatment of each specific payment in the payee jurisdiction.

635. It would be designed to operate as an administrable filter to determine whether the subject to tax rule should apply in a particular case. Thus, it would be counter-productive if, in applying this filter, a payer had to determine whether a particular payment was subject to a sufficient rate of taxation. The subject to tax rule is designed to protect the tax base of source countries by targeting arrangements that use certain types deductible intra-group payments as a mechanism to shift profits from source countries to jurisdictions where those payments are subject to no or low rates of nominal taxation. The rule does not apply to all deductible payments to connected parties but focuses on payments made under transactions that are considered to give rise to the most significant profit shifting risks. The rule is intended to be straightforward for taxpayers and tax administrations to apply and to avoid giving rise to undue compliance and administration costs.

636. Without a materiality threshold, an MNE would be required to identify and compute the adjusted nominal tax rate for every covered payment made to connected persons in each separate payee jurisdiction, which for a large MNE could be thousands of payments for which there is no distinct line item in its financial statements. Moreover, the subject to tax rule is intended to serve as a tool to discourage MNEs from structuring themselves in a way designed to take advantage of tax treaties to make base-eroding payments to connected persons, in order to benefit from low tax outcomes in the other contracting jurisdiction. MNEs are unlikely to incur the costs of structuring themselves in this way unless the result would secure material tax advantages.

637. Similar materiality considerations underlie the allocation of audit resources by tax administrations to cases where the tax at risk best justifies costly interventions. For this reason, tax administrations build such thresholds into their domestic regimes including, for example, excluding small and medium sized enterprises from the scope of transfer pricing legislation or applying safe harbours for intra-group payments falling below a de minimis value. Chapter B.4.5.2 of the UN Transfer Pricing Manual sets out two safe harbours that may be used by tax authorities – a safe harbour for low-value services that are unconnected to an associated enterprise’s main business activity; and a minor expenses safe harbour – and notes as a rationale that the administrative costs and compliance costs may be disproportionate to the tax at stake.

638. There are a number of possible approaches to the design of a materiality threshold, which could be used in isolation or in combination, and three approaches are discussed below. The choice of an approach will be informed by views on the levels at which MNEs are likely to enter into structuring arrangements to take advantage of low tax outcomes and the appropriate allocation of tax administrations’ resources to risk.

Threshold based on the size of the MNE

639. The income inclusion and undertaxed payments rules apply to MNE groups above the €750m threshold adopted by the Inclusive Framework under BEPS Action 13 (Country by Country Reporting). As a standalone treaty rule the subject to tax rule does not need to be limited to groups meeting that size threshold, but there are merits in considering a threshold based on the size of the MNE group.

640. The subject to tax rule focuses on a defined set of high-risk cross-border payments between connected persons other than individuals and is therefore addressing particular risks arising in an MNE group context. A threshold based on the characteristics of an MNE group would therefore be consistent with this focus and would serve to target the rule on those MNE groups most likely and best equipped to enter into BEPS structures taking advantage of low-tax outcomes.

641. A threshold based on the size of an MNE group is also easy to administer and apply, especially in the context of a payments-based rule, because it does not rely on information that might not be available

at the point of payment or during the period in which a payment is made. This clearly has advantages for both tax administrations and taxpayers. Although a size threshold applying for the purposes of the subject to tax rule does not need to align with the €750m threshold applying for the purposes of the GloBE, it should not be set too low in recognition of the lower risk of material base-eroding payments in smaller groups. It seems clear, for example, that micro, small and medium sized enterprises (SMEs)¹⁶⁰ should be excluded from the scope of the rule. A number of jurisdictions provide exclusions for SMEs in their domestic transfer pricing and other rules, on similar materiality grounds.

Threshold based on value of covered payments made to connected persons in other contracting state

642. Because the subject to tax rule focuses on particular categories of cross-border, connected-person payments giving rise to greater BEPS risks, the materiality threshold could be set by reference to the value of such payments in a year. Where the €-value of covered payments made to connected persons in the other contracting jurisdiction exceeded a fixed amount in a year, the subject to tax rule would apply. The test would apply to all covered payments irrespective of the tax treatment. Such a threshold could be designed in a way that recognises that what is considered a significant risk can vary between small and large jurisdictions and be informed by existing safe-harbour regimes. For example, the United Nations Transfer Pricing Manual discusses safe harbours for “minor expenses” and example 20 alludes to a \$750,000 threshold. The UN Manual also refers to an Australian safe-harbour regime that applies a safe-harbour for intra-group services payments which applies an aggregated \$500,000 threshold.

643. An approach that relies on the value of payments in a year raises administrative and compliance questions, where the total value of payments in a year is not known and cannot be established at the point a particular payment is made. To address this, the determination of whether the threshold is crossed for a particular year could be made on the basis of the average value of covered payments to connected persons in the other contracting jurisdiction in the preceding three years. Where that average exceeds the threshold, the subject to tax rule would apply to all such payments in the current year. Such an approach may, however, result in both over- and under-withholding – where (although the threshold is crossed according to the three year average) payments in a year ultimately fall below the threshold, or vice versa – and give rise to concerns about excessive contingent withholding and potential delayed repayment. Administrative approaches to minimising or eliminating these issues, including applying the top-up tax on an ex-post basis in the form of an annualised charge are discussed further in section 5.3.3 below.

Threshold based on a ratio

644. Under this approach, the subject to tax rule will not apply where the total amount of covered payments the payer had made (or was expected to make) to any connected persons in the other contracting jurisdiction over the course of the payer’s financial year were below a certain ratio. Building off a risk assessment concept, the threshold will be designed to measure whether the payer makes a sufficient amount of covered payments (as defined above) during the relevant period to connected persons in the other contracting jurisdiction to justify further intervention by the source jurisdiction and allow an efficient allocation of a jurisdiction’s tax administration’s resources to risk. The threshold is intended to focus the operation of the subject to tax rule by excluding from its scope those connected person arrangements that would not typically be expected to give rise to BEPS concerns. As with the €-value approach described

¹⁶⁰ SME is not a term defined at the international level, but there are existing examples of definitions. For instances SMEs are defined in the EU recommendation 2003/361. The main factors determining whether an enterprise is an SME under that approach are staff headcount and either turnover or balance sheet total. The size thresholds for SMEs are a staff headcount below 250 and either turnover below or equal to €50m or a balance sheet total below or equal to €43m.

above, this materiality test will capture all covered payments and apply irrespective of the tax treatment of each specific payment in the payee jurisdiction.

645. The threshold would be met when (i) the total amount of covered payments the payer had made (or was expected to make) to any connected persons in the other contracting jurisdiction over (ii) the payer's total expenditures except cost of goods exceeded a certain percentage. In order to be able to compute this ratio at the time when the payment is made, both the payments and expenditures taken into account could be an average calculated across the preceding three years. This raises similar administrative and compliance considerations as the €-value approach discussed above, and potential remedies are discussed in section 5.3.3 below.

646. Both the €-value and ratio approaches could also include an anti-fragmentation rule that prevented the MNE splitting payments under the same arrangement between multiple payers in the source state to avoid reaching the threshold.

5.2.6. Subject to tax rule applies on a nominal basis

647. The subject to tax rule will be triggered where a covered payment is subject to a nominal tax rate in the payee jurisdiction that is below an agreed minimum rate, after adjusting for certain permanent changes in the tax base. A rule that sought to establish the effective tax rate on a particular payment or transaction (after taking into account relevant deductions) would be prohibitively complex both from an administrative and compliance perspective. Focusing on a nominal tax rate test makes the rule simpler to apply, particularly in the context of the other mechanics of the rule discussed further below (such as top-up withholding).

648. Using an effective tax rate test in the context of a withholding tax measure would be particularly difficult as an effective tax rate test measures the tax imposed on an entity's net income over a defined accounting period and it would not be possible to establish the effective tax rate in the payee jurisdiction at the time when a payment is made (and the withholding tax would need to be levied). A nominal tax rate test is easier for tax administrations to administer (particularly those with low capacity) and is more in line with the policy goal of the subject to tax rule to focus on specific low-tax outcomes in respect of specific payments.

649. Because the subject to tax rule is a treaty rule, the taxes that will be taken in account for the purposes of applying the nominal rate test will be those that are covered taxes for the purposes of the treaty, as defined in the treaty in provisions equivalent to Article 2 of the OECD Model Tax Convention. These covered taxes may not align with the taxes that are covered taxes for the purposes of the GloBE, but this is consistent with the nature of bilateral tax treaties which include rules setting the scope of their application (e.g. to defined persons and taxes).

Nominal test applies on a payments basis

650. A rule that looked only to the statutory rate applied to a payment, however, and did not take account of specific provisions that alter the amount of the payment that is brought within the charge to tax, might fail to capture cases in which a payment is subject to low levels of taxation and leave countries exposed to BEPS risks. Such an approach would not, therefore, offer a credible response to targeting the base-erosion concerns that underpin the rule. To balance these considerations, the determination of the adjusted nominal rate would start with the statutory rate applicable to the counterparty in the payee jurisdiction and adjust this by reference to any preferential rate or special exemptions, exclusions, reductions or expansions that are linked directly to the payment or the entity receiving it. Multiplying the actual tax rate on the payment by the proportion of the payment that is subject to tax in the payee jurisdiction would produce the adjusted trigger tax rate. For example, where a company in State X receives foreign source royalty income, State X might

- a. apply a preferential tax rate to that royalty payment;
- b. exclude a certain percentage of the royalty payment from taxation;
- c. apply tax at a low rate, but to an amount that is greater than the income;
- d. allow resident companies a deduction for deemed expenditure associated with payments of that character that is in addition to or calculated independently of the payee's actual expenditure

In all these cases this approach would calculate the rate of tax on the payment by reference to the proportion of the payment that is subject to tax after taking into account the exclusion or deduction from the payment.

651. An adjusted nominal rate determined along these lines would, for example, apply to low or zero rate jurisdictions; payments to a territorial regime where such payments are not brought into account as income in the residence state; payments eligible for a preferential tax regime and regimes that provided for a full or partial exclusion from income.

No adjustment for general deductions against the tax base

652. This approach would not, however, take into account deductions from the tax base that were not directly linked to the item of income or category of payee. For example, adjustments such as super-deductions for certain categories of expenditure or notional interest or dividend deductions and other unilateral downward adjustments of profit would, therefore, not be covered by the subject to tax rule. And deductions, in computing profits of the payee, for costs that represent actual business expenditures incurred should not give rise to an adjustment of the nominal tax rate. Taking these types of general deductions from the tax base into account would raise prohibitive challenges from a design perspective, such as how to allocate the reduction in the tax base to particular payments, and would add another layer of complexity and controversy to the application of the rule. It would also raise questions about what account should be taken of the non-deductibility of certain expenditure, such as whether the nominal rate needed to be adjusted upwards to take account of the fact that some interest expenses might be non-deductible.

Tax base calculated otherwise than by reference to income

653. The nominal tax rate test would need to be further adjusted for those jurisdictions that calculate their tax base other than by reference to a resident's income. For example the Zakat levied on corporations by the Kingdom of Saudi Arabia is a tax on both income and equity. The Zakat is levied at 2.5% but since it is imposed on income and equity it results in a higher effective rate. Equally certain members of the Inclusive Framework have income tax regimes that impose an income tax on a corporation when the corporation's income is distributed to its shareholders, rather than when it is earned. The statutory tax rates in these jurisdictions may equal or exceed the agreed minimum rate of tax, thereby ensuring that ultimately the income is not subject to a low rate of tax. Absent a distribution, however, the income is not subject to tax in the year it is earned. The design of a nominal tax rate test mechanisms would need to be adjusted in these cases to reflect to specific features of these countries regimes. For example, for jurisdictions with a corporate tax base that is not calculated by reference to income, the payee may be able to certify that, notwithstanding the low nominal rate, the average tax burden on all income of the payee over an agreed period was in excess on the minimum rate.

No adjustment for exemption or credit under treaty elimination article

654. Under paragraph 1 of Article 23 A of the OECD Model, the residence jurisdiction is obliged to exempt an item of income from tax where the source jurisdiction is permitted to tax that item of income in accordance with the treaty. This treaty exemption is, prima facie, an exemption, exclusion, or reduction in

the tax base that is linked directly to the payment or the entity receiving it. But taking the treaty exemption into account for the purposes of computing the adjusted nominal rate would produce outcomes that go beyond the intended functioning of the subject to tax rule, which is not to reallocate taxing rights between jurisdictions but to allow source jurisdictions to apply a top-up tax to covered payments that are subject to low nominal rates in the residence jurisdiction.. This is illustrated by example X1 in Annex A.

655. In order to address this issue, the entitlement to an exemption under provisions equivalent to Article 23 A of the OECD Model will not be taken into account when computing the adjusted nominal rate for the purposes of the subject to tax rule.

656. To the extent that similar considerations could arise in respect of the residence jurisdiction's obligation under paragraph 1 of Article 23 B and paragraph 2 of Article 23 B to provide a credit against its own tax on an item of income for the tax paid on that income in the source jurisdiction, the entitlement to credit under those provisions will also be disregarded when computing the adjusted nominal rate for the purposes of the subject to tax test.

657. Disregarding the entitlement to exemption or credit under the elimination article in a tax treaty in this way for the purposes of computing the adjusted nominal rate raises questions about the interaction between the source jurisdiction's right to apply a top-up tax under the subject to tax test and the residence jurisdiction's obligation to provide relief by exemption or credit for that top-up tax. These questions are addressed in section 5.3.2 below.

Question for WP1 delegates

Do delegates agree that, for the reasons outlined above, the obligation to provide an exemption or credit under the elimination of double taxation provisions of a tax treaty should be disregarded when computing the adjusted nominal tax rate for the purposes of the subject to tax test?

Setting nominal tax rate

658. Given that the nominal tax rate trigger applies to the gross amount of the payment, on a transaction by transaction basis and does not allow for blending, the subject to tax rule might, in certain cases, give rise to the risk of over-taxation. This over-taxation could arise, for example, where a covered payment is made to an entity that is subject to tax at a nil rate but which has incurred expenses in deriving that income. In this case, applying the minimum ETR determined under the income inclusion and undertaxed payments rules to the gross amount of the payment when computing the top-up rate to be applied to that payment under the subject to tax rule would give rise to an effective tax rate above that minimum rate and could even give rise to taxation in excess of economic profit. In order to limit this risk of over-taxation, Inclusive Framework members could decide to limit both the trigger rate and the amount of top-up tax under the subject to tax rule to a rate that is lower than the minimum ETR determined under the income inclusion and undertaxed payment rules.

5.3. Operation and effect

5.3.1. Top-up to a minimum rate

659. The effect of the rule will be to allow the source jurisdiction to tax the gross amount of the payment up to an agreed minimum rate. That is, the payer jurisdiction would be able to impose a withholding tax on the covered payment at a rate that was equal to the difference between the minimum rate provided for under the subject to tax rule and the adjusted nominal tax rate applicable to the covered payment in the payee jurisdiction. As noted above, in order to mitigate this risk of over-taxation, it may be appropriate to

limit both the trigger rate and the amount of top-up tax under the subject to tax rule to a rate that is lower than the minimum ETR set under the income inclusion and undertaxed payment rule. Having a lower trigger and top-up rate under the subject to tax rule would limit the risk of over-taxation and be intended to arrive at a net tax burden that is (after taking into account any tax levied on the gross amount of the payment) equal, or at least broadly similar, to the minimum effective rate under the income inclusion and undertaxed payments rules. To address this and conform with the broader GloBE objective of avoiding double and excessive taxation, the top-up rate could be set at a rate that is lower than the minimum rate agreed for the income inclusion and undertaxed payments rules.

660. In general, no top-up tax would be imposed in circumstances in which the relevant treaty already provided for source taxation on the covered payment. But the treaty rule would include provision for applying top-up tax where the existing allocation of taxing rights was less favourable to the payer jurisdiction (for example, where the treaty provides for a low rate – say 5 per cent – on the gross payment and the top-up mechanism would result in increased taxing rights). This will take the form of an ordering rule in the relevant provisions, the effect of which will be to allow the payer jurisdiction to apply the higher of the rate agreed in the treaty or the top-up rate provided for under the subject to tax rule.

5.3.2. Interaction with treaty elimination articles

661. This section deals with a technical feature of the subject to tax rule that will need to be incorporated as part of the final design, in order to avoid unintended outcomes resulting from the interaction with other treaty provisions.

662. As discussed in section 5.2.6 above, the computation of the adjusted nominal rate (and therefore the amount of top-up required to bring that rate up to the agreed minimum rate) will not take account of the obligation to provide exemption or credit in the residence jurisdiction under the elimination of double taxation provisions in a tax treaty between the payer and payee jurisdictions. This avoids an unintended reallocation of taxing rights between the jurisdictions that would go beyond the intended effect of the subject to tax rule. But questions also arise about the interaction between the source jurisdiction's right to apply a top-up tax under the subject to tax rule and the residence jurisdiction's obligation, under the elimination of double taxation provisions of a tax treaty, to provide relief by way of exemption or credit in those circumstances.

663. Under paragraph 1 of Article 23 A of the OECD Model, the residence jurisdiction is obliged to exempt an item of income where the source jurisdiction is permitted to tax that item of income in accordance with the treaty. Where the conditions are met for the subject to tax rule to apply, the source jurisdiction will be permitted, in accordance with the treaty, to apply a top-up tax and the residence jurisdiction will then be obliged under the provisions of the elimination article to exempt that income from tax. Even where that obligation is not taken into account for the purposes of determining the adjusted nominal rate, and therefore does not increase the top-up tax that can be applied in the source jurisdiction, the residence jurisdiction will nevertheless be deprived of its taxing right. The result of this will be that only the source jurisdiction will tax the affected payment; and only at the top-up rate. This effect can be illustrated by adapting example X1 in Annex A – see example X2 in Annex A..

664. This outcome can be considered to be at odds with the intended effect of the subject to tax rule, which is not to reallocate taxing rights away from the residence jurisdiction but to permit the source jurisdiction to apply a top-up tax to covered payments that are subject to low nominal rates in the residence jurisdiction, in order to bring the tax on those payments up to an agreed minimum rate.

665. Similar considerations arise where the residence jurisdiction is obliged to provide a credit under paragraph 1 of Article 23 B or paragraph 2 of Article 23 A of the OECD Model. Even where that credit is not taken into account in computing the adjusted nominal rate for the purposes of the subject to tax test,

the residence jurisdiction's taxing right is reduced by the credit it is obliged to give for the top-up tax applied in the source jurisdiction. This is illustrated by example X3 in Annex A.

666. In order to avoid these outcomes, the residence jurisdiction's obligation to provide exemption or credit under the elimination of double taxation provisions of a tax treaty could be switched-off where the source jurisdiction is only exercising a taxing right in accordance with the treaty because it is applying a top-up tax in accordance with the subject to tax rule. The effect of this approach is illustrated by example X4 in Annex A. There would then be no reallocation of taxing rights away from the residence jurisdiction and, given the limitation imposed on the source jurisdiction to only apply a top-up to the agreed minimum rate, concerns about unrelieved double taxation might be minimal.

667. This approach could, however, result in a cliff-edge where a covered payment to which the subject to tax rule applies is subject to an existing source jurisdiction taxing right under the terms of the treaty at a rate above the top-up rate. This is illustrated in example X5 in Annex A.

668. Although this outcome does not disturb the position obtaining before the subject to tax rule came into contemplation, it does mean that the combined residence and source taxation of a covered payment in respect of which all the conditions for the subject to tax rule to apply are met will be lower than it would be if the rule had applied to produce a top-up tax. To avoid this outcome, without depriving the source jurisdiction of its bilaterally agreed right to tax the income at a rate above the top-up, the residence jurisdiction's obligation to provide relief by way of exemption or credit could be proportionately limited. The effect of this will bring the combined rate in the residence and source jurisdictions up to the agreed minimum rate under the subject to tax rule (assumed to be 7.5%). This is illustrated in example X6 in Annex A.

Questions for WP1 delegates

Do delegates agree that switching-off the residence jurisdiction's obligation to provide exemption or credit under the elimination provisions of a tax treaty, where the source jurisdiction is only taxing in accordance with the treaty because it is apply a top-up tax under the subject to tax rule, better aligns with the intended outcome of the rule?

Do delegates further consider that the residence jurisdiction's obligation to provide exemption or credit under the elimination provisions of a tax treaty should be proportionately limited, where the conditions for the application of the subject to tax rule apply but the source jurisdiction applies an existing treaty rate above the top-up rate, to provide for combined taxation at the agreed minimum rate?

5.3.3. Administrative considerations

669. The subject to tax rule is intended to address remaining BEPS risks by restoring to source jurisdictions a limited right to apply a top-up tax to a defined set of set of connected person payments resulting in low tax outcomes in the other contracting jurisdiction, in order to bring the tax on those payments up to an agreed minimum rate. Because this top-up tax will be applied to the gross amount of the payment it may be appropriate, as discussed in section 5.3.1 above, to limit both the trigger rate and the amount of top-up tax under the subject to tax rule to a rate that is lower than the minimum ETR set under the income inclusion and undertaxed payment rule, in order to limit the risk of over-taxation and arrive at a net tax burden that is equal, or at least broadly similar, to the minimum effective rate under the income inclusion and undertaxed payments rules.

670. However, although such an approach will mitigate the risk of covered payments ultimately being over-taxed, there remains a risk of temporary over-taxation if the source jurisdiction applies contingent withholding taxes at higher rates at the point of payment and requires the recipient entities to file claims for treaty relief and repayment after the year-end. Paragraph 109 of the Commentary on Article 1 of the

OECD Model notes that jurisdictions are not prevented by the treaty from adopting this approach, but observes that delay in making refunds can result in a direct cost to taxpayers and that it is extremely important that refunds are made expeditiously. The Commentary goes on to say that, in order to ensure the expeditious implementation of benefits under a treaty, it is highly preferable for source jurisdictions to automatically limit the tax they levy in accordance with the relevant provisions of the treaty. In the context of the subject to tax rule, this would mean limiting the tax applied at the point of payment to the top-up rate.

671. Consistent with these aims, consideration will be given to administrative approaches facilitating as far as possible the application of the subject to tax rule in a way that: ideally, allows the tax applied to covered payments to be limited to the top-up tax that is due after computing the adjusted nominal rate and applying the materiality threshold; and in any event minimises the need for and delay in obtaining refunds of contingent withholding taxes in excess of the top-up. These could include applying the subject to tax rule on an annualised ex-post basis.

Note for delegates

When the subject to tax rule was discussed at the joint meeting of WP1 and WP11 on 28 July 2020, delegates agreed that applying excessive contingent withholding taxes at the point of payment and possible delays in obtaining refunds could result in over-taxation contrary to the intended effect of the subject to tax rule. Delegates indicated that they would be in favour of developing administrative approaches that would serve to mitigate or eliminate these concerns. Some delegates had suggested such administrative and design responses, including:

- Applying the subject to tax rule on an ex-post basis as an annualised charge. Advantages of this approach would include certainty about the value of in-scope covered payments made, the application of the materiality threshold conditions, the adjusted nominal rate and the amount of top-up tax to be charged. Because the tax would be payable by the non-resident recipient of the payments, there may be concerns about collection of the tax. But since there will always be a resident affiliated entity making the covered payments, tax that is not paid by the non-resident could be recovered from that resident under domestic joint liability provisions or via an assistance in collection article in the relevant treaty. It might also be possible to collect the tax by withholding from subsequent payments.
- Administrative procedures allowing applications to be made for, or prescribing, a standard (lower) withholding tax rate with any true-ups may be paid at the closing of the financial year (a suitable interest rate may be prescribed for the true-up payment).
- A certification system permitting the MNE to “prove-out” of the rule in respect of particular payments or periods.

Question for delegates:

Do delegates agree that administrative approaches that serve to eliminate or minimise the prospect of temporary over-taxation should be developed as part of the design of the subject to tax rule?

Delegates are invited to provide comments on this section to assist the Secretariat in advancing the design of this aspect of the rule and revising this section of the Report.

6 Implementation and Rule Co-ordination

6.1. Overview

672. This chapter first summarises the rule co-ordination and rule order framework within which the different elements of Pillar 2 are intended to operate. It then discusses questions of implementation of each of the elements as well as mechanisms to ensure that effective co-ordination and tax certainty in practice.

6.2. Rule order

673. Chapters 2 to 5 of this Report include recommendations for the design of an income inclusion rule (IIR) and an undertaxed payment rule (UTPR), together referred to as the GloBE rules, as well as a subject to tax rule (STTR). These rules are complemented by a switch-over rule (SOR) that removes treaty obstacles from the application of the IIR to certain branch structures and applies where the treaty otherwise obligates the contracting state to use the exemption method.¹⁶¹ The Policy Note and the Programme of Work¹⁶² call for the development of rules under Pillar 2 that operate to co-ordinate these different elements in order to ensure that they interact in a way that minimises compliance and administration costs and avoids the risk of double taxation.

674. The co-ordination between these various elements of Pillar 2 is already described in the previous chapters, but for ease of reference is also summarised below.

6.2.1. Subject to Tax Rule

675. Where the subject to tax rule (STTR) permits the source jurisdiction to apply a top-up tax to a covered payment, for example in the form of a withholding tax, the effect of that additional tax will be taken into account in determining the effective tax rate under the GloBE rules.¹⁶³ Under the jurisdictional blending approach this top-up tax is assigned to the Constituent Entity that brings the payment into account as income.¹⁶⁴ By taking the tax charged as a consequence of the STTR into account in calculating the ETR of the payee, the GloBE rules effectively give priority to the application of the STTR. Example 6.2.1A provides an illustration of the interaction of the STTR with the IIR while Example 6.2.1B provides an illustration of the interaction of the STTR with the UTPR. These examples demonstrate that the STTR applies even if the MNE Group is subject to the IIR or the UTPR. These examples further illustrate that the

¹⁶¹ See Section 4.2.1

¹⁶² Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, OECD/G20 Inclusive Framework on BEPS, OECD, Paris (OECD 2019), Paragraph 58.

¹⁶³ See Section 3.2.3.

¹⁶⁴ See Section 3.6.2.

withholding tax levied under the STTR is taken into account in order to determine the ETR (and, if relevant, the top-up tax) of the jurisdiction where the recipient is located.

6.2.2. Switch-over Rule

676. The IIR will apply where the parent of the MNE derives income attributable to a foreign permanent establishment (PE) that benefits from a tax exemption under the laws of the parent jurisdiction. In this case the income of that exempt PE will need to be apportioned between the PE jurisdiction and the parent jurisdiction (together with any tax on that income) under the GloBE rules in order to accurately calculate the jurisdictional ETR in the parent jurisdiction and the PE jurisdiction. A parent that seeks to apply the IIR to the income of an exempt PE will, however, be prevented from doing so where the parent jurisdiction has entered into a bilateral tax treaty that obliges the parent jurisdiction to exempt the income of the PE in the hands of its own resident. A jurisdiction that found itself in the position where it was unable to tax the low taxed income of a PE due to the operation of the treaty would not be able to implement an IIR that was compatible with the requirements of the GloBE rules. A switch-over rule is therefore required in order to allow the state of the parent's residence to tax the income of the PE up to the minimum rate as provided for under the income inclusion rule.¹⁶⁵

6.2.3. GloBE rules

677. The mechanisms for calculating and allocating the tax base and covered taxes under GloBE rules are designed to take into account both domestic and foreign taxes imposed on each Constituent Entity's income.¹⁶⁶ Therefore, the effect of existing rules for taxing foreign income (such as under a CFC regime) or for taxing non-residents on domestic source income (such as through a withholding tax mechanism) are taken into account when determining a Constituent Entity's ETR under the GloBE on a jurisdictional basis. The significance of giving priority to withholding taxes and taxes imposed under a CFC regime is described in further detail in Chapter 3.

Income inclusion rule (IIR)

678. As described further in Chapter 5 of the Report, the IIR applies in priority to the UTPR under the GloBE rules. However, the IIR includes further co-ordination rules that ensure that the IIR in different jurisdictions cannot be applied to the same interest in low-taxed income. The primary mechanism for co-ordinating the application of the IIR in each jurisdiction is through the "top-down approach" which gives priority to the application of the IIR in the jurisdiction of the Constituent Entity that is at or near the top of the ownership chain in the MNE Group, starting with the Ultimate Parent Entity. In the event the Ultimate Parent Entity is not located in a jurisdiction that has implemented the IIR, then responsibility for applying the IIR falls to the Constituent Entity that is directly owned and controlled by that Ultimate Parent Entity, and so on, down the chain of ownership.

679. The application of the top-down approach is subject to a further rule that specifically addresses the application of the IIR in the case of "split-ownership structures". Split-ownership structures are those where a significant portion of the equity interests in a Constituent Entity are held by persons outside the MNE Group. (see Chapter 3). This rule pushes the obligation to apply the IIR down to the partially-owned "intermediate" parent. The intermediate parent then applies the IIR to its share of the income of any low-taxed Constituent Entity in which that Intermediate Parent has a direct or indirect ownership interest.

¹⁶⁵ See section 4.2.1

¹⁶⁶ See section 3.6..

Undertaxed payment rule (UTPR)

680. As noted above the IIR takes priority over the UTPR. Therefore, no top-up tax may be allocated under the UTPR in respect of a Constituent Entity that is controlled, directly or indirectly, by a foreign Constituent Entity that is subject to an IIR in accordance with the GloBE rules. From an implementation perspective, it therefore makes sense to ensure that jurisdictions have the time to introduce the IIR before the UTPR takes effect.

6.3. Implementation

681. Both the STTR and SOR require changes to existing bilateral tax treaties. These could be implemented through bilateral negotiations and amendments to individual treaties. But the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the MLI), emerging from BEPS Action 15, may offer a model for a more coordinated and efficient approach. The MLI is a multilateral treaty that applies alongside existing bilateral treaties and modifies their application. It represents a significant efficiency gain compared to the alternative of multiple pairs of bilateral negotiations. The MLI requires one negotiation and allows countries to go through a single ratification procedure in their legislature covering all of their affected treaties. Using the MLI, or a similar instrument, to give effect to the STTR and SOR in relevant treaties would therefore offer a quicker and more effective path to implementation of these rules.

682. The IIR and UTPR can be implemented by way of changes to domestic law. Therefore, it is a matter for individual jurisdictions to decide to implement the IIR and UTPR in their domestic legislation consistent with the terms set out in this Report. This is similar to the approach taken, for instance, in BEPS Actions 2, 3 4 and 13. Jurisdictions may also consider staggering the implementation of the rules, allowing the IIR to come into effect first and activating the UTPR later to help ensure rule order and rule coordination.

6.4. Treaty compatibility

6.4.1. General principles

683. The common starting point for an analysis of the compatibility of the IIR and UTPR with existing tax treaty obligations is the general principle that, with limited exceptions, tax treaties are not intended to restrict a jurisdiction's right to tax its own residents. This longstanding principle is now codified in Article 1(3) of the OECD Model (often referred to as the "saving clause"), and reads as follows:

This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28.

684. As a general matter, then, tax treaties should not present any obstacle to jurisdictions implementing an IIR and UTPR along the lines envisaged under the GloBE.

6.4.2. Income Inclusion rule (IIR)

685. The IIR operates by requiring a parent entity (in most cases, the Ultimate Parent Entity) to bring into account as income its proportionate share of the income of each Constituent Entity located in a low-tax jurisdiction in which it owns an equity interest. That income is then taxed in the parent entity's hands up to the GloBE minimum rate, after crediting any covered taxes (as defined for the purposes of the GloBE) on that income. In subjecting a domestic taxpayer to tax on its share of the foreign income of a controlled subsidiary, therefore, the IIR operates in a way that is closely comparable to a CFC rule and raises the

same treaty questions. Although there are a number of differences between the IIR and the CFC rules of many jurisdictions, these do not alter the analysis.

686. The compatibility of CFC regimes with treaty obligations is addressed in paragraph 81 of the Commentary on Article 1 of the OECD Model Tax Convention (MTC), which concludes that they do not conflict with treaty obligations. Paragraph 81 reads as follows:

A significant number of countries have adopted controlled foreign company provisions to address issues related to the use of foreign base companies. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities. It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 [...] that this common feature of controlled foreign company legislation conflicted with these provisions. Since such legislation results in a State taxing its own residents, paragraph 3 of Article 1 confirms that it does not conflict with tax conventions. The same conclusion must be reached in the case of conventions that do not include a provision similar to paragraph 3 of Article 1 [...]"

687. For the same reasons, it can be concluded that an IIR along the lines envisaged under the GloBE is similarly compatible with the provisions of tax treaties that are generally based on the OECD Model.

6.4.3. Undertaxed payments rule (UTPR)

688. The UTPR serves as a backstop to the IIR. It operates when the IIR does not apply by providing jurisdictions with a tool to protect themselves from the effect of base eroding transactions. In order to do so, the UTPR takes the form of a limitation (or denial) of the deduction of intra-group payments, or an equivalent adjustment. The extent to which the deduction of an intra-group payment is affected by the UTPR depends on the amount of top-up tax that is allocated to a UTPR Taxpayer. As described in section 4.3. the UTPR uses the same mechanics as the IIR for determining the MNE's jurisdictional ETR and the amount of top-up tax allocable under the rule. The UTPR, however, operates through an allocation key that is based on deductible intra-group payments.

689. The top-up tax is allocated to a UTPR taxpayer that is a member of the same MNE group as the low-tax entity as follows:

- First, if the UTPR taxpayer makes any deductible payments to the low-tax entity during the relevant period, the top-up tax that applies to the income of such entity is allocated in proportion to the deductible payments made to such low-tax entity by all UTPR taxpayers;
- Second, if the UTPR taxpayer has net intra-group expenditure, the remaining top-up tax is allocated in proportion to the total amount of net intra-group expenditure incurred by all UTPR taxpayers.

690. The rationale for the two-step approach is that the full amount of top-up tax may not be allocated after application of the first allocation key. This can happen if there are no direct payments made to any low-tax entity from a UTPR taxpayer or if the adjustments on direct payments are not sufficient to soak up the computed top-up tax. In such a case, the remaining top-up tax after the first allocation key applied is allocated to the UTPR taxpayers in proportion to their net intra-group expenditures. The UTPR taxpayers with net related party income are disregarded for the purpose of the second allocation key. Both allocation keys only take into account the payments that were made in the same year as the year when the top-up tax arises.

691. The UTPR provides a coordinated mechanism to identify the maximum amount of top-up tax that can be allocated and that can be imposed on each UTPR Taxpayer. The top-up tax imposed on each UTPR taxpayer is capped by reference to the gross amount of deductible intra-group payments that are

taken into account for the purpose of the allocation keys. The UTPR, however, does not provide any requirements as to how this top-up tax is collected. The adjustment in the payer jurisdiction could take the form of a denial or a limitation of a deduction for intra-group payments, or an equivalent tax computed by reference to those payments. The precise method under which the adjustment is made will be a matter of domestic law implementation left to the jurisdictions applying the UTPR (see above section 4.3.7).

692. Because the UTPR has the potential to apply in any jurisdiction where a UTPR taxpayer makes an intra-group payment, and because the outcomes under the UTPR will vary based on the amount of intra-group payments made by each entity, the UTPR is a more complex rule to apply and requires a greater amount of co-ordination between jurisdictions than the IIR. In practice, however, the scope for the application of the UTPR is expected to be relatively narrow. This is because the UTPR only applies where the entity is not otherwise subject to an IIR that is implemented in accordance with the GloBE rules under the laws of another jurisdiction (see above section 6.2 about rule order).

693. The UTPR would also, therefore, affect how a country taxes its own residents. Since a denial of a deduction under the UTPR could result in a higher taxable base than the base solely based on arm's length profits, some may question whether the denial could conflict with Article 9(1) (Associated Enterprises) or, where the UTPR applies to a PE, Article 7(2) MTC. It is generally recognised, however, that a country is free to compute the taxable profits of its resident enterprises as it deems appropriate and is not, for example, constrained to taxing the accounting profits or the prices that would be charged at arm's length. A frequently quoted illustration of this point, found in the domestic law of many countries, are rules denying a deduction for entertainment expenses. As mentioned above, this longstanding principle is now codified in Article 1(3) of the OECD Model (the "saving clause") and is further confirmed by paragraph 30 of the Commentary on Article 7 MTC, as follows:

Paragraph 2 determines the profits that are attributable to a permanent establishment for the purposes of the rule in paragraph 1 that allocates taxing rights on these profits. Once the profits that are attributable to a permanent establishment have been determined in accordance with paragraph 2 of Article 7, it is for the domestic law of each Contracting State to determine whether and how such profits should be taxed as long as there is conformity with the requirements of paragraph 2 and the other provisions of the Convention. Paragraph 2 does not deal with the issue of whether expenses are deductible when computing the taxable income of the enterprise in either Contracting State. The conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 3 of Article 24 [...]

Non-discrimination provisions

694. The general principle codified in Article 1(3) MTC is, however, constrained in some circumstances by Article 24 MTC (the non-discrimination provision). In relation to the UTPR two provisions of Article 24 need to be considered. Article 24(4) requires equal treatment to be given to payments between resident taxpayers when compared to payments made by a resident to a non-resident. In order to comply with Article 24(4), the conditions for deductibility should not be different merely because the payment is made to a non-resident. And, where the UTPR applies to deemed payments by a PE, Article 24(3) requires that the taxation on that PE shall not be less favourably levied than that on resident enterprises carrying on the same activities.

695. Under the first step described above, the UTPR applies by reference to the average ETR enjoyed by the local group in a particular jurisdiction and not by reference to the residence of the payee entity. This means that the UTPR will not apply where a payment is made from a jurisdiction that is characterised as a low tax jurisdiction for that group in a particular year (based on the local group's ETR profile in that jurisdiction in that year), regardless of whether the payment is to a non-resident. And it means that two otherwise comparable payments from a jurisdiction that is characterised as a high tax jurisdiction for groups

A and B (which are unrelated) for a particular year to non-resident entities that are members of groups A and B, both located in the same treaty partner jurisdiction, will be treated differently where that other jurisdiction is characterised as a low-tax jurisdiction for group A and a high-tax jurisdiction for group B (based on the ETR profile of the local group in that jurisdiction in the particular year). For group A, the UTPR will apply; for group B it will not apply. This demonstrates that the denial of a deduction under the UTPR is not determined by the residence of the recipient of the payment but by the jurisdiction's classification as high- or low-tax on the basis of the local group's effective tax rate profile in the relevant period.

696. Under the second step described above, deniability can arise in respect of any net related party expenditure, whether the payment is made to a domestic or foreign member of the group. The net related party expenditure is determined on an entity-by-entity basis. Under this step, therefore, the UTPR will apply in the same way to intra-group payments made to domestic and non-resident group entities without any distinction.

697. For these reasons, it can be concluded that a UTPR along the lines envisaged under the GloBE rules is compatible with the obligation not to discriminate on the basis of the residence of the recipient of a deductible payment set out in Article 24(4). A similar conclusion can be reached in relation to Article 24(3) for the reasons set out below.

698. PEs are treated as separate Constituent Entities for the purpose of the GloBE rules. Deemed or notional payments from a PE to its head office (HO) that are recognised for tax purposes will be included in the definition of payments, provided they meet the general criteria for being deductible in the payer jurisdiction. This applies to payments taken into account under either the first or second step described above. Such a PE could therefore be a UTPR taxpayer and be subject to a denial of deduction where the PE is in a jurisdiction characterised as high-tax and its HO is in a jurisdiction characterised as low-tax on the basis of the ETR profile in each jurisdiction in a particular year, in the same way as described above. The UTPR will then apply, using the same mechanics as the IIR for determining the MNE's jurisdictional ETR and the amount of top-up tax allocable under the rule and applying to the PE the two step allocation key based on the PE's deductible intra-group payments (that is, the deemed payments recognised for tax purposes). The effect is the same as for payments made by a group entity that is a UTPR taxpayer.

699. Article 24(3) requires that the taxation on a PE shall not be less favourably levied in the host jurisdiction as compared to a hypothetical enterprise resident in that jurisdiction and carrying on the same activities. In applying this test, as with the other tests in Article 24, paragraph 3 of the Commentary on Article 24 MTC sets out the following general principles:

“The various provisions of Article 24 prevent differences in tax treatment that are solely based on certain specific grounds [...] Thus, for these paragraphs to apply, other relevant aspects must be the same. The various provisions of Article 24 use different wording to achieve that result (e.g. “in the same circumstances” in paragraphs 1 and 2; “carrying on the same activities” in paragraph 3; “similar enterprise in paragraph 5). Also, whilst the Article seeks to eliminate distinctions that are solely based on certain grounds, it is not intended to provide foreign nationals, non-residents, enterprises of other States or domestic enterprises owned and controlled by non-residents with a tax treatment that is better than that of nationals, residents or domestic enterprises owned or controlled by residents.”

700. The UTPR applies to a PE that is a UTPR Taxpayer, in the same way as to a UTPR Taxpayer that is a group entity, as a mechanism to allocate top-up tax resulting from a low-tax outcome within an MNE. The mechanism takes the form of a limitation (or denial) of the deduction of intra-group payments, or an equivalent adjustment, based on deductible payments to a low-tax entity or net related party expenditures in the relevant period. It is not, therefore, a tax on the activities of the PE but a rule designed to serve as a backstop to the IIR by allocating top-up tax among the Constituent Entities in an MNE group when the IIR does not apply. Paragraph 41 of the Commentary on Article 24 MTC notes that:

“[...] the equal treatment principle of paragraph 3 only applies to the taxation of the permanent establishment’s own activities. That principle, therefore is restricted to a comparison between the rules governing the taxation of the permanent establishment’s own activities and those applicable to similar business activities carried on by an independent resident enterprise. It does not extend to rules that take account of the relationship between an enterprise and other enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfers of property between companies under common ownership) since the latter rules do not focus on the taxation of an enterprise’s own business activities similar to those of the permanent establishment but, instead, on the taxation of a resident enterprise as part of a group of associated enterprises. Such rules will operate to ensure or facilitate tax compliance and administration within a domestic group. It therefore follows that the equal treatment principle has no application. [...]”

6.5. Effective co-ordination of the GloBE rules

6.5.1. Model legislation and guidance

701. The IIR and UTPR can be implemented by way of changes to domestic law. To enhance consistency and improve rule co-ordination, model legislation will be developed setting out the detailed rules for the IIR and UTPR. The model legislation will serve as a template that jurisdictions could use as the basis for domestic legislation.

702. As jurisdictions move into the implementation stage, questions of interpretation may arise. In the interest of consistent implementation and certainty for both tax administrations and taxpayers, the IF would develop co-ordinated guidance to respond to those questions. This is similar to the approach used in connection with the implementation of BEPS Action 13.

703. Work on model legislation could proceed in parallel to the work on agreeing changes that would be required to the OECD Model Convention to introduce the STT rule. Jurisdictions may also consider staggering the implementation of the rules, allowing the IIR to come into effect first and activating the UTPR a number of years later once a critical mass of jurisdictions had adopted the GloBE rules.

6.5.2. Multilateral review process

704. To simplify both the compliance with the UTPR and the administration of the rule in instances where the UTPR should not apply, there is a need for a system that allows an MNE Group to certify that Constituent Entities of the MNE are parented in a jurisdiction which has implemented an IIR in line with the GloBE requirements.

705. This determination of whether a jurisdiction’s IIR is in line with GloBE can be facilitated through a multilateral review process. The multilateral process for determining whether a jurisdiction has introduced an IIR in line with GloBE requirements would be a collective assessment and would result in publication of an agreed compilation of jurisdictions that had implemented an IIR consistent with the rules contained in this Report .

706. Parallel with this process, tax administrations that have implemented an IIR could agree on simplified risk assessment procedures that could be applied in determining compliance with the IIR in each jurisdiction. Options for development of simplified risk assessment procedures are discussed further in Section 3.10. These simple procedures could also include a mechanism for demonstrating that the effective tax rate in the parent jurisdiction for GloBE purposes was above the agreed minimum rate.

707. Separately, IF members may also consider it useful to undertake a general review of the operation of the GloBE rules (IIR and UTPR) as implemented in jurisdictions’ domestic law after a certain number of years of their application to ensure that they are working as intended. This could be linked to the process that allows IF members to consider whether the way the rules operate in a particular context “results in

material competitive distortions in the application of the GloBE rules".¹⁶⁷ Where IF members identify specific issues or risks, the IF could develop further guidance to address these. This would be similar to the peer review process for IF members with respect to their implementation of the BEPS Action 13 minimum standard on CbC Reporting, and the ongoing development of guidance.

6.5.3. Multilateral convention

708. While not strictly necessary for jurisdictions to implement the GloBE rules, IF Members will explore the development of provisions that could be included in a new multilateral convention to ensure consistency and certainty in the application and operation of the IIR and UTPR, and supplement the model legislation, guidance and multilateral review process with a legal overlay that underpins the political agreement on Pillar Two.

709. The provisions would contain the key elements and high-level principles of the GloBE rules that are necessary to ensure consistent and coordinated application across multiple jurisdictions, in particular rule-order and the top-down approach. They could also contain the key design elements of the GloBE rules that require common defined terms, including tax base, definition of covered taxes, jurisdictional blending approach, and the allocation rules for the UTPR. Rather than containing the detailed rules for the IIR and UTPR itself, the multilateral convention could instead refer to the model legislation, as well as any further guidance that is developed.

710. Unlike the MLI used to implement the tax treaty related BEPS measures, the provisions would not seek to modify existing treaty provisions. Instead, the provisions could be included in a new multilateral convention, which would be a standalone international public law instrument designed specifically for the purposes of ensuring consistent, coordinated and comprehensive application of the GloBE rules, and which would coexist with the existing tax treaty network. This is similar to the approach being developed for the new multilateral convention under Pillar One so it may be possible to include the GloBE provisions in that instrument and combine these into a single convention, which could also have the benefit of setting out the interaction between Pillar One and Pillar Two.¹⁶⁸

711. A multilateral convention could also confirm the compatibility of the GloBE rules with existing double tax treaties, as well as contain specific provisions required for consistent and coordinated application of the UTPR, in particular exchange of information and dispute resolution mechanisms (see below section 6.6.2).

6.6. Dispute prevention and resolution

6.6.1. STTR and SOR

712. The STTR and the SOR are treaty rules that would be incorporated into existing tax treaties. Therefore, they would benefit from the existing dispute resolution mechanisms in the relevant tax treaties. In accordance with the BEPS Action 14 Minimum Standard, all treaties involving the members of the Inclusive Framework on BEPS should include a MAP article that is in line with Article 25(1-3) of the OECD Model Tax Convention. Therefore, a mutual agreement procedure could be initiated in case a taxpayer would consider that one jurisdiction has applied the STTR or the SOR in a way that resulted or will result in taxation is not in accordance with the tax treaty.

¹⁶⁷ See the discussion on 'Other generally accepted financial accounting standards' in section 3.3.3.

¹⁶⁸ See Section 10.2.2. *Public international law implementation* of the Pillar One Blueprint

6.6.2. *GloBE rules (IIR and UTPR)*

713. Based on the agreed rule order and the binary way in which the GloBE rules operate, it is expected that the IIR will apply in the majority of the situations where an MNE Group is subject to the GloBE rules in respect of its low-tax income. Since the IIR is designed to be applied at a single Parent level, it is also not expected that there would be significant scope for disputes between tax administrations regarding the application of the IIR.

714. As mentioned above, the UTPR operates as a backstop and should not apply in situations where the low-tax Constituent Entities are controlled, directly or indirectly by a foreign Constituent Entity that is subject to an IIR that complies with the GloBE requirements. If there is a mechanism in place for identifying those jurisdictions that have implemented an IIR in line with the requirements of the GloBE rules as well as a standard mechanism for the MNE to certify that it is subject to these rules then it is not expected that there will be significant scope for disputes between tax administrations as to the non-application of the UTPR either.¹⁶⁹

715. There is more scope for disputes to arise when the UTPR applies since several jurisdictions would apply the rule simultaneously. This risk, however, should remain rather limited since (i) as a backstop, the UTPR is only expected to be applied in a limited number of situations and (ii) the UTPR calculation and allocation rules are largely mechanical and less subject to interpretation than other rules allocating taxing rights (such as transfer pricing rules). However, an adjustment made in relation to the application of the UTPR in a jurisdiction can potentially affect other jurisdictions that have applied the UTPR and been allocated a top-up tax.

716. With a view to ensuring an effective coordination of the GloBE rules, jurisdictions may consider that it is necessary to provide for tax certainty in applying these rules, and the UTPR more specifically. A number of dispute prevention and dispute resolution mechanisms could be further explored and developed for that purpose.

717. The development of model legislation and guidance as well as standardised returns for the application of the UTPR may help to prevent disputes arising by facilitating consistent application of the UTPR and multilateral working by tax administrations.¹⁷⁰ Jurisdictions could rely on the Convention on Mutual Administrative Assistance in Tax Matters (“MAAC”) to exchange this information.¹⁷¹ Alternatively, jurisdictions that want to introduce the GloBE rules could enter into a new multilateral convention for the GloBE rules that could set out these mechanisms (see also above section 6.5).

718. In the situations where a tax administration reassesses the UTPR return filed by the taxpayer in its jurisdiction, it could be required to initiate simultaneous tax examinations across several jurisdictions potentially affected by the reassessment of the UTPR return.¹⁷² The legal framework for simultaneous tax

¹⁶⁹ See above section 5.3.7. on the Compliance and administration of the UTPR

¹⁷⁰ See also section 5.3.7 about certification mechanism and standard returns for the purpose of the UTPR.

¹⁷¹ The Convention on Mutual Administrative Assistance in Tax Matters as Amended by the 2010 Protocol (the MAAC) is a multilateral treaty aimed at assisting countries to better enforce their tax laws by providing an international legal framework for exchanging information and co- operating in tax matters with a view to countering international tax evasion and avoidance. As of June 2020, there are 137 participating jurisdictions in the MAAC.

¹⁷² Simultaneous tax examinations refer to an arrangement between two or more tax administrations to examine simultaneously, each in its own territory, the tax affairs of a person or persons in which they have a common or related interest, with a view to exchanging any relevant information which they so obtain.

examinations could rely on the provision of the MAAC.¹⁷³ Simultaneous tax examinations have proven to be an effective tool to ensure the right amount of tax is paid while minimising the risk of double taxation.¹⁷⁴ Such tool could therefore be used and/or adapted for the needs of the UTPR more widely.

719. In case a jurisdiction reassesses the UTPR return filed by the taxpayer, and this results in double taxation for the taxpayer (for example, because it affects the top-up tax that was allocated to another jurisdiction), a mutual agreement procedure could be initiated under existing treaties. For that purpose, competent authorities of the relevant jurisdictions could rely on the provision contained in Article 25(3), second sentence of the OECD Model Tax Convention, which allows them to consult together for the elimination of double taxation in cases that are not provided for in the Convention. This would require, however, that the jurisdictions involved in the double taxation have entered into a tax treaty with each other, which may not be the case with all jurisdictions involved. Alternatively, jurisdictions that want to introduce the GloBE rules could enter into a new multilateral convention that would provide for dispute resolution mechanisms concerning the application of the GloBE rules (see also above section 6.5). Further consideration could also be given as to whether this convention could be combined with the instrument that is under consideration for the purposes of Pillar One.

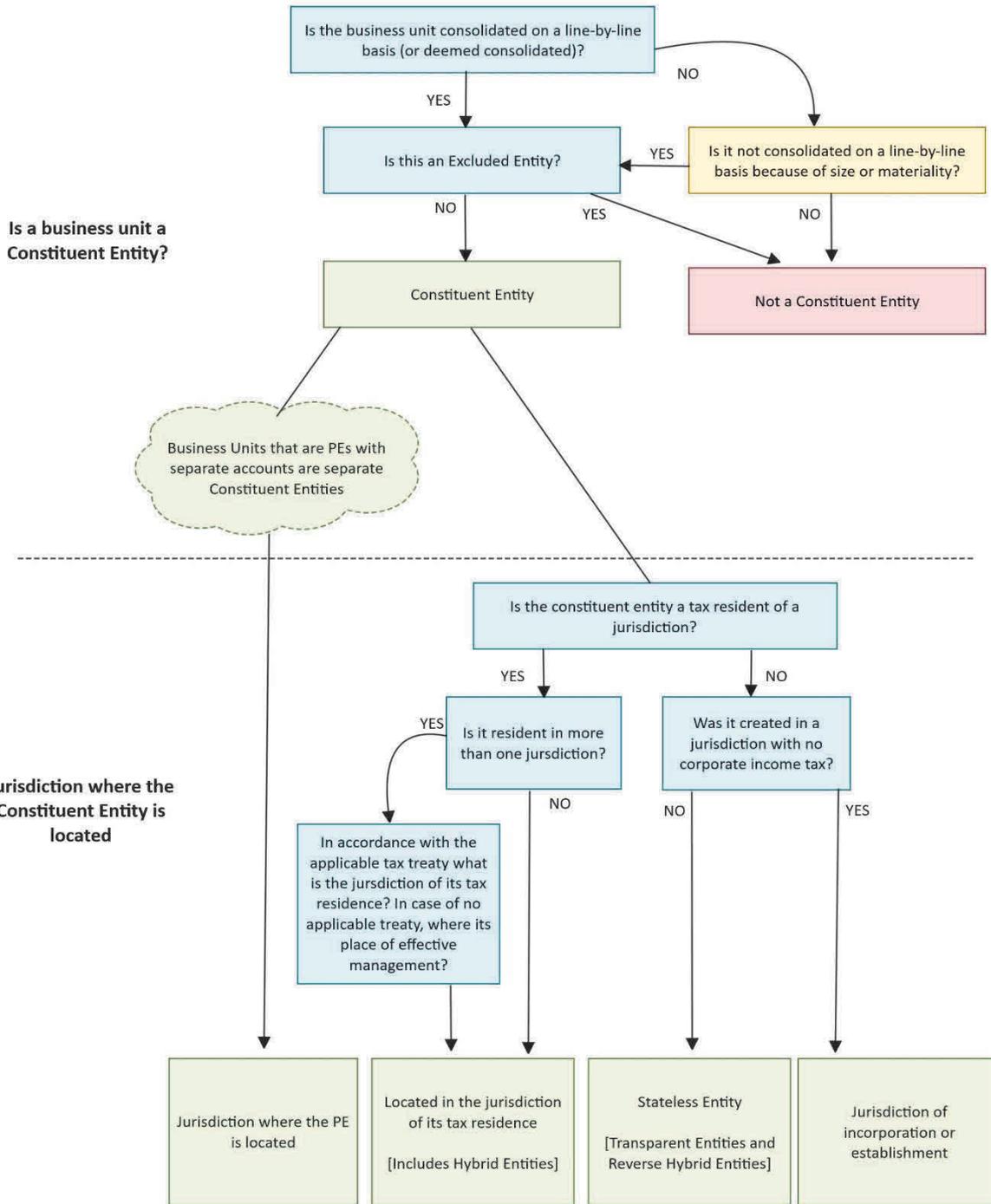
¹⁷³ Under the MAAC, two or more jurisdictions may consult together for the purposes of determining cases and procedures for a simultaneous tax examination (Article 8). One jurisdiction may also request its competent authority to be present during tax examinations that occur in another jurisdiction (Article 9).

¹⁷⁴ OECD (2019), Joint Audit 2019 – Enhancing Tax Co-operation and Improving Tax Certainty: Forum on Tax Administration, OECD Publishing, Paris

Annex A. Examples

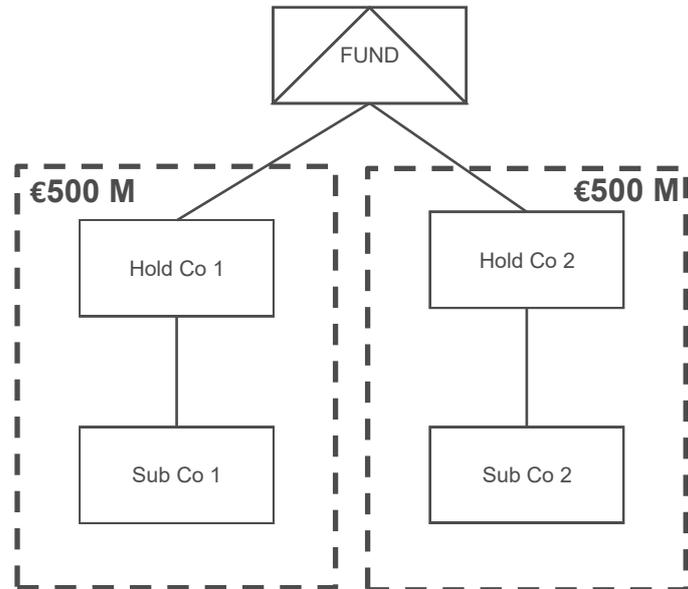
Chapter 2 Flow Chart and Example

Flow Chart 2.2.2.



Example 2.4.4

1. FUND is an investment entity that does not consolidate the accounts of its investments under IFRS 10. FUND is the majority shareholder of Hold Co 1 and Hold Co 2, the ultimate parent entities of two different MNE Groups whose consolidated revenue is of €500 million each. Separate consolidated financial statements are prepared for MNE Group 1 and MNE Group 2.



2. MNE Group 1 and MNE Group 2 are considered to be separate groups because FUND is not required to consolidate both of them on a line-by-line basis. Therefore, the consolidated revenue of MNE Group 1 and MNE Group 2 should be computed separately for purposes of the €750 million threshold. The consolidated revenue of each MNE Group, i.e., MNE Group 1 and MNE Group 2, is below €750 million. Accordingly, both groups are out of the scope of the GloBE rules.
3. If FUND were an entity required to consolidate Hold Co 1, Hold Co 2, Sub Co 1, and Sub Co 2 on a line-by-line basis, but was an investment fund excluded for the application of the GloBE rules in accordance with the rules set in the section on sectoral carve-outs, then the computation of the threshold would apply as if FUND was not required to consolidate. In this case, Hold Co 1 and Hold Co 2 would be separate MNE Groups and therefore, they would compute their revenues separately.

Chapter 3 Examples

Example 3.2.5A. Covered Taxes – Zakat

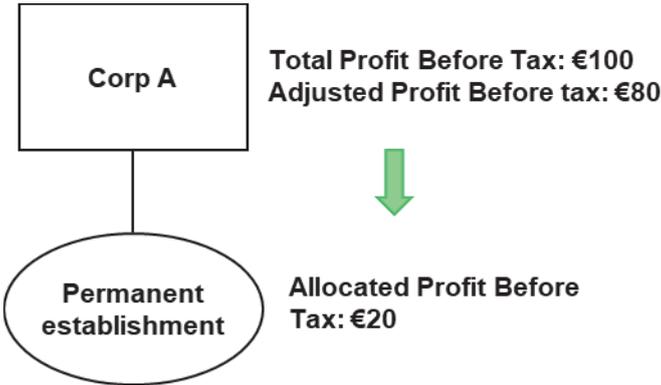
1. The Zakat levied on corporations by the Kingdom of Saudi Arabia is an example of a tax on both income and equity. The Zakat is levied at 2.5% on a Saudi's share of a resident company (also applies to citizens of Gulf Cooperation Council countries) but since it is imposed on income and equity it results in a higher effective rate. Corporate income tax is levied at 20% on a non-Saudi's share of a resident company or a non-resident's income from a permanent establishment in Saudi Arabia and a higher corporate income tax rate is imposed on Saudi working in the oil and gas industries. The corporate Zakat could be considered as an alternative to corporate income tax levied on a different basis.

The Zakat base is the total of the corporate taxpayer's current year's income and equity as calculated for financial accounting purposes after adjustments for certain items. In general terms these two elements of the Zakat base are determined as follows:

- e. The starting point for calculating the income portion of the Zakat base begins with the company's annual profit or loss as calculated for financial reporting purposes. This profit or loss is then adjusted by the changes to certain provisions or reserves, such as bad debts.
 - f. The starting point for calculating the equity portion of the Zakat base begins by:
 - i. calculating shareholder equity as determined under IFRS (excluding current year profit and any distributions); and
 - ii. adjusting for the balance of certain provisions, including bad debts
- (a) This amount is then increased by long-term liabilities and decreased by the cost of certain deductible assets to arrive at an adjusted net equity amount.
2. In this case both components of the Zakat base meet the definition of a covered tax under the GloBE as set out in this paper.
- (b) The first element of the Zakat base is on the company's income (i.e. adjusted profit or loss for the year). The adjustments for provisions and reserves is consistent with (but not a requirement of) the definition of an income tax for the purposes of the GloBE rules.
 - (c) The second component of the Zakat base is a measure of adjusted equity. The equity component of the Zakat base is determined under financial accounting rules adjusted for certain provisions. This amount is then subject to a further adjustment that decreases the equity portion of the Zakat base to the extent that the company's deductible assets exceed its long-term debt.
3. Although this latter adjustment may have the effect of excluding a portion of the shareholder equity from the tax base, this feature of the Zakat does not disqualify it from being treated as a tax on the equity of the corporation. The extent to which a corporation's liabilities are taken into account in determining equity under accounting and local law are a matter of domestic tax policy design which do not impact on the intended outcomes under the GloBE rules.
4. A company's liability for Zakat is calculated on the total of adjusted income and adjusted equity base or only on the income base (where the equity component is negative) or only the equity base (when the corporation has an operating loss). Thus, a profitable company will always be liable for Zakat on its income while a corporation that has an operating loss for the year will nonetheless be subject to Zakat on the adjusted equity portion of the Zakat base. Accordingly, Zakat operates as a tax on income or equity or both and is therefore properly considered a covered tax for the purposes of the GloBE rules.

Example 3.6.2A. Jurisdictional blending: Permanent establishments – assignment of income and taxes

1. Corp A (resident in jurisdiction A) is a Constituent Entity of an MNE Group whose Ultimate Parent Entity is tax resident in Jurisdiction X. Corp A has a permanent establishment located in jurisdiction B. Corp A has €100 of profit before tax. Jurisdiction A exempts the income of foreign permanent establishments.¹⁷⁵ Pursuant to the tax laws of jurisdiction B, Corp A is required to determine the portion of its income attributable to its permanent establishment located in jurisdiction B. Corp A determines that €20 of its profit before tax is attributable to the permanent establishment and pays €5 of tax in jurisdiction B on this basis. Under the rule, €20 of profit before tax would be allocated to jurisdiction B.



¹⁷⁵ This sentence has been amended to reflect a comment made by Canada.

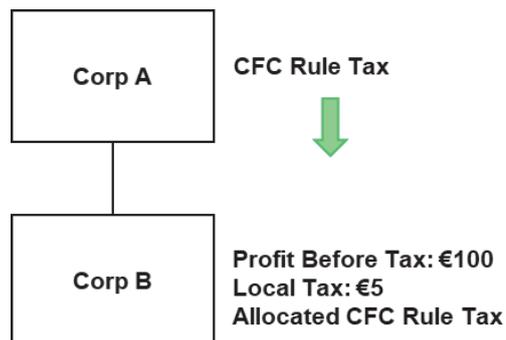
Example 3.6.2B. Jurisdictional blending: assignment of withholding taxes

1. Corp A (resident in jurisdiction A) owns Corp B (resident in jurisdiction B) and Corp C (resident in jurisdiction C). In Year 1, Corp B makes a €100 royalty payment to Corp A. Jurisdiction B applies a 10% withholding tax to the payment. Also in Year 1, Corp C earns €100 of profit before tax and pays €20 of tax in jurisdiction C and pays a dividend to Corp A.¹⁷⁶ Under the laws of jurisdiction A, Corp A includes the intra-group dividend in its taxable income, and after taking into account a foreign tax credit for the tax paid in jurisdiction C, Corp A pays €5 of residual tax in jurisdiction A related to the intra-group dividend.
2. Each constituent entity's income is assigned to its tax jurisdiction of residence. The €10 of withholding tax paid to jurisdiction B on the royalty received from Corp B is assigned to jurisdiction A because it is tax paid in respect of income assigned to jurisdiction A. The €5 of tax paid in jurisdiction A with respect to the dividend from Corp C is assigned to jurisdiction C because it is paid in respect of income that was assigned to jurisdiction C.

¹⁷⁶ This sentence has been amended to reflect a comment made by Canada.

Example 3.6.2C. Jurisdictional blending: CFC rule – assignment of taxes

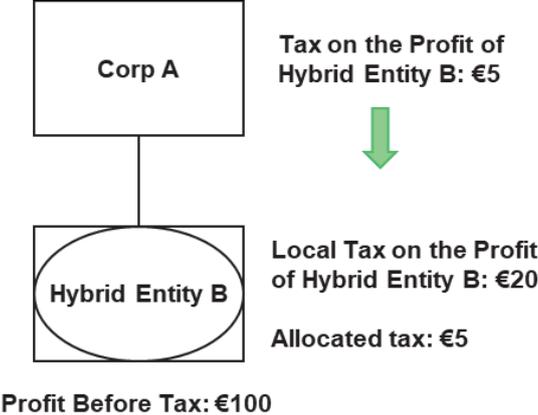
1. Corp A (resident in jurisdiction A) wholly owns Corp B (resident in jurisdiction B). Corp B earns €100 of profit before tax and pays €5 of tax in jurisdiction B. Under the CFC rules of jurisdiction A, Corp A includes €100 of income of Corp B computed pursuant to the jurisdiction A CFC rules in its taxable income, with a foreign tax credit for taxes paid in jurisdiction B.¹⁷⁷ Assume the result is that residual CFC rule tax is paid in jurisdiction A. The CFC regime tax paid in jurisdiction A is assigned to jurisdiction B, which results in the taxes being assigned to the same jurisdiction as the underlying income. If the ETR of the CFC regime taxes exceeds the minimum tax rate, the income subject to the CFC rule and the taxes on that income are excluded from the jurisdiction B ETR computation.



¹⁷⁷ This sentence has been amended to reflect a comment made by Canada.

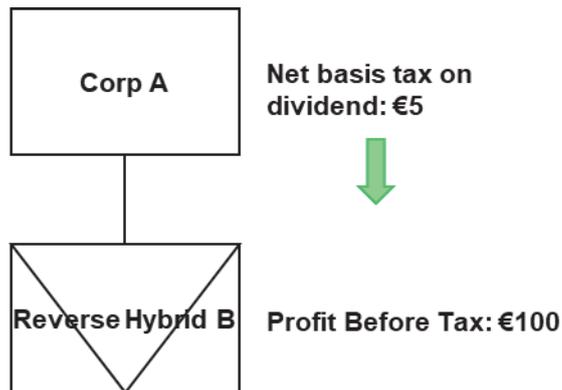
Example 3.6.2D. Jurisdictional blending: Hybrid entity – assignment of taxes

1. Corp A (resident in jurisdiction A) wholly owns Hybrid Entity B (resident in jurisdiction B). Hybrid Entity B is a corporation that is tax resident in jurisdiction B, but is tax transparent for purposes of jurisdiction A. Hybrid Entity B earns €100 of profit before tax and pays €20 of tax in jurisdiction B. Jurisdiction A does not exempt Corp A’s share of the income of Hybrid Entity B and therefore Corp A includes the income of Hybrid Entity B in its taxable income, which is taxed in jurisdiction A less a foreign tax credit for taxes paid in jurisdiction B. Assume the result is that Corp A pays €5 of residual tax in jurisdiction A. Hybrid Entity B’s income is assigned to its tax jurisdiction of residence, jurisdiction B. The €5 of tax paid in jurisdiction A with respect to the income of Hybrid Entity B is assigned to jurisdiction B.



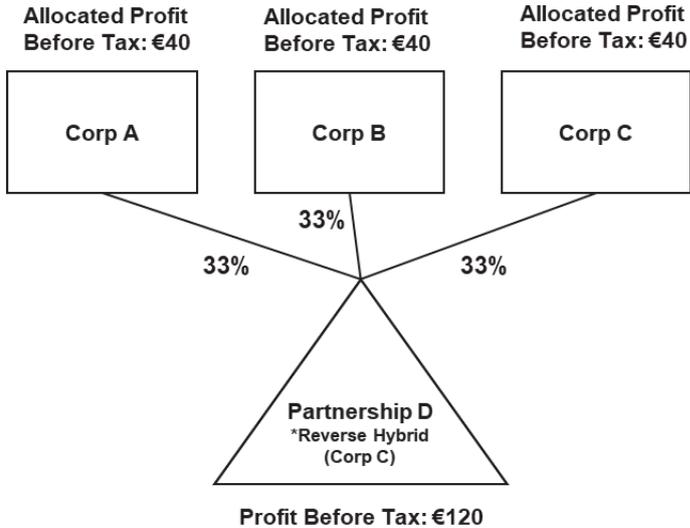
Example 3.6.2E. Jurisdictional blending: Reverse-hybrid entity – assignment of taxes

1. Corp A (resident in jurisdiction A) wholly owns Reverse-Hybrid B (organised in jurisdiction B). Reverse-Hybrid B is treated as tax transparent for purposes of jurisdiction B and has no jurisdiction of tax residence. However, Reverse-Hybrid B is not tax transparent for purposes of jurisdiction A. Reverse-Hybrid B earns €100 of profit before tax in Year 1. Jurisdiction A imposes €5 of net basis tax on a €100 dividend paid from Reverse-Hybrid B to Corp A in Year 1. Jurisdiction B imposes no tax on the income of Reverse-Hybrid B or the distribution to Corp A. Reverse-Hybrid B's income is assigned to stateless because it has no jurisdiction of tax residence and its owner's tax jurisdiction does not treat the entity as tax transparent. The €5 of tax paid in jurisdiction A related to the underlying income earned by Reverse-Hybrid B is assigned to stateless.



Example 3.6.2F. Jurisdictional blending: Partially tax transparent & partially hybrid entity– assignment of income

1. Corp A (resident in jurisdiction A), Corp B (resident in jurisdiction B), and Corp C (resident in jurisdiction C), are constituent entities of MNE Group ABC and own equal shares of an entity, Partnership D, which regularly conducts business operations in jurisdiction D. Partnership D is treated as a tax transparent entity by jurisdictions A, B, and D. Corp A and Corp B do not have a permanent establishment in jurisdiction D as a result of their ownership of Partnership D or otherwise and are subject to tax in their respective jurisdictions on their share of Partnership D’s income. Jurisdiction C does not treat Partnership D as tax transparent and Corp C does not have a permanent establishment in jurisdiction D. Partnership D earns €120 of profit in Year 1 and is not subject to tax in jurisdiction D. Partnership D is a stateless entity because it has no tax jurisdiction of residence. However, Partnership D’s income is allocated to some of its owners in accordance with the partnership agreement because Corp A’s and Corp B’s tax jurisdiction treats Partnership D as a tax transparent entity. Accordingly, Corp A and Corp B are each allocated €40 of profit before tax. The remainder of Partnership D’s income – Corp C’s €40 share – is allocated to the stateless jurisdiction. Corp A and Corp B are subject to tax in Year 1 in their tax jurisdiction of residence on their allocable share of the partnership income. The tax paid by each partner on its share of the partnership income is assigned to that partner’s tax jurisdiction of residence. Corp C is not subject to tax on its allocable share of the partnership income in Year 1. Therefore, no covered taxes are assigned to Jurisdiction D in Year 1.



Example 3.7.2A. Local tax carry-forward

1. The following example illustrates the application of the local tax carry-forward rule where there was no IIR tax paid by the shareholder in a previous period. Assume that MNE-1 owns Subsidiary A, which is subject to tax in Jurisdiction A, and that the minimum tax rate is 10%. Subsidiary A's GloBE tax base is 1,000 in each of Year 1, Year 2, and Year 3. Subsidiary A pays 140 of tax in Year 1, 80 of tax in Year 2, and 50 of tax in Year 3. MNE-1 has never paid IIR tax in respect of Jurisdiction A.

Subsidiary A	Year 1	Year 2	Year 3
Income	1,000	1,000	1,000
Minimum tax (10%)	100	100	100
Local tax paid (Jurisdiction A)	140	80	50
Excess taxes	40	0	0
Local tax carry-forward used	0	20	20
Local tax carry forward remaining	40	20	0
GloBE Tax (top up to 10%)	0	0	30

2. As shown above, Subsidiary A paid excess taxes of 40 in Year 1, and MNE-1 creates a Year 1 local tax carry-forward in that amount. In Year 2, Subsidiary A paid less than the minimum tax on its GloBE tax base and used 20 of the local tax carry-forward to increase the tax expense in Jurisdiction A to the minimum rate. MNE-1 reduced its Year 1 local tax carry-forward by the amount used in Year 2. In Year 3, Subsidiary A increased its tax expense in Jurisdiction A by the remaining balance of the Year 1 local tax carry-forward to 70. However, even after adding the carry-forward to the Year 3 tax paid, the ETR computed for Subsidiary A's GloBE tax base is below the minimum tax rate ($70 \text{ tax} / 1,000 \text{ GloBE tax base} = 7\% \text{ ETR}$). Therefore, MNE-1 is subject to 30 of top-up tax ($100 \text{ minimum tax} - 70 \text{ tax expense}$) in respect of Jurisdiction A in Year 3.

Example 3.7.2B. IIR tax credit

1. The following example illustrates the application of the IIR tax credit and the ordering rule. Assume that MNE-2 owns one subsidiary, Subsidiary A, in Jurisdiction A, and the agreed minimum tax rate is 10%. At the beginning of Year 4, MNE-2 had paid 100 of IIR tax in Year 2 and IIR tax of 20 in Year 3 in respect of Jurisdiction A. Prior to Year 4, Subsidiary A had never had excess taxes. In Year 4, Subsidiary A had 1,000 of income and paid 275 of tax in Jurisdiction A. In Year 5, Subsidiary A had 1,000 of income and paid 60 of tax in Jurisdiction A.

Subsidiary A	Year 2	Year 3	Year 4	Year 5
Income	1,000	1,000	1,000	1,000
Local tax paid (Jurisdiction A)	0	80	275	60
Minimum tax (10%)	100	100	100	100
IIR Tax (top up to 10%)	100	20	0	40
IIR tax credit used	0	0	0	40
Excess taxes (local tax – min tax)	0	0	175	0
Local tax carry forward (excess tax – IIR tax credit created for year)	0	0	55	55
IIR tax paid (aggregate)	100	120	0	0
IIR tax credit (aggregate)	0	0	120	80

2. As shown above, Subsidiary A paid 175 of taxes in excess of the minimum tax rate in Year 4. The excess taxes create IIR tax credits in respect of IIR taxes paid in years 2 and 3. The remaining 55 of excess taxes paid create a local tax carry-forward.

3. In Year 5, Subsidiary A has an ETR of 6% (i.e. below the minimum rate) and owed 40 of top-up tax. However, MNE-2 has an IIR tax credit of 120. MNE-2 uses 40 of that credit to pay the IIR top-up tax liability and reduces its Year 2 IIR tax credit by 40. At the beginning of Year 6, MNE-2's IIR tax credit is 80, and its Year 4 Jurisdiction A local tax carry-forward is 55.

Example 3.7.2C. Application of IIR tax credit to IIR tax arising in respect of a different jurisdiction

1. The following example illustrates how the IIR tax credit can be applied in respect of an IIR tax liability that arises in respect of a low-tax outcome in another jurisdiction. Assume that Parent is a corporation organized and subject to tax in Country A, which has adopted the GloBE proposal and the agreed minimum tax rate is 10%. Parent owns Subsidiary B in Country B and Subsidiary C in Country C. In Year 1, Subsidiary B earns 1,000 of income and pays no tax in Country B, and Subsidiary C earns 1,000 of income and pays 100 of tax in Country C. In Year 2, Subsidiary B earns 400 of income and pays 100 of tax in Country B, and Subsidiary C earns 1,000 of income and pays 20 of tax in Country C.

	Subsidiary B			Subsidiary C		
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Income	1,000	400	1,000	1,000	1,000	1,000
Local tax paid	0	100	100	100	20	100
Minimum tax (10%)	100	40	100	100	100	100
IIR Tax (top up to 10%)	100	0	0	0	80	0
IIR tax credit used	0	0	0	0	60	0
IIR Tax Paid	100	0	0	0	20	0
Excess taxes (local tax – min tax)	0	60	0	0	0	0
Local tax carry-forward (excess tax – IIR tax credit created for year)	0	0	0	0	0	0
IIR tax paid (aggregate)	100	40	40	0	20	20
IIR tax credit	0	60	0	0	0	0

2. As shown above, Parent pays 100 of tax to Country A under the income inclusion rule in respect of income of Subsidiary B for Year 1 because the tax paid in Country B on Subsidiary B's income was below the minimum tax rate. In Year 2, Subsidiary B pays 60 of tax in Country B in excess of the minimum tax on income earned in Country B. Also in Year 2, Parent incurs 80 of income inclusion rule tax liability in respect of income earned by Subsidiary C that was subject to tax below the minimum rate.

3. At the end of Year 2, Parent creates an IIR tax credit of 60 as a result of the excess taxes paid in Year 2. Parent is eligible to use the IIR tax credit of 60 against its Country A IIR tax liability arising in respect of Country C in the same year. (The 60 IIR tax credit arising in Country B in Year 2 and used in Country C in Year 2 is highlighted in bold in the chart above.) After using the credit, Parent pays 20 of IIR tax with respect to Country C in Year 2. At the beginning of Year 3, Parent has 40 of IIR tax paid in Year 1 in respect of Country B and 20 of IIR tax paid in Year 2 in respect of Country C that has not given rise to an IIR tax credit.

Example 3.7.4A. Distribution taxes modification with recapture.

1. The following example illustrates the methodology for addressing distribution taxes. X Corporation earns 100 of income in Year 1, 150 of income in Year 2, and 200 of income in Year 3. X distributes 100 50 of income in Year 3. Assume that the distribution tax rate in X's jurisdiction is 20%, the minimum tax rate is 12%, and the specified period for payment of distribution tax liability is two years. In Year 1, X accrues 12 of tax for GloBE purposes, which is the minimum tax on 100 of income. Accordingly, X's ETR for Year 1 is 12% and X's income is not subject to a top-up tax under the GloBE proposal. Similarly, in Year 2, X accrues 18 of tax for GloBE purposes on 150 of income and incurs no top-up tax liability. In Year 3, X accrues 24 of tax for GloBE purposes on 200 of income and X paid 10 of distribution tax in Year 3. As demonstrated in the table below, the 10 of distribution tax paid by X in Year 3 reduces the Year 1 outstanding balance of accrued minimum tax from 12 to 2. The 2 remaining balance of accrued minimum tax from Year 1 is treated as a reduction to the tax expense in the numerator of the ETR fraction in Year 3. Thus, X's ETR for Year 3 is 11% ($[(24 \text{ accrued minimum tax} - 2 \text{ recapture of accrued minimum tax}) / 200 \text{ GloBE tax base}]$). X's GloBE tax liability for Year 3 is 2 ($[200 \text{ GloBE tax base} \times 12\%] - 22 \text{ tax expense}$), which equals the recaptured accrued minimum tax.

	Year 1	Year 2	Year 3
Income	100	150	200
Minimum Tax (12% tax rate)	12	18	24
Distribution tax paid	0	0	10
Distribution tax paid in excess of accrued tax outstanding balance (A)	0	0	0
Accrued tax for GloBE purposes (B)	12	18	24
Recapture of accrued tax in preceding tax year (C)	0	0	(2)
Total tax expense for ETR computation purposes (A + B - C)	12	18	22
Top-up tax (Min tax - Total tax expense for ETR computation purposes)	0	0	2

Example 3.7.4B. Distribution taxes modification with excess taxes paid.

1. Assume the same facts as in Example 3.7.4A, except that X distributed 200 in Year 3. The distribution tax of 40 (200 x 20%) would have eliminated the outstanding balances of accrued minimum tax for Year 1 (12) and Year 2 (18), and the excess (10) would have been included in the tax expense and numerator of the ETR fraction in Year 3. The minimum tax liability on 200 of income in Year 3 would be 24. As demonstrated in the table below, X would accrue 14 of minimum tax that when added to the 10 of excess distribution tax paid in Year 3 would produce an ETR equal to the 12% minimum tax rate on 200 of income and no top-up tax liability.

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Income	100	150	200
Minimum Tax (12% tax rate)	12	18	24
Distribution tax paid	0	0	40
Distribution tax paid in excess of accrued tax outstanding balance (A)	0	0	10
Accrued tax for GloBE purposes (B)	12	18	14
Recapture of accrued tax in preceding tax year (C)	0	0	0
Total tax expense for ETR computation purposes (A + B – C)	12	18	24
Top-up tax (Min tax – Total tax expense for ETR computation purposes)	0	0	0

Example 3.7.5A. Post-filing decrease in local tax liability.

1. The following example illustrates the application of the carry-forward adjustment approach to the treatment of post-filing decreases in local tax liability. Assume that MNE1 is subject to an income inclusion rule in its jurisdiction of tax residence and owns a single entity, X Corp, that is tax resident in Jurisdiction X and that Local Tax Carry-forwards are allowed to be used to reduce the tax liability of the succeeding 10 years from the year in which they were created. X Corp's covered taxes in Jurisdiction X exceeded the minimum tax on its income by 100 in Year 1 and 80 in Year 2. Accordingly, X Corp established a Local Tax Carry-forward of 100 for Year 1 and 80 for Year 2. In Year 3, X Corp initiated a refund claim with respect to 100 of tax paid to Jurisdiction X in Year 1. In Year 4, X Corp initiated a refund claim with respect to 30 of tax paid to Jurisdiction X in Year 2. In Year 6, X Corp and Jurisdiction X settled the Year 1 refund claim with a refund of 60 and Jurisdiction X refunded 30 with respect to the Year 2 refund claim. The refunds in Year 6 were a final determination of X Corp's refund claims in respect of Year 1 and Year 2. Prior to Year 6, X Corp had used 10 of its Local Tax Carry-forward from Year 1 in the computation of the Jurisdiction X ETR for a taxable year. The post-filing tax decreases in Jurisdiction X liability reduce X Corporation's Local Tax Carry-forwards for Year 1 and Year 2 by 60 and 30, respectively, as of the beginning of Year 6. Thus, beginning with the Year 6 ETR computation for Jurisdiction X, X Corp has 30 of Local Tax Carry-forward from Year 1 and 50 of Local Tax Carry-forward from Year 2 to increase the covered tax expense in the numerator of the ETR fraction to achieve a minimum tax rate in Jurisdiction X.

Example 3.7.5B. Post-filing increase in local tax liability.

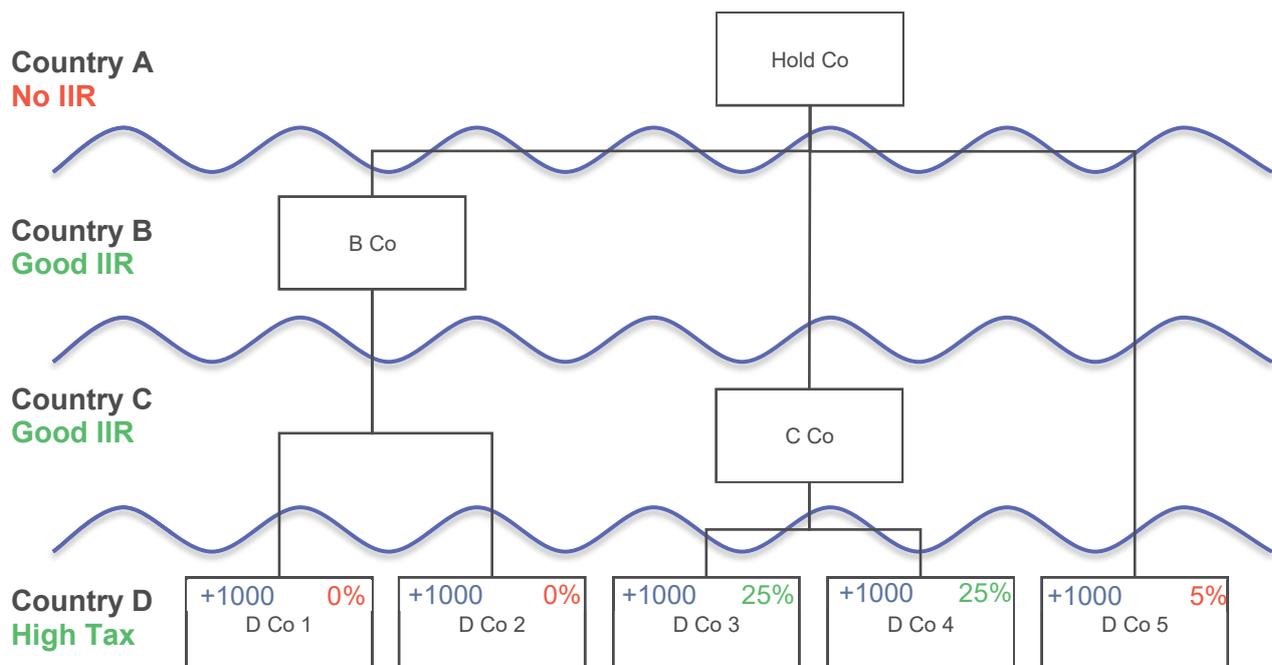
1. The following example illustrates the application of the carry-forward adjustment approach to the treatment of post-filing decreases in local tax liability. Assume that MNE2 is subject to an income inclusion rule in its jurisdiction of tax residence and owns a single entity, Y Corp, that is tax resident in Jurisdiction Y. In Year 1, MNE2 paid 80 IIR tax in respect of Jurisdiction Y. In Year 3, Jurisdiction Y asserted additional liability of 30 in respect of Year 1 and in Year 5, a Jurisdiction Y court determined, with finality, that Y Corp was liable for the additional 100 tax in respect of Year 1. MNE2 did not pay IIR tax in respect of Jurisdiction Y, and Y Corp did not pay excess tax in Jurisdiction Y, for any year subsequent to Year 1. As of the beginning of Year 5, Y Corp first creates an IIR tax credit of 80 and then a Local Tax Carry-forward of 20 with respect to Year 1.

Chapter 4 - Examples

Chapter 4.2

Example 4.2.1A.

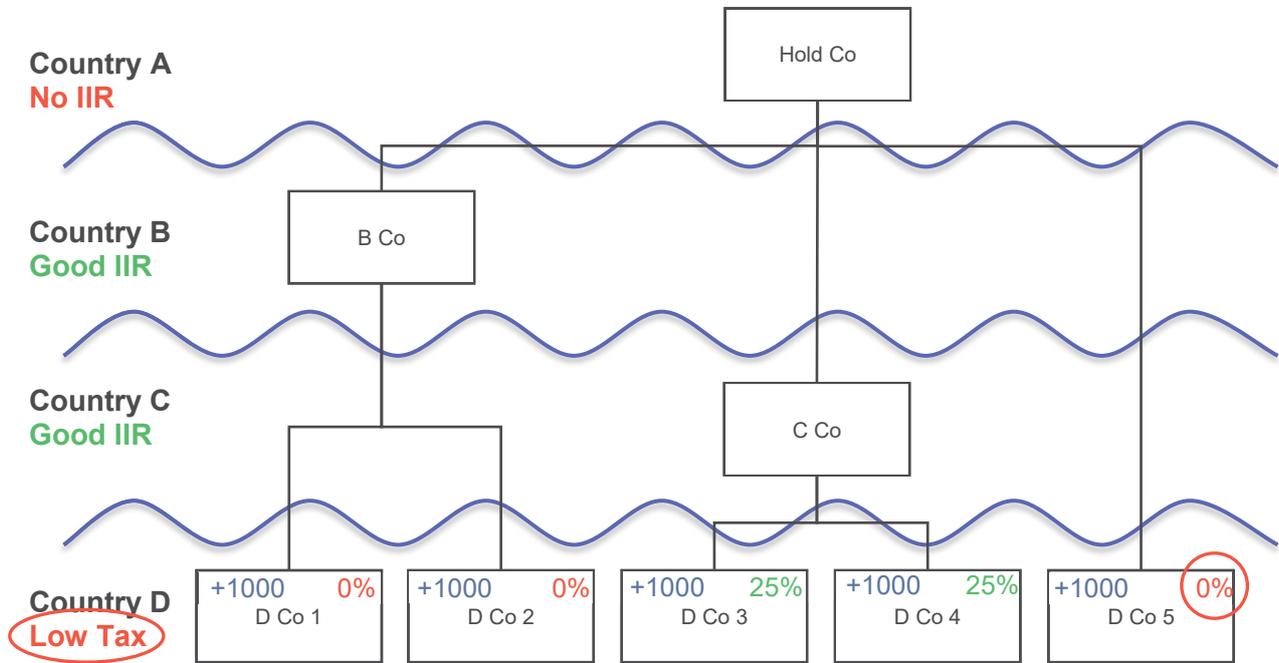
1. The MNE Group consists of eight constituent entities located in jurisdictions A, B, C and D. Hold Co is a tax resident of Country A and is the Ultimate Parent Entity of an MNE Group subject to the GloBE rules. Hold Co owns directly the shares of B Co (tax resident in Country B), C Co (tax resident in Country C) and D Co 5 (tax resident in Country D). D Co 5 is subject to a tax rate of 5%.
2. B Co owns the shares of D Co 1 and D Co 2 (tax residents in Country D) that are subject to a tax rate of 0%.
3. C Co owns the shares of D Co 3 and D Co 4 (tax residents in Country D) that are subject to a tax rate of 25%.
4. Country B and Country C have adopted an income inclusion rule in accordance with Chapters 4, 5, and 6 of this document. Assume that the minimum rate is 11%.



5. Country D is not a low-tax jurisdiction because the Constituent Entities located therein are subject to tax at or above the minimum rate in accordance with rules in Chapter 4. Therefore, no entity within the MNE Group is required to apply the GloBE rules to the income earned through the Constituent Entities located in Country D.

Example 4.2.1B.

1. The facts are the same as Example 4.1.1A, except that income of D Co 5 is exempt from tax in Country D.



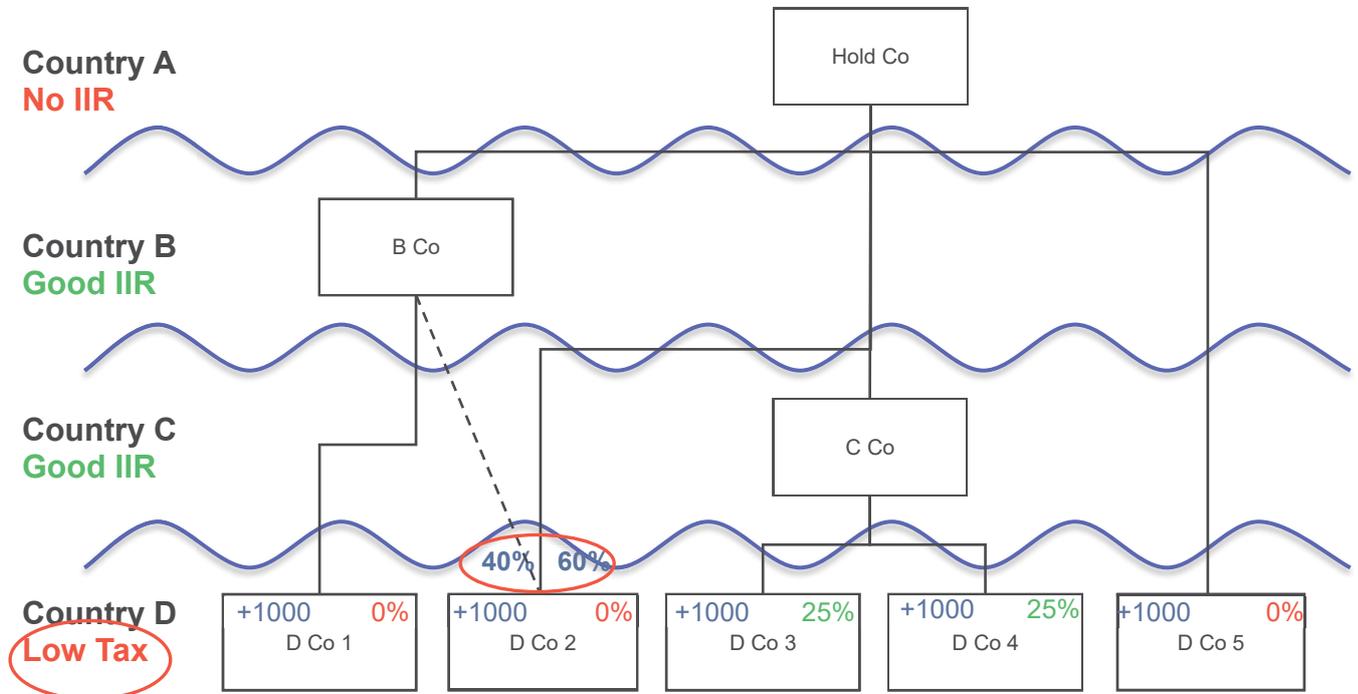
2. Country D is a low tax jurisdiction because the ETR on the income of Constituent Entities located therein ($500/5,000 = 10\%$) is below the minimum rate of 11%. Accordingly, B Co and C Co are Parents because they own equity interests in Constituent Entities located in a low-tax jurisdiction and they are not controlled by another Constituent Entity that is subject to an income inclusion rule. The top-up tax percentage is 1% ($11\% \text{ minimum ETR} - 10\% \text{ ETR}$). Therefore, the top-up tax allocated in respect of each Constituent Entity located in Country D is 10 ($1,000 \text{ adjusted income} \times 1\%$), for a total of 50.

3. Under the top-down approach, B Co and C Co are Parents required to apply the income inclusion rule and pay the top-up tax in respect of low-tax Constituent Entities that they own. B Co and C Co are required to pay 20 each. In both cases, the Parent determines its share of the top-up tax by multiplying the top-up tax computed for each Constituent Entity by its ownership percentage of the entity ($100\% \times 10$).

4. D Co 5 is not controlled by a Parent. Therefore, the 10 of top-up tax computed in respect of D Co 5 is allocated to other Constituent Entities pursuant to the undertaxed payments rule.

Example 4.2.2A.

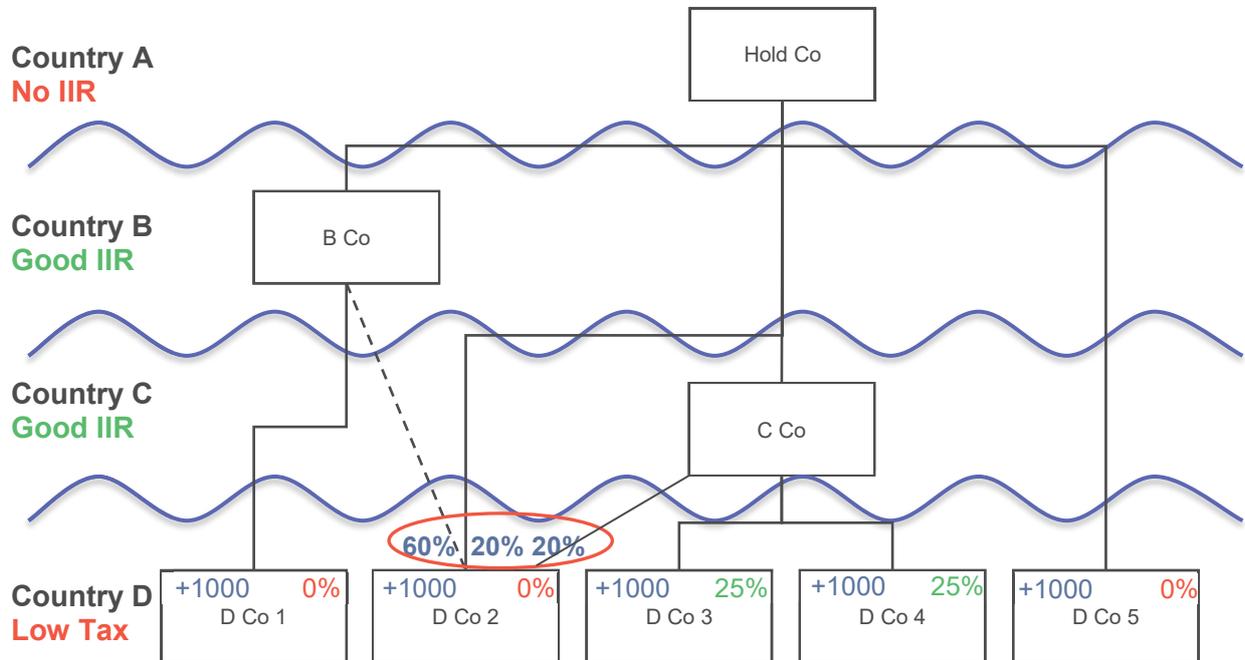
1. The facts are the same as Example 4.2.1B, except that shares of D Co 2 are owned by Hold Co (60%) and B Co (40%).



2. Country D is a low tax jurisdiction because the Constituent Entities located in such jurisdiction are subject to an effective tax rate test of 10%, which is below the minimum rate of 11%. The top-up tax percentage is 1% and the top-up tax computed under the rules of Chapter 4 for each Constituent Entity in Country D is 10 (1,000 adjusted income x 1%).
3. Under the top-down approach, B Co is required to apply the income inclusion rule with respect to D Co 2 even if it owns only 40% of its shares. B Co's top-up tax liability is determined based on its ownership percentage. Therefore, B Co is required to pay 14. 10 with respect to the income of D Co 1 (100% x 10) and 4 with respect to the income of D Co 2 (40% x 10). As in Example 2, C Co is required to pay \$20 with respect to income of D Co 3 and D Co 4.
4. D Co 5 is not controlled by a Parent. Therefore, the 10 of top-up tax computed in respect of D Co 5 is allocated to other Constituent Entities pursuant to the undertaxed payments rule. In addition, the 10 top-up tax computed in respect of D Co 2 with a 4 credit for top-up tax allocated under the income inclusion rule is allocable to other Constituent Entities pursuant to the undertaxed payments rule.

Example 4.2.2B.

1. The facts are the same as Example 4.2.2.A, except that shares of D Co 2 are owned by Hold Co (20%), B Co (60%), and C Co (20%).

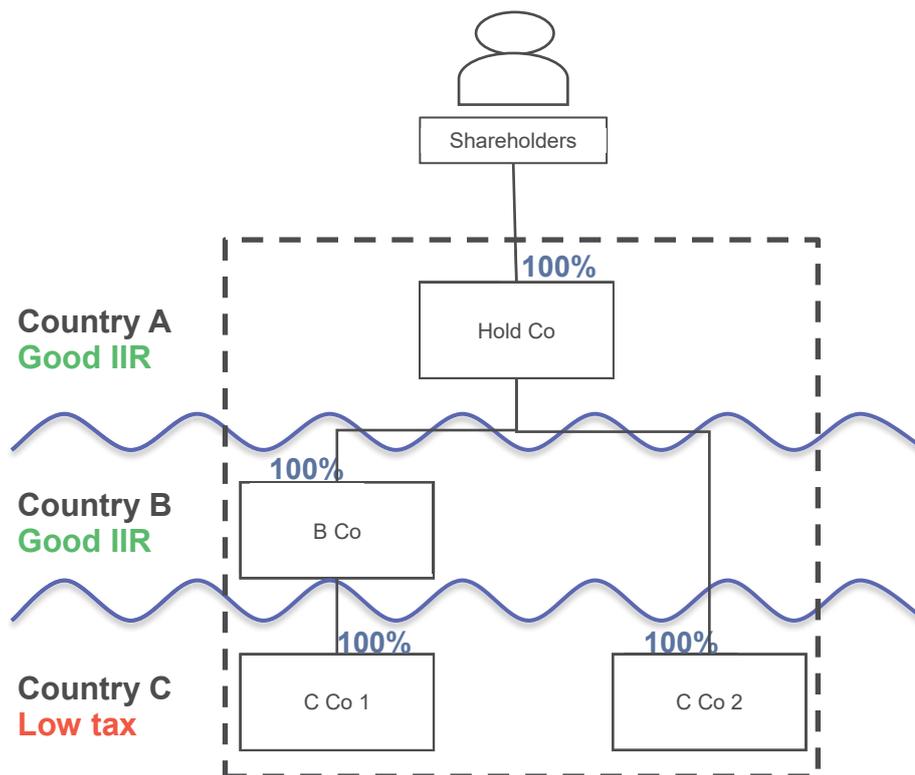


2. Country D is a low tax jurisdiction because the Constituent Entities located in such jurisdiction are subject to an effective tax rate test of 10%, which is below the minimum rate of 11%. The top-up tax percentage is 1% and the top-up tax computed under the rules of Chapter 4 for each Constituent Entity in Country D is 10 (1000 income x 1%).

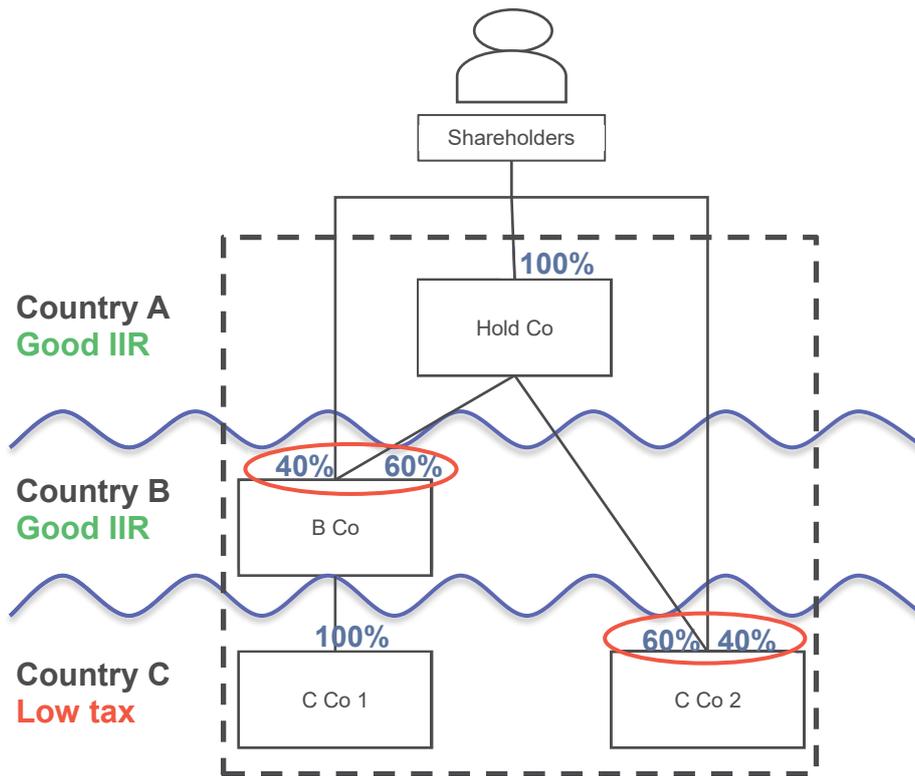
3. Under the top-down approach, B Co and C Co are required to apply the income inclusion rule with respect to D Co 2. B Co's and C Co's respective top-up tax liabilities are initially computed based on their proportionate interest in D Co 2's income. B Co is initially allocated 6 of top-up tax (60% x 10) and C Co is initially allocated 2 of top-up tax (20% x 10). The remaining 20% of the top-up tax (2) would be allocated to Hold Co if it were a Parent. B Co, as a Parent that controls the low taxed Constituent Entity, must increase its top-up tax liability by the top-up tax that would be allocable to Hold Co. Accordingly, B Co is allocated 2 of additional top-up tax.

Example 4.2.3A.

1. The example illustrates a tax avoidance scheme aimed to avoid the GloBE rules in case there were no rules on split-ownership (Section 4.2.3).
2. Hold Co is the Ultimate Parent of a family owned MNE Group subject to the GloBE rules. Hold Co owns all the shares of B Co, an entity located in Country B. B Co holds all the shares of C Co 1, an entity located in Country C. Hold Co also holds all the shares of C Co 2, an entity located in Country C.
3. The ETR of C Co 1 and C Co 2 is below the minimum rate. Therefore, Hold Co would be required to apply the income inclusion rule with respect to 100% of the income of C Co 1 and C Co 2.



4. To avoid the GloBE rules, Hold Co spins-off 40% of its shares of B Co and C Co 2 to its own shareholders. If the ETR test and tax liability under the GloBE rules was based only in the Ultimate Parent's ownership percentage of C Co 1 and C Co 2, then this reorganization would cut GloBE tax liability by 40%.



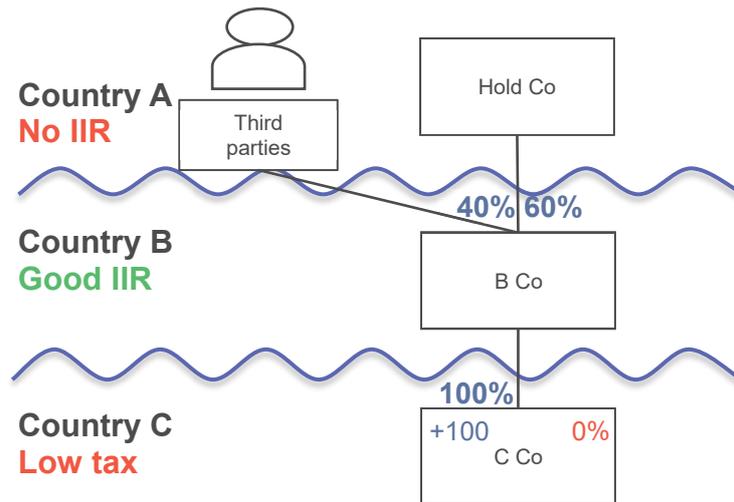
Split-ownership rules

5. The split-ownership rules under Section 4.2.3, require B Co to apply the income inclusion rule on 100% of the income of C Co 1. Therefore, the reorganization would not have an effect on the top-up tax paid under the GloBE rules with respect to the income of C Co 1.

6. However, these rules do not cover 40% of the income of C Co 2 because it is an entity subject to low taxation and the entity that is partially owned. This result would not change even if there was an intermediate entity between Hold Co and C Co 2.

Example 4.2.3B.

1. Hold Co is the Ultimate Parent Entity of an MNE Group subject to the GloBE rules. Hold Co is a tax resident of Country A, a jurisdiction that has not adopted the income inclusion rule. It owns 60% of the shares of B Co, a Constituent Entity of the group located in Country B that has adopted the GloBE rules. The remaining 40% of the shares of B Co are owned by minority shareholders that are not Constituent Entities of the MNE Group. B Co owns 100% of the shares of C Co, a Constituent Entity located in Country C. C Co has an effective tax rate of 0%. In this example, the minimum tax rate is 11%.



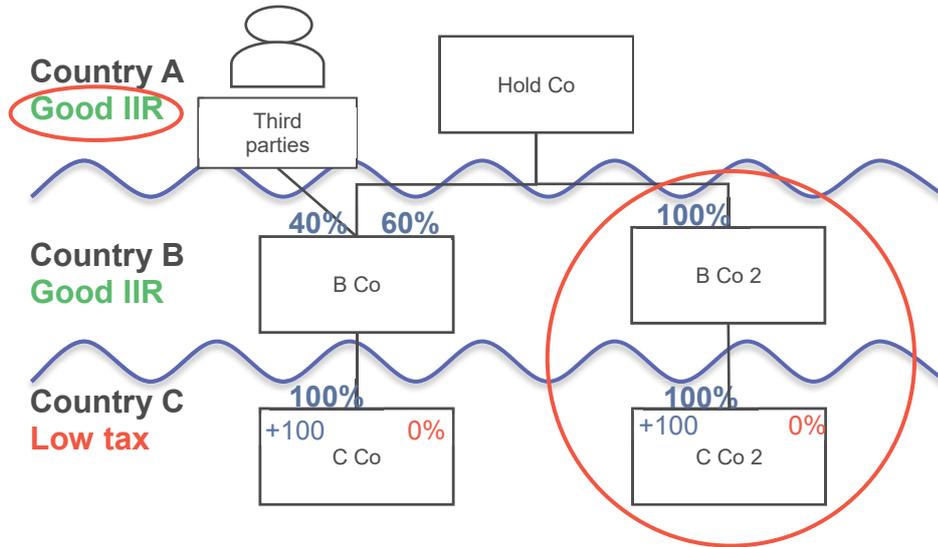
2. The top-up tax percentage computed for Country C is 11% (11% minimum rate – 0% ETR). If the top-up tax under the GloBE rules was based on Hold Co's ownership percentage of C Co, then Hold Co would be required to pay 6.6 of top-up tax ($100 \times 60\% \times 11\%$). However, Hold Co is located in a jurisdiction that has not adopted the GloBE rules. Therefore, under the top-down approach, B Co is required to apply the income inclusion rule. If B Co were required to pay 6.6, then Hold Co would be effectively paying 3.96. The tax cost of the remaining 2.64 would be borne by the minority shareholders.

Adopted approach

3. Under the adopted approach, however, the top-up tax percentage computed for Country C is 11% (11% minimum rate – 0% ETR). Accordingly, the top-up tax computed for C Co is 11 [(100 (income) \times 11% (top-up tax percentage))]. B Co computes its share of the top-up tax of C Co based on its ownership percentage of C Co, 100%, and pays 11 of top-up tax. Consequently, Hold Co effectively pays 6.6, while the remaining 4.4 of the tax cost is borne by the minority shareholders of B Co.

Example 4.2.3C.

1. The facts are the same as Example 4.2.3B, except that Country A has adopted an income inclusion rule and Hold Co also owns 100% of the shares of B Co 2 (located in Country B), an entity that holds 100% of the shares of C Co 2 (located in Country C). The income of C Co 2 is subject to an effective tax rate of 0%.



2. The ETR of Country C is of 0%, and therefore, the top-up tax percentage is 11% [11% (minimum tax rate) – 0% (ETR)]. The top-up tax computed for C Co and C Co 2 is 11 each [(100 (income) x 11% (top-up tax percentage)].

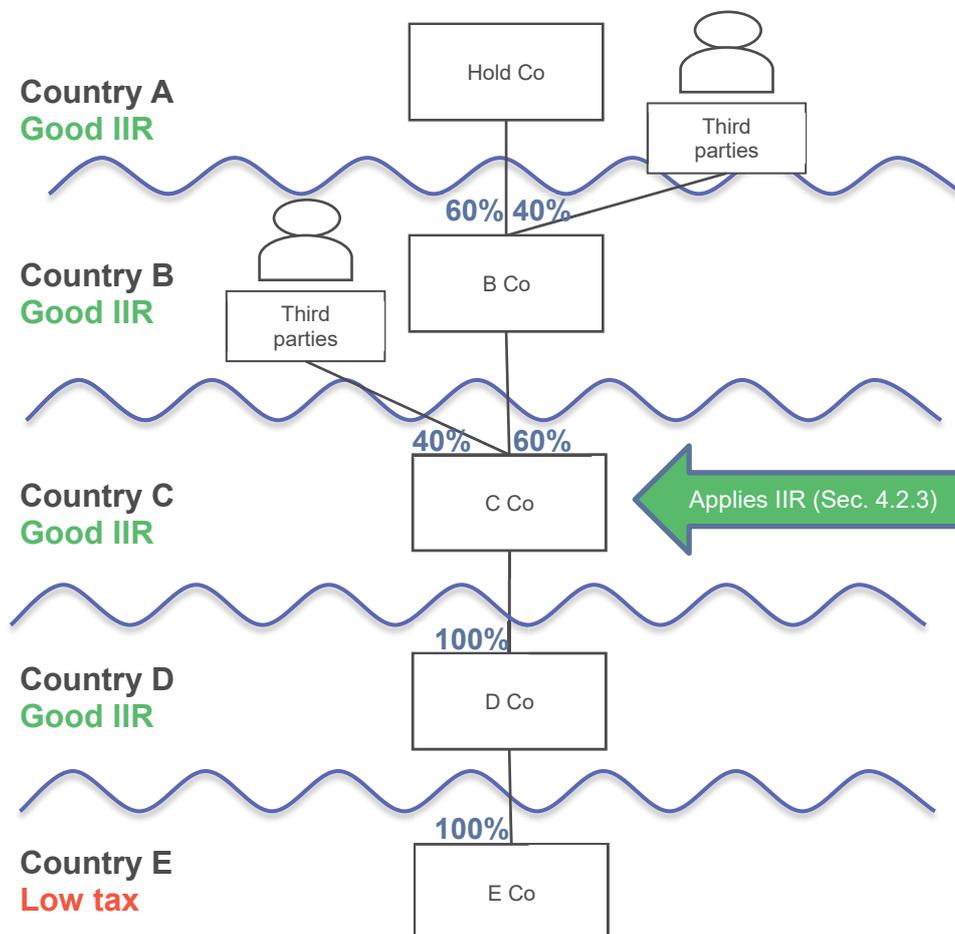
3. Under the top-down approach in Section 5.2.3, Hold Co is required to apply the income inclusion rule. However, B Co is also required to apply the income inclusion rule with respect to the income of C Co in accordance with the split-ownership rules in Section 5.2.3 because it is a partially owned intermediate parent.

4. B Co is required to pay 11 (100% x 11), which is the same result as in Example 5.2.3B.

5. Hold Co is also required to apply the income inclusion rule. To avoid double taxation, Hold Co computes its top-up tax only with respect to its share of C Co 2's income and pays a tax of 11 (100% x 11). If there were no split ownership rules, Hold Co's tentative top-up tax for Country C Constituent Entities would be 17.6 [(60% x 11) + (100% x 11)] rather than the total of 22 top-up tax paid by the MNE Group (11 paid by B Co + 11 paid by Hold Co).

Example 4.2.3D.

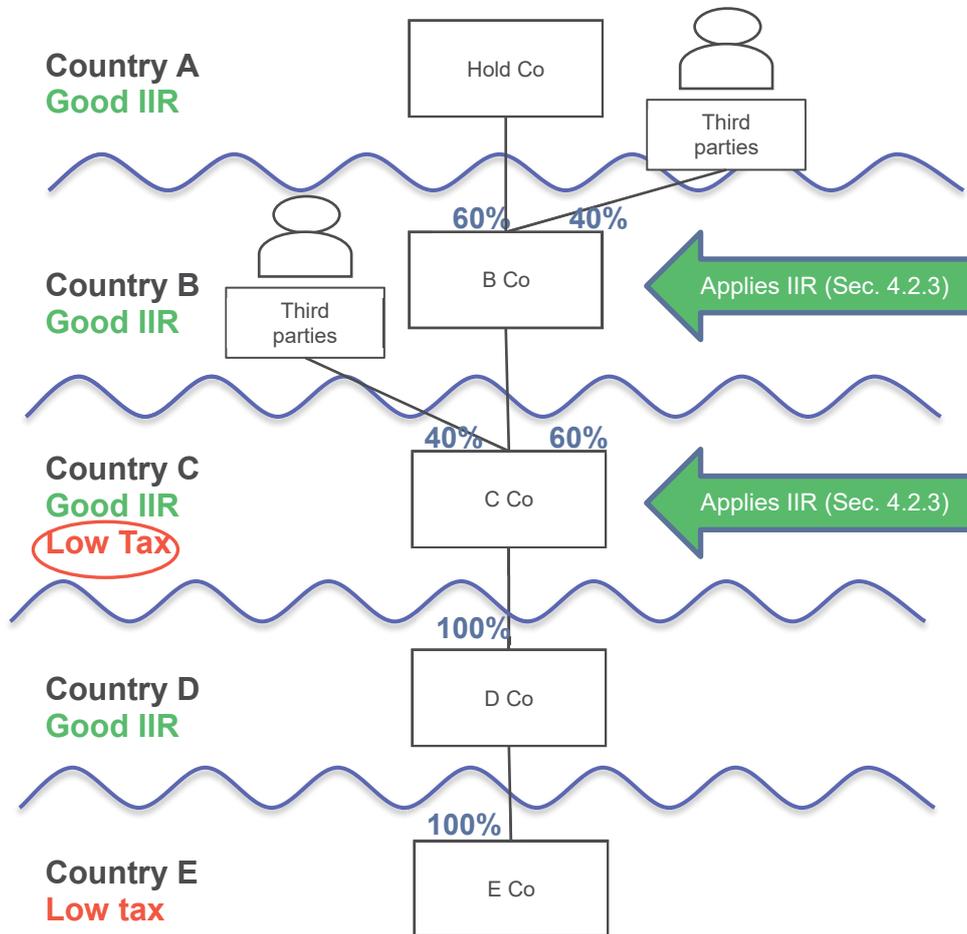
1. In this example, Hold Co is the Ultimate Parent Entity of an MNE Group subject to the GloBE rules. Hold Co is located in Country A. Hold Co holds 60% of the shares of B Co, an entity located in Country B. The remaining 40% of the shares of B Co are held by minority shareholders that are not Constituent Entities of the MNE Group. B Co holds 60% of the shares of C Co, an entity also located in Country C. The remaining 40% of the shares of C Co are held by minority shareholders that are not Constituent Entities of the MNE Group. C Co owns 100% of the shares of D Co, an entity located in Country D. D Co holds 100% of the shares of E Co, an entity located in Country E and whose income is subject to an ETR below the minimum rate. The income of all other Constituent Entities is subject to tax above the minimum rate. The GloBE rules have been adopted by Countries A, B, C and D.



2. C Co is required to apply the income inclusion rule under the split-ownership rules (Section 5.2.3). Hold Co and B Co are not required to apply the income inclusion rule with respect to the income of E Co.

Example 4.2.3E.

1. The facts are the same as in Example 4.2.3D, except that the income of C Co is also subject to an effective tax rate below the minimum rate.

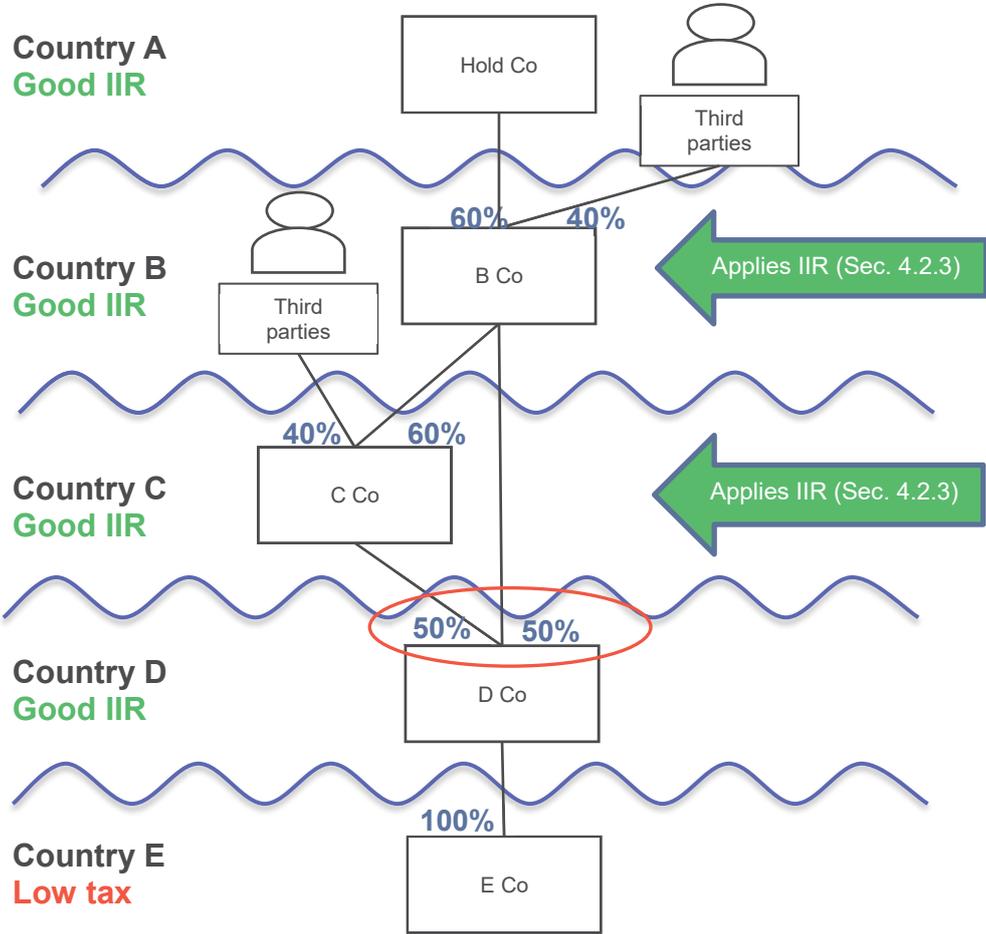


2. In this situation, C Co effectively applies the income inclusion rule with respect to the income of E Co based on the same analysis set out in Example 4.2.3D.

3. B Co is required to apply the income inclusion rule with respect to the income of C Co because it is a Partially Owned Intermediate Parent holding shares of a low-taxed entity. Hold Co has to exclude from its income inclusion rule the income of C Co that was already subject to the income inclusion rule of B Co.

Example 4.2.3F.

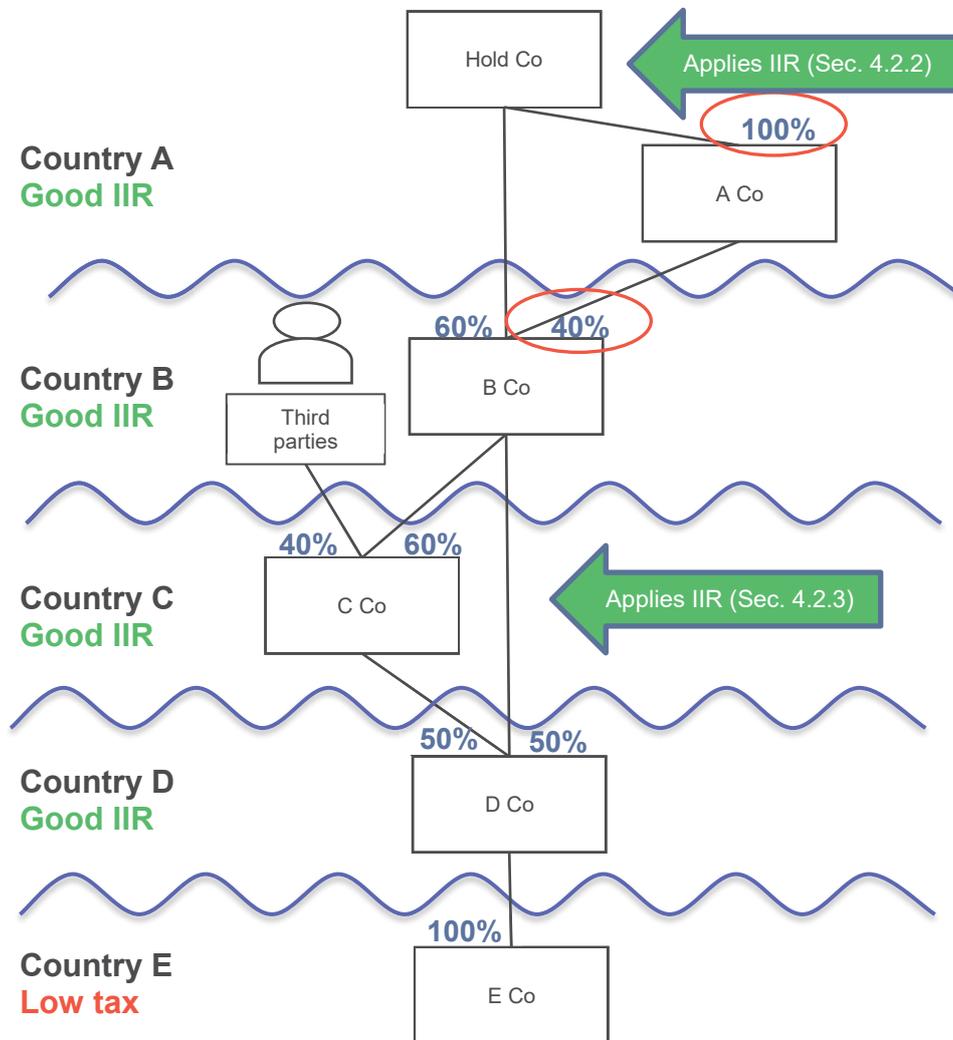
1. The facts are the same facts as in Example 4.2.3D, except that C Co only holds 50% of the shares of D Co while the remaining 50% are held by B Co.



- 2. In this example, B Co owns indirectly 80% of the income of E Co (30% through its ownership of the of C Co and 50% through its ownership of D Co)
- 3. As in Example 7, C Co still has priority to apply the IIR with respect to 50% of the income of E Co. Hold Co and B Co are not required to apply the IIR with respect to this portion of E Co’s income.
- 4. However, B Co is still required to apply the IIR with respect to the other 50% of income of E Co. Hold Co is not required to apply the IIR with respect to this portion of E Co’s income.
- 5. The fact that D Co is not controlled by B Co or C Co is not relevant because all of them are Constituent Entities of the same MNE Group as they are controlled by Hold Co.

Example 4.2.3G.

1. The facts are the same as Example 4.2.3D except that 40% of the shares of B Co are held by A Co, a Constituent Entity of the MNE Group wholly owned by Hold Co.

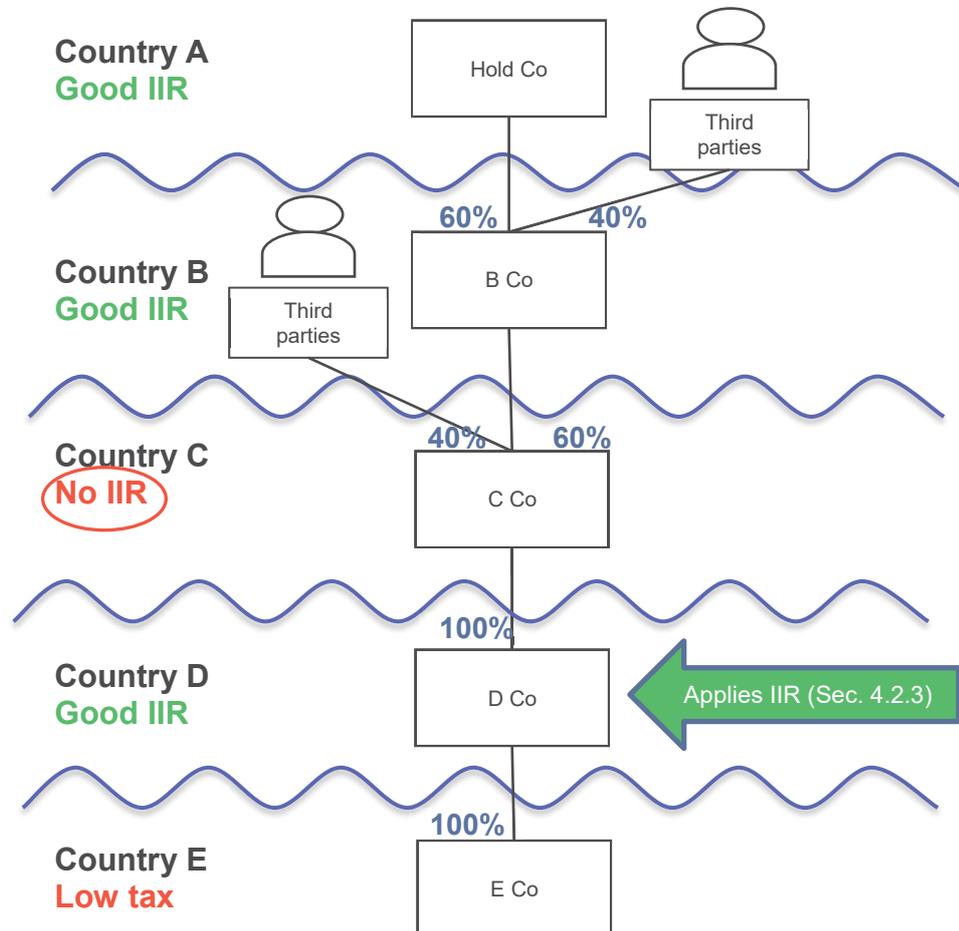


2. As in Example 8, C Co is required to apply the income inclusion rule because it is a Partially Owned Intermediate Parent. D Co is not required to apply the income inclusion rule because all of its equity interests are held by Constituent Entities required to apply the income inclusion rule (Hold Co, B Co and C Co).

3. B Co is not a Partially Owned Intermediate Parent because all of its equity interests are held by Hold Co. Under the top-down approach (Section 5.2.2), Hold Co has priority to apply the income inclusion rule and therefore, Country B has to deactivate its income inclusion rule. However, Hold Co would only apply the income inclusion rule with respect of 50% of the income of E Co because the other 50% is already subject to an income inclusion rule of a Partially Owned Intermediate Parent (C Co) based on the split-ownership rules set out in Section 4.2.3.

Example 4.2.3H.

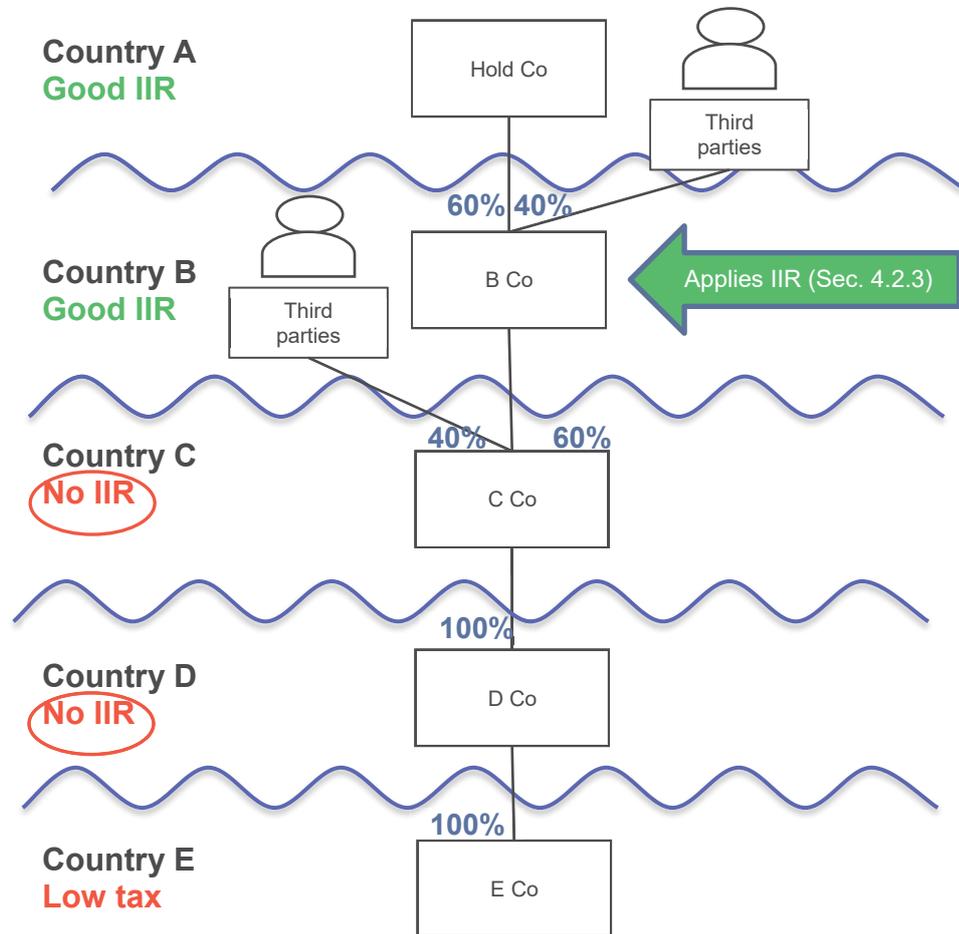
1. The facts are the same as in Example 4.2.3D, except that Country C has not adopted the income inclusion rule.



2. In this situation, the next intermediate parent entity down the ownership chain that owns equity interests in the low-tax Constituent Entity and that is subject to an income inclusion rule applies the income inclusion rule (if such exists). Therefore, D Co is required to apply the income inclusion rule. Hold Co and B Co are required to exclude the income of E Co from the income inclusion rule.

Example 4.2.3J.

1. The facts are the same as in Example 4.2.3D except that difference is that Countries C and D have not adopted the income inclusion rule.



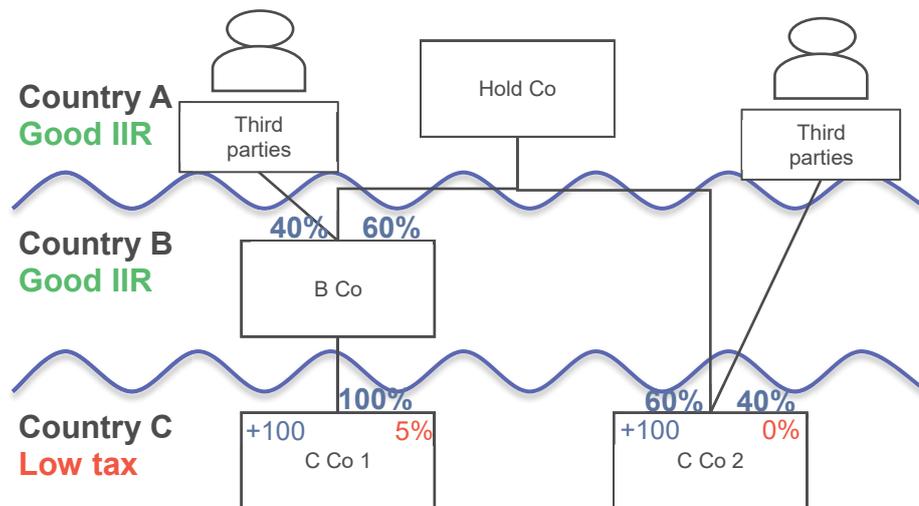
2. In this situation, the Partially Owned Intermediate Parent has to apply the rule (B Co). B Co is not required to exclude the income of E Co because C Co and D Co are not subject to an income inclusion rule. Hold Co is required to exclude the income of E Co from its income inclusion rule, as it is already subject to the income inclusion rule of B Co.

3. B Co would be required to collect 60% of the top-up tax for E Co because it owns indirectly only 60% of its equity interests. The remaining 40% would not be taxed under the GloBE rules because they are not subject to an income inclusion rule and because the undertaxed payments rule would not apply because E Co is controlled by a Constituent Entity subject to an income inclusion rule.¹⁷⁸

¹⁷⁸ The simplified version of the IIR for associate entities would address this situation if the minority shareholder(s) of C Co is an MNE Group subject to the GloBE rules.

Example 4.2.3K.

1. Hold Co is the Ultimate Parent Entity of an MNE Group subject to the GloBE rules. Hold Co is located in a jurisdiction that has adopted the income inclusion rule. Hold Co holds 60% of the shares of B Co, an entity located in Country B. The remaining 40% of the shares are held by minority shareholders that are not Constituent Entities of the MNE Group. Country B has adopted the income inclusion rule. B Co owns 100% of the shares of C Co, a Constituent Entity located in Country C.
2. Hold Co also holds 60% of the shares of C Co 2, an entity located in Country C.
3. The income of C Co 1 is subject to a covered tax of 5, while the income of C Co 2 is exempt. In this example, the minimum tax rate adopted by the GloBE rules is 10%.



4. The ETR of C Co 1 and C Co 2 is of 2.5%. Therefore, the MNE Group is required to pay a tax of 15. The top-up tax for C Co 1 and C Co 2 is 7.5 each [100 (income) x 7.5 ETR difference]
5. Hold Co is required to apply the income inclusion rule based on its ownership percentage in accordance to the top-down approach (Section 5.2.2). B Co is also required to apply the income inclusion rule based on the split-ownership rules (Section 5.2.3).
6. B Co is required to pay 7.5 (100% x 7.5). On the other hand, Hold Co applies the income inclusion rule only with respect to the income of C Co 2 because the income of C Co 1 was already subject to the income inclusion rule of B Co and therefore, is required to pay 4.5 (60% x 7.5).
7. The MNE Group had a total top-up tax of \$15. However, after the application of the rules, the MNE Group effectively paid \$12 (\$7.5 paid by B Co + \$4.5 paid by Hold Co). The remaining 3 of tax derives from income that belongs to the minority shareholders of C Co 2. In this case, the split-ownership rules (Section 5.2.3.) were not applicable to 100% of the MNE's low-taxed income because the entity subject to low taxation (C Co 2) is an entity that is not wholly owned by the MNE Group.

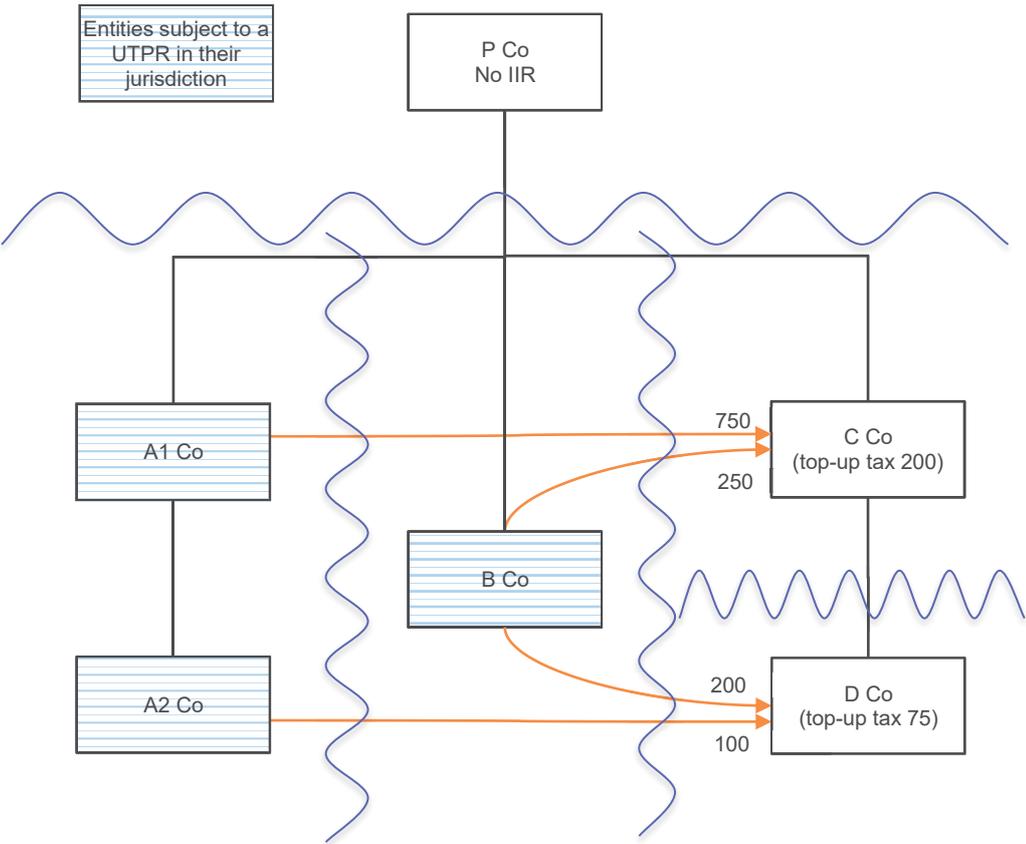
Chapter 4.3

Example 4.3.4A. Example of operation of the first allocation key of the UTPR (without any cap)

Facts

1. An MNE is parented in jurisdiction P and operates in jurisdictions A, B, C and D. It is further assumed that the MNE's jurisdictional ETR in jurisdiction P (the Ultimate Parent jurisdiction), jurisdiction A and jurisdiction B is above the minimum rate. P Co directly owns all of the equity interests in A1 Co, B Co and C Co. A1 Co owns all of the equity interests in A2 Co and C Co owns all of the equity interests in D Co. A1 Co and A2 Co are tax resident in the same jurisdiction (jurisdiction A). B Co, C Co and D Co are tax resident of jurisdiction B, jurisdiction C and jurisdiction D respectively. Jurisdictions A and B introduced the UTPR.
2. This MNE's jurisdictional ETR in jurisdictions C and D are below the minimum rate. A top-up tax is computed in relation to the profits made in these two jurisdictions. The top-up tax amounts to 200 and 75 in relation to the profits made in jurisdictions C and D respectively.¹⁷⁹ There is no income inclusion rule that applies in relation to the profits made in jurisdictions C and D because jurisdictions P and C have not implemented the income inclusion rule.
3. The direct payments structure involving Constituent Entities established in jurisdictions where the MNE's jurisdictional ETR is below the minimum rate is as follows:
 - A1 Co made payments to C Co. These payments amounted to 750.
 - A2 Co made payments to D Co. These payments amounted to 100.
 - B Co made payments to C Co and to D Co. These payments amounted to 250 and 200 respectively.
4. The following chart summarises these facts.

¹⁷⁹ These top-up taxes are assumptions



Question

5. How are the top-up taxes computed in relation to the profits made in jurisdictions C and D allocated under the first allocation key of the UTPR?

Answer

6. Each of the amounts of top-up tax (200 and 75) is allocated as follows:
- The top-up tax allocated to A1 Co amounts to 150 (75% x 200)
 - The top-up tax allocated to A2 Co amounts to 25 (33.33% x 75)
 - The top-up tax allocated to B Co amounts to 100 (25% x 200 + 66.66% x 75)
7. The effect of a potential cap on the amount allocated under the first allocation key is disregarded for the purpose of this example. If a cap applied and limited the amount of top-up taxes allocated under the first allocation key, the remaining amount of top-up tax would be allocated under the second allocation key.

Analysis

8. If the MNE has an effective tax rate that is below the agreed minimum rate in several jurisdictions where it is operating, the first allocation key would be applied to the top-up tax owed in relation to the profits made in each jurisdiction separately. The example provided here aims at illustrating this mechanism. The

effect of a potential cap on the amount allocated under the first allocation key is disregarded for the purpose of this example.

Allocation of the top-up tax computed in relation to the profits made by C Co

9. The top-up tax computed in relation to the profits made by C Co is allocated to UTPR Taxpayers established in jurisdictions A and B in proportion to the direct payments these entities made to C Co. The proportions of direct payments received by C Co are as follows:

UTPR Taxpayers	Amount of direct payments made to C Co	Proportion of direct payments
A1 Co	750	$\frac{750}{1000} = 75\%$
B Co	250	$\frac{250}{1000} = 25\%$
Total	1000	100%

10. The top-up tax computed in relation to the profits made by C Co amounts to 200. The top-up tax is allocated to UTPR Taxpayers established in jurisdictions A and B in proportion to the amount of direct payments computed above. This mechanism results in the following allocation:

UTPR Taxpayers	Proportion of direct payments	Allocated top-up tax
A1 Co	75%	$75\% \times 200 = 150$
B Co	25%	$25\% \times 200 = 50$
Total	100%	200

11. The effect of a potential cap on the amount allocated under this allocation key is disregarded for the purpose of this example. If there remains any unallocated top-up tax on the profits made in jurisdiction C after this cap applies, it will be allocated under the second allocation key.

Allocation of the top-up tax computed in relation to the profits made by D Co

12. The top-up tax computed in relation to the profits made by D Co is allocated to UTPR Taxpayers established in jurisdictions A and B in proportion to the direct payments these entities made to D Co. The proportions of direct payments received by D Co are as follows:

UTPR Taxpayers	Amount of direct payments made to D Co	Proportion of direct payments
A2 Co	100	$\frac{100}{300} = 33.33\%$
B Co	200	$\frac{200}{300} = 66.66\%$
Total	300	100%

13. The top-up tax computed in relation to the profits made by D Co amounts to 75. The top-up tax is allocated to UTPR Taxpayers established in jurisdictions A and B in proportion to the amount of direct payments computed above. This mechanism results in the following allocation:

UTPR Taxpayers	Proportion of direct payments	Allocated top-up tax
A2 Co	33.33%	33.33% x 75 = 25
B Co	66.66%	66.66% x 75 = 50
Total	100%	75

14. The effect of a potential cap on the amount allocated under this allocation key is disregarded for the purpose of this example. If there remains any unallocated top-up tax on the profits made in jurisdiction D after this cap applies, it will be allocated under the second allocation key.

Total amount of top-up tax allocated under the first allocation key

15. The top-up tax computed in relation to the profits made in jurisdictions C and D are cumulative. Therefore, UTPR Taxpayers established in jurisdictions A and B are allocated the following top-up tax:

UTPR Taxpayers	Top-up tax allocated in relation to the profits made in jurisdiction C	Top-up tax allocated in relation to the profits made in jurisdiction D	Total top-up tax
A1 Co	150	n.a.	150
A2 Co	n.a.	25	25
B Co	50	50	100
Total	200	75	275

16. As a result of the first allocation key, the total amount of top-up tax of is allocated as follows:

- The top-up tax allocated to A1 Co amounts to 150
- The top-up tax allocated to A2 Co amounts to 25
- The top-up tax allocated to B Co amounts to 100

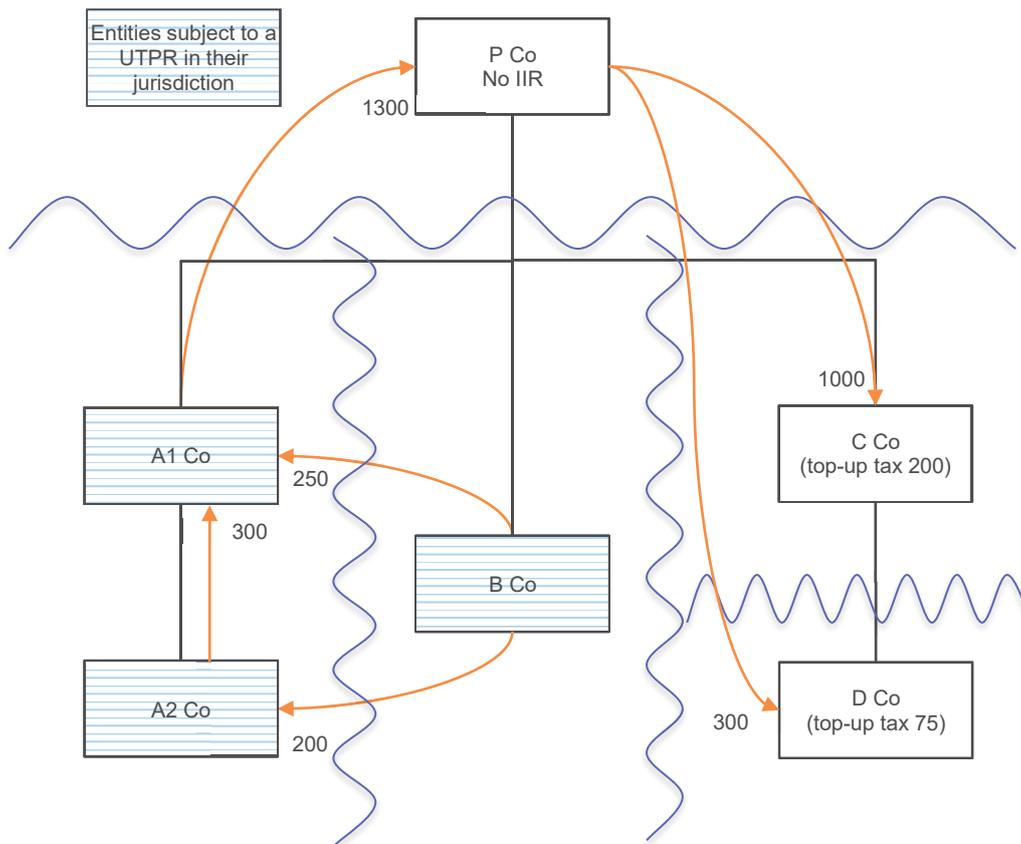
17. The effect of a potential cap on the amount allocated under this allocation key is disregarded for the purpose of this example. If there remains any unallocated top-up tax on the profits made in jurisdiction C or D after this cap applies, it will be allocated under the second allocation key.

Example 4.3.4B. Example of the operation of the UTPR when the first allocation key does not apply

Facts

1. The same facts as for Example 4.3.2A are assumed for this example, except for the fact that no direct payments are made by entities subject to a UTPR to entities located in jurisdictions where the MNE's jurisdictional ETR is below the agreed minimum rate. Therefore, no top-up tax is allocated under the first allocation key and only the second allocation key applies.

2. The following chart summarises these facts.



Question

3. How are the top-up taxes computed in relation to the profits made in jurisdictions C and D allocated under the UTPR?

Answer

4. The first allocation key of the UTPR does not apply in this fact pattern. The second allocation key applies to the remaining (i.e. total in this case) amount of top-up tax.

5. The second allocation key of the UTPR allocates such a total amount of top-up tax (200 + 75 = 275) in proportion to net intra-group expenditure of the UTPR Taxpayers. The net intra-group expenditure of A1 Co, A2 Co and B Co are respectively 58%, 8% and 34% of the aggregated amount of the sum of their net intra-group expenditures.

6. These entities are therefore allocated a portion of top-up tax as follows:

- The top-up tax allocated to A1 Co amounts to 159.5 (58% x 275)
- The top-up tax allocated to A2 Co amounts to 22 (8% x 275)
- The top-up tax allocated to B Co amounts to 93.5 (34% x 275)

Analysis

7. The first allocation key of the UTPR does not apply in this fact pattern. Under the second allocation key, all remaining top-up taxes (i.e. those that were not allocated under the first allocation key) are aggregated to form one pool of top-up tax that is allocated in proportion to each UTPR Taxpayer's net intra-group expenditure.

8. The set of related party transactions results in the following amounts of net intra-group expenditure:

UTPR Taxpayers	Related party Income	Related party expenses	Amount of net intra-group expenditure
A1 Co	300 + 250 = 550	1300	550 – 1300 = (750)
A2 Co	200	300	200 – 300 = (100)
B Co	-	250+200 = 450	(450)

9. The proportion of net intra-group expenditure can be computed on the basis of these net intra-group expenditures computed at the entity level.

UTPR Taxpayers	Amount of net intra-group expenditure	Proportion of net intra-group expenditure
A1 Co	(750)	$\frac{750}{1300} = 58\%$
A2 Co	(100)	$\frac{100}{1300} = 8\%$
B Co	(450)	$\frac{450}{1300} = 34\%$
Total	(1300)	100%

10. The total amount of top-up tax can then be allocated amongst A1 Co, A2 Co and B Co in proportion to their net intra-group expenditure.

UTPR Taxpayers	Proportion of net intra-group expenditure	Allocated top-up tax
A1 Co	58%	$58\% \times 275 = 159.5$
A2 Co	8%	$8\% \times 275 = 22$
B Co	34%	$34\% \times 275 = 93.5$

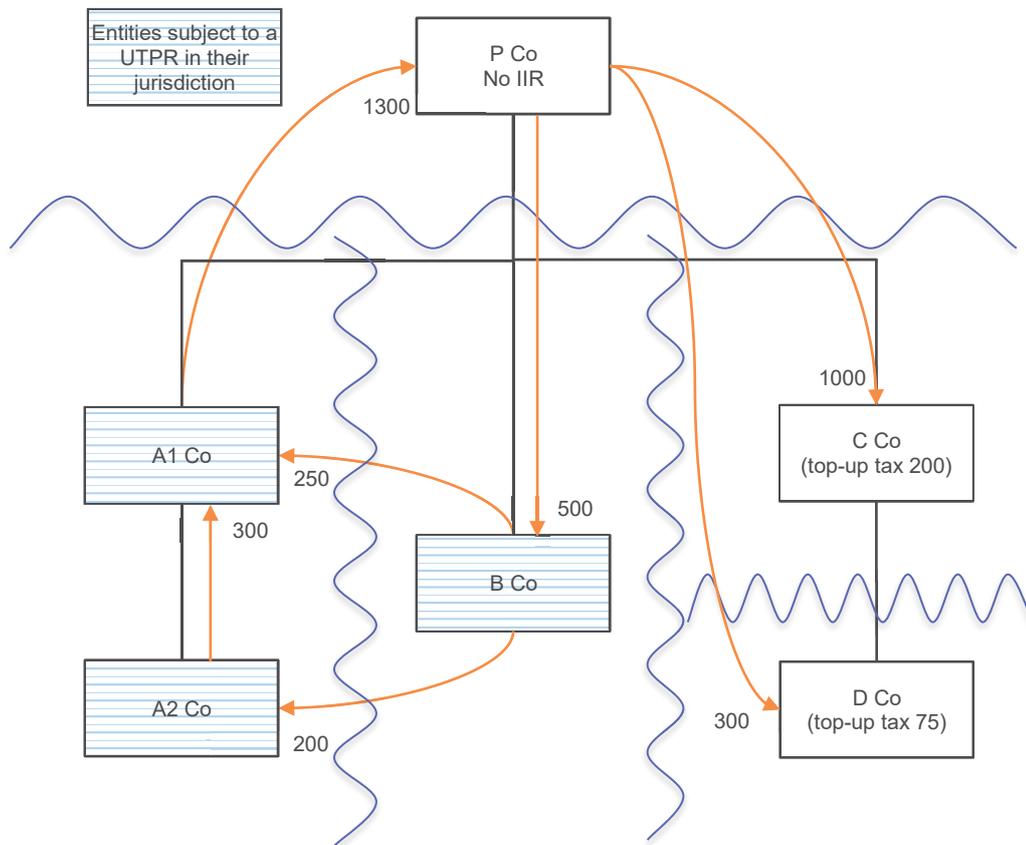
Total	100%	275
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11. The difference with the top-up tax allocated under the second allocation key in Example 4.3.2A results from the fact that, under the second allocation key, the top-up tax is aggregated before being allocated to all Constituent Entities in proportion to their net intra-group expenditure.

Example 4.3.4C. Example of the operation of the UTPR when the first allocation key does not apply and one entity has net related party income for the purpose of the second allocation key

Facts

1. The same facts as for Example 4.3.2B are assumed for this example. It is further assumed that B Co received another intragroup payment for an amount of 500 from P Co.
2. The following chart summarises these facts.



Question

3. How are the top-up taxes allocated in relation to the profits made in jurisdictions C and D under the UTPR?

Answer

4. The first allocation key of the UTPR does not apply in this fact pattern. The second allocation key applies to the total amount of top-up tax.
5. The second allocation key of the UTPR allocates such a total amount of top-up tax ($200 + 75 = 275$) in proportion to net intra-group expenditure of the UTPR Taxpayers. The net intra-group expenditure of A1 Co and A2 Co are respectively 88% and 12% of the aggregated amount of the sum of their net intra-group expenditures. The net related party income of B Co is disregarded for this purpose.

6. These entities are therefore allocated a portion of top-up tax as follows:

- The top-up tax allocated to A1 Co amounts to 242 (88% x 275)
- The top-up tax allocated to A2 Co amounts to 33 (12% x 275)

Analysis

7. The first allocation key of the UTPR does not apply in this fact pattern. Under the second allocation key, all remaining top-up taxes (i.e. those that were not allocated under the first allocation key) are aggregated to form one pool of top-up tax that is allocated in proportion to each UTPR Taxpayer's net intra-group expenditure.

8. The set of related party transactions results in the following amounts of net intra-group expenditure:

UTPR Taxpayers	Related party Income	Related party expenses	Amount of net intra-group expenditure
A1 Co	300 + 250 = 550	1300	550 – 1300 = (750)
A2 Co	200	300	200 – 300 = (100)
B Co	500	250+200 = 450	Net related party income

9. The proportion of net intra-group expenditure can be computed on the basis of these net intra-group expenditures computed at the entity level. Entities with net related party income are disregarded for this purpose.

UTPR Taxpayers	Amount of net intra-group expenditure	Proportion of net intra-group expenditure
A1 Co	(750)	$\frac{750}{850} = 88\%$
A2 Co	(100)	$\frac{100}{850} = 12\%$
B Co	Net related party income	n.a.
Total	(850)	100%

10. The total amount of top-up tax can then be allocated amongst A1 Co and A2 Co in proportion to their net intra-group expenditure.

UTPR Taxpayers	Proportion of net intra-group expenditure	Allocated top-up tax
A1 Co	88%	$88\% \times 275 = 242$
A2 Co	12%	$12\% \times 275 = 33$
Total	100%	275

Example 4.3.4D. Example of the operation of the UTPR when a Constituent Entity subject to the UTPR is resident in a jurisdiction where the MNE's jurisdictional ETR is below the minimum rate

Facts

1. The same facts as for Example 4.3.2B are assumed for this example. It is further assumed that B Co is established in a jurisdiction where the MNE's jurisdictional ETR for the current year is below the agreed minimum rate.

Question

2. How are the top-up taxes allocated in relation to the profits made in jurisdictions C and D under the UTPR?

Answer

3. The first allocation key of the UTPR does not apply in this fact pattern. The second allocation key applies to the total amount of top-up tax.

4. The second allocation key of the UTPR allocates such a total amount of top-up tax (200 + 75 = 275) in proportion to net intra-group expenditure of the UTPR Taxpayers. B Co is not eligible to apply the UTPR because it is established in a jurisdiction where the MNE's jurisdictional ETR is below the minimum rate. Therefore, the net intra-group expenditure of B Co is disregarded for this purpose.

5. The net intra-group expenditure of A1 Co and A2 Co are respectively 88% and 12% of the aggregated amount of the sum of their net intra-group expenditures.

6. These entities are therefore allocated a portion of top-up tax as follows:

- The top-up tax allocated to A1 Co amounts to 242 (88% x 275)
- The top-up tax allocated to A2 Co amounts to 33 (12% x 275)

Analysis

7. The first allocation key of the UTPR does not apply in this fact pattern. Under the second allocation key, all remaining top-up taxes (i.e. those that were not allocated under the first allocation key) are aggregated to form one pool of top-up tax that is allocated in proportion to each UTPR Taxpayer's net intra-group expenditure.

8. Only the Constituent Entities that are eligible to apply the UTPR are taken into account for this purpose. B Co is not eligible to apply the UTPR and is not a UTPR Taxpayer because it is established in a jurisdiction where the MNE's jurisdictional ETR is below the minimum rate. Therefore, the net intra-group expenditure of B Co is disregarded for this purpose.

9. The set of related party transactions results in the following amounts of net intra-group expenditure for the UTPR Taxpayers:

UTPR Taxpayers	Related party Income	Related party expenses	Amount of net intra-group expenditure
A1 Co	$300 + 250 = 550$	1300	$550 - 1300 = (750)$
A2 Co	200	300	$200 - 300 = (100)$

10. The proportion of net intra-group expenditure can be computed on the basis of these net intra-group expenditures computed at the entity level. UTPR Taxpayers with net related party income are disregarded for this purpose.

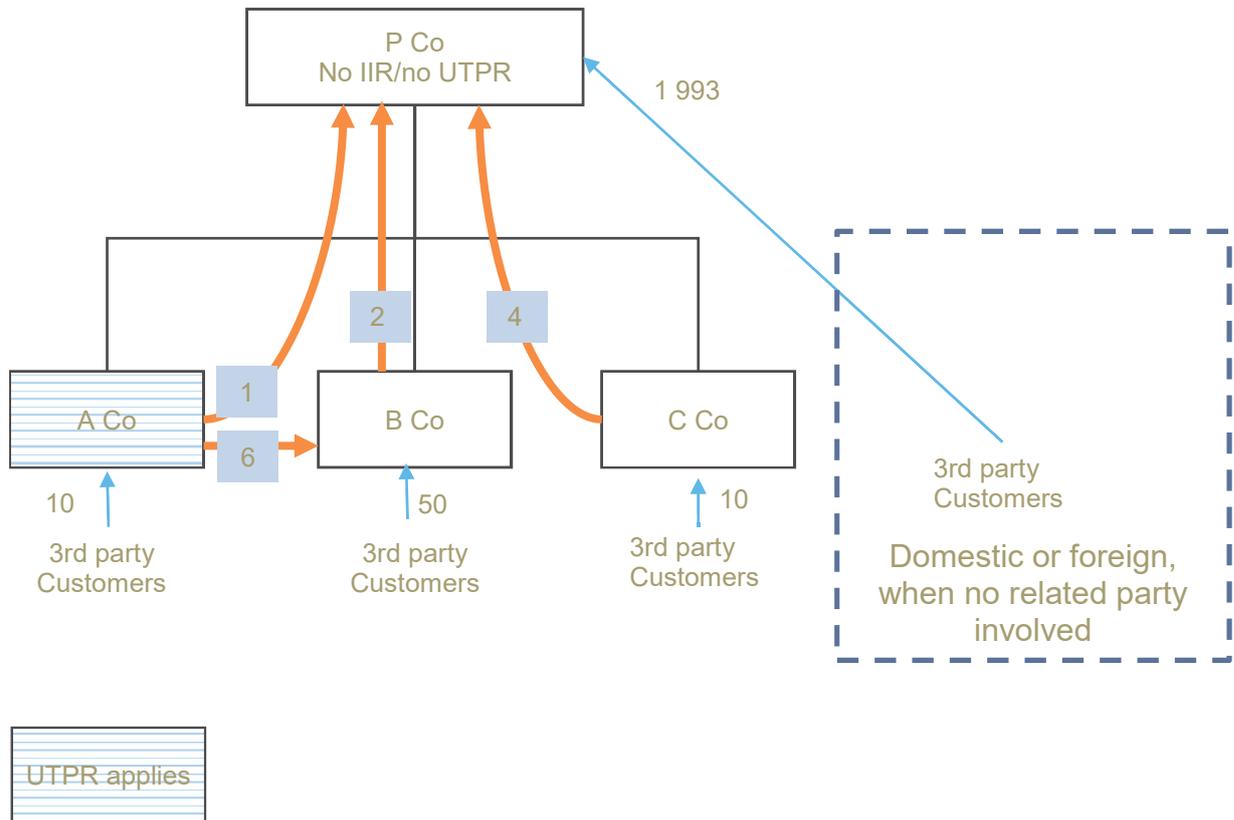
UTPR Taxpayers	Amount of net intra-group expenditure	Proportion of net intra-group expenditure
A1 Co	(750)	$\frac{750}{850} = 88\%$
A2 Co	(100)	$\frac{100}{850} = 12\%$
Total	(850)	100%

11. The total amount of top-up tax can then be allocated amongst A1 Co and A2 Co in proportion to their net intra-group expenditure.

UTPR Taxpayers	Proportion of net intra-group expenditure	Allocated top-up tax
A1 Co	88%	$88\% \times 275 = 242$
A2 Co	12%	$12\% \times 275 = 33$
Total	100%	275

Example 4.3.5A. Illustration of the operation of the overall cap*Facts*

1. P Co is the parent company of an MNE group in scope of Pillar Two rules and directly owns three subsidiaries: A Co, B Co and C Co.
2. P Co and its subsidiaries are located in jurisdictions P, A, B and C respectively.
3. P Co has a total revenue of 2 000m and expenses of 1 800m. P Co's profit is 200m and it is subject to a 9% ETR in jurisdiction P, while the minimum rate is 10%.
4. The MNE's ETR in jurisdictions A, B and C is above the minimum rate.
5. Only jurisdiction A has introduced the UTPR. A Co is subject to a 20% CIT rate in its jurisdiction.
6. A Co made a direct payment of 1m to P Co and another payment of 6m to B Co. B Co and C Co also made direct payments to P Co of 2m and 4m respectively.
7. This set of simplified assumptions and the relevant amounts are summarised in the chart below.

*Question*

8. What is the top-up tax allocated to A Co under the UTPR?

Answer

9. The top-up tax allocated to A Co, after taking into account the overall cap mechanism, is 70,000.

Analysis

10. The top-up tax percentage is the difference between the minimum rate (assumed to be 10%) and the MNE's ETR in the low-tax jurisdiction (assumed to be 9%). The top-up tax percentage for Jurisdiction P under this fact pattern is 1%.

11. In this scenario, the foreign sources of intragroup revenue do not exceed the low-tax Income in the low-tax Jurisdiction.

- The foreign sources of intragroup revenue in Jurisdiction P amount to $1m + 2m + 4m = 7m$
- The total amount of Adjusted GloBE income in Jurisdiction P is equal to P Co's income since there are no other Constituent Entities established in Jurisdiction P. This income amounts to 200m.

12. Since the foreign sources of intragroup revenue do not exceed the low-tax Income in the low-tax Jurisdiction, a limitation applies to the allocable top-up tax computed above.

13. The limitation is computed by applying the top-up tax percentage to the foreign sources of intragroup revenue in Jurisdiction P, i.e.:

$$1\% \times 7m = 70,000.$$

14. The top-up tax allocated in the group would therefore be limited to 70,000 in this example.

15. This limited amount of top-up tax would be allocated in full to A Co under the UTPR as a result of the first allocation key since A Co is the only entity of the group subject to the UTPR and it has made direct payments to P Co.

16. Assuming this subsidiary was subject to a 20% CIT rate in its jurisdiction, denying the deduction of the payment of 1m would result in a maximum top-up tax of 200,000. This cap would not be reached and A Co would be allocated the whole top-up tax of 70 000.

Annex 4.3.8A. - Draft information template

1. This annex provides an example of an information template that is comprised of four tables intended to capture most of the information that could be required in order to apply the undertaxed payments rule. The first table contains the information necessary to calculate the total amount of top-up tax. The second table contains a list of intragroup entities. The third table summarises the information necessary to apply the first allocation key of the rule and the fourth table summarises the information necessary to apply the second allocation key of the rule on an entity-by-entity basis. In addition to these tables, an overview of the MNE group's structure could also be required.

Table 1
Computation of top-up tax

Name of the MNE group:				
Fiscal year concerned:				
Currency used:				
Tax Jurisdiction ¹⁸⁰	ETR in the jurisdiction	If ETR in the jurisdiction below the minimum rate		
		Top-up tax percentage	Adjusted income of each low-tax Constituent Entity (one row per low-tax Constituent Entity)	Top-up tax (one row per low-tax Constituent Entity)

¹⁸⁰ All tax jurisdictions where the MNE Group is established should be listed in this and the following tables, where relevant. These jurisdictions also include the Ultimate Parent Jurisdiction. Footnote added further to a suggestion from Canada.

Table 2
List of group entities

Name of the MNE group:			
Fiscal year concerned:			
Tax Jurisdiction	Undertaxed payments rule applicable in that jurisdiction? (yes/no)	Constituent entities resident in the tax jurisdiction	Tax jurisdiction of organisation or incorporation if different from tax jurisdiction of residence
		1.	
		2.	
		3.	
		1.	
		2.	
		3.	

Table 3
Direct payments made to low-tax Constituent Entities

		Name of the MNE group:		Fiscal year concerned:		Currency used:	
Constituent entities resident in the tax jurisdiction	Tax Jurisdictions	If MNE's ETR in the jurisdiction below the minimum rate (as per Table 1)		If ETR in the jurisdiction at or above the minimum rate (as per Table 1)			
		Related party income		Related party expenses			
		(one row per constituent entity resident or established in a jurisdiction where the MNE's ETR is below the minimum rate, as per Table 1)		(one row per constituent entity resident or established in a jurisdiction where the MNE's ETR is below the minimum rate, as per Table 1)			
		Entity	Residence jurisdiction (in line with Table 2)	Amount	Entity	Residence jurisdiction (in line with Table 2)	Amount
		1.			1.		
		2.			2.		
		3.			3.		
		1.			1.		
		2.			2.		

Table 4
Intragroup payments

Name of the MNE group:			
Fiscal year concerned:			
Currency used:			
UTPR Taxpayer	Tax Jurisdictions (only those where an undertaxed payments rule applies and where the MNE's jurisdictional ETR is at or above the minimum rate)	Related party income (Total amount)	Related party expenses (including those already identified in Table 3) (Total amount)

2. The information provided in Table 4 would not be necessary if there is no remaining top-up tax to be allocated under the second allocation key of the rule. This would be the case if all top-up tax computed as per Table 1 is already allocated to entities that made direct payments to low-tax Constituent entities under the first allocation key of the UTPR. In such a situation, the MNEs could be given the option not to provide Table 4, but to certify that the second allocation key of the rule does not apply (see section 4.3.8 about the certification requirements that can avoid application the rule).

Chapter 5 Examples

Example X1 – Interaction between adjusted nominal rate computation and exemption under tax treaty elimination of double taxation provisions

1. Imagine that States R and S have a tax treaty including a royalty article following Article 12 of the OECD Model, but including the subject to tax rule; and that State R has adopted the Article 23 A exemption method in the elimination article. State R has a statutory rate of 20% but, under a special regime applying to certain royalty income, excludes 80 per cent of the income from tax. Without any other adjustment, this will mean that only 20 per cent of the income is subject to the 20% rate, producing an adjusted nominal rate of 4%. Imagine also that the agreed adjusted nominal trigger rate for the purposes of the subject to tax rule is 7.5% and that all the other conditions for its application are met. SCO, a resident of State S, makes a covered royalty payment to RCO, a resident of State R. Because the adjusted nominal tax rate applied to the royalty payment is below the 7.5% trigger rate, State S is prima facie entitled to apply a top-up tax of 3.5% under the subject to tax rule. But this means that State S is permitted to tax the income in accordance with the treaty and State R is now obliged to exempt the income in accordance with Article 23 A. The effect of taking the treaty exemption into account is therefore to reduce the adjusted nominal rate to 0% and increase the top-up tax that can be applied in State S to 7.5%, depriving State R of its 4% taxing right and reallocating an exclusive taxing right to State R (up to the agreed minimum rate)

Example X2 – Interaction between the application of the subject to tax rule and tax treaty elimination of double taxation provisions (exemption)

2. The facts are the same as example X1, apart from the obligation on State R to apply the exemption method under Article 23 A of the OECD Model is not taken into account in computing the adjusted nominal rate for the purposes of the subject to tax rule. State R has a statutory rate of 20% but, under a special regime applying to certain royalty income, excludes 80 per cent of the income from tax. This will mean that only 20 per cent of the income is subject to the 20% rate, producing an adjusted nominal rate of 4%. The adjusted nominal trigger rate for the purposes of the subject to tax rule is assumed to be 7.5% and all of the conditions for the rule to apply are met. SCO, a resident of State S, makes a covered royalty payment to RCO, a resident of State R. Because the adjusted nominal tax rate applied to the royalty payment is below the 7.5% trigger rate, State S is entitled to apply a top-up tax of 3.5% under the subject to tax rule. State R is now obliged to exempt the income in accordance with Article 23 A. The effect is that State R gives up its right to tax at 4% and does not tax the payment, while State S only applies a top-up tax at 3.5%

Example X3 – Interaction between the application of the subject to tax rule and tax treaty elimination of double taxation provisions (credit)

3. The facts are the same as example X2, except that State R applies the credit instead of the exemption method. State R would now apply its tax at 4% and provide a credit against that tax for the 3.5% tax applied in State S. State S would apply a top-up tax of 3.5%. The result is that the payment is taxed at 4% (split between 0.5% net in State R and 3.5% in State S).

Example X4 – Effect of switching-off tax treaty elimination of double taxation provisions where the subject to tax rule applies

4. In order to avoid these outcomes, the residence jurisdiction's obligation to provide exemption or credit under the elimination of double taxation provisions of a tax treaty could be switched-off where the source jurisdiction is only exercising a taxing right in accordance with the treaty because it is applying a top-up tax in accordance with the subject to tax rule. On the same facts as examples X2 and X3 above,

the effect of this under both the exemption and credit methods would be that State R would tax the item of income at 4% and State S would apply a top-up tax at 3.5%. There would be no reallocation of taxing rights away from the residence jurisdiction.

Example X5 – Effect of tax treaty elimination of double taxation provisions where the conditions for the subject to tax rule to apply are met, but the source jurisdiction is permitted to apply a higher treaty rate than the top-up rate (no restriction)

5. Imagine that a treaty permits the source jurisdiction to tax royalties at the rate of 5% and includes the subject to tax rule. Consistent with the ordering rule approach outlined in paragraph XX of the report, the source jurisdiction can apply the higher of that existing treaty rate and the top-up rate. Adapting the facts of example X4, and because 5% is higher than the 3.5% top-up rate in that example, the source jurisdiction is permitted to apply the 5% rate. In this scenario, the subject to tax rule is triggered (because all of the conditions for its application are met) but it is not applied (because the source jurisdiction is exercising an existing taxing right that does not depend upon those conditions and which results in a higher rate of source taxation). If the residence jurisdiction's obligation to exempt the income or provide a credit under the elimination of double taxation provisions in the treaty were not restricted, the residence state will either exempt the income or provide a credit for the tax applied in the source jurisdiction (up to the amount of the residence jurisdiction's tax on the same income). Applying the exemption method will result in no tax in the residence jurisdiction and a 5% tax in the source jurisdiction, with the result that the total tax is 5%. Applying the credit method will have the same result, with the residence jurisdiction providing a credit against its own tax for the tax applied on the income in the source jurisdiction. This will cover in full the 4% tax in the residence jurisdiction, leaving no net tax paid there, and the source jurisdiction will tax at 5%. In each case, the total residence and source jurisdiction tax is 2.5% below the agreed minimum rate (assumed to be 7.5%).

Example X6 – Effect of tax treaty elimination of double taxation provisions where the conditions for the subject to tax rule to apply are met, but the source jurisdiction is permitted to apply a higher treaty rate than the top-up rate (proportionate restriction)

6. On the same facts as example X5, the effect of applying a proportionate restriction when applying elimination of double taxation provisions in a tax treaty would be:

- Under exemption method – the residence jurisdiction would exempt 37.5% of the income over which it has taxing rights before the application of the elimination provisions in the treaty, bringing its rate down from 4% to 2.5%. (To achieve the target 2.5% rate, the proportion of the income taxable in the residence jurisdiction at 4% will need to be reduced to $2.5/4 \times 100 = 62.5\%$, requiring an exemption of 37.5% of the income.)
- Under the credit method – the residence jurisdiction would provide a credit for the 5% source jurisdiction tax capped at 1.5% (instead of the full 4%), leaving the residence jurisdiction applying tax at $4\% - 1.5\% = 2.5\%$.

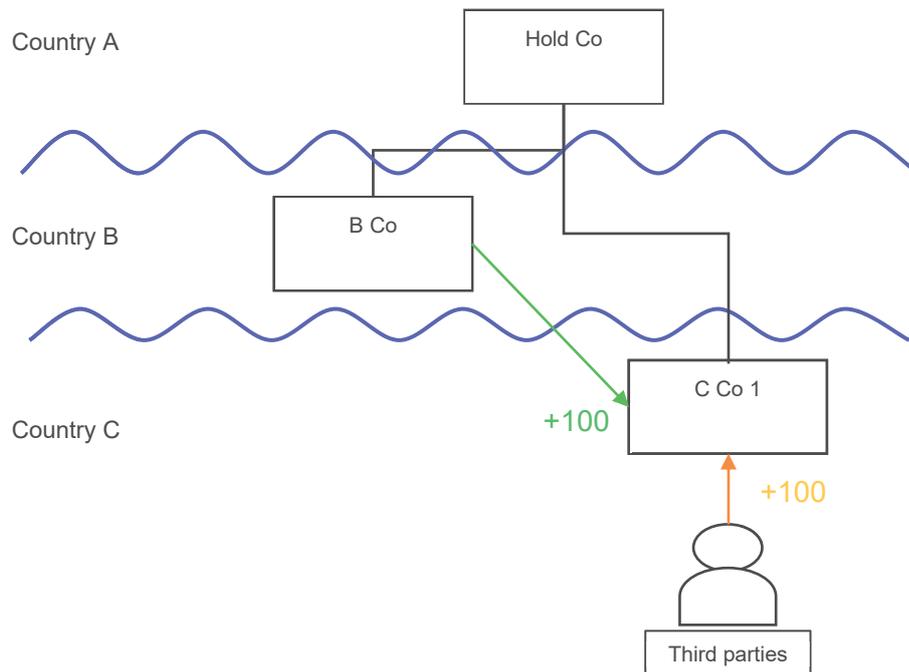
In both cases, the combined residence and source jurisdiction tax would then be equal to the minimum rate under the subject to tax rule (assumed to be 7.5%).

Chapter 6 - Examples

Example 6.2.1A - Interaction between the subject to tax rule and the income inclusion rule

Facts

1. The MNE Group consists of four constituent entities located in jurisdictions A, B and C. Hold Co is a tax resident of Country A and is the Ultimate Parent Entity of an MNE Group subject to the GloBE rules. Hold Co owns directly the shares of B Co (tax resident in Country B), C Co 1 (tax resident in Country C).
2. C Co 1 holds valuable intangible property of the group and licenses it to B Co, which made a payment of 100 to C Co 1. Country C has a corporate tax rate of 25% and a preferred regime that exempts 80% of royalty income. C Co 1 also receives other foreign source payments of 1 000 from third parties that are not taxable in Country C. It is assumed that Hold Co and B Co have no income.
3. Hold Co is subject to an Income Inclusion Rule in Country A.
4. Countries B and C have a tax treaty that follows the OECD Model Tax Convention and contains a subject to tax rule.
5. It is assumed that the minimum adjusted nominal tax trigger rate for the purposes of the subject to tax rule is 7.5% and that the minimum rate for the GloBE rules is 10%.
6. This set of simplified assumptions and the relevant amounts are summarised in the chart below.



Question

7. How do the subject to tax rule (STTR) and the income inclusion rule (IIR) interact under these assumptions?

Answer

8. The top-up tax imposed under the STTR is 2.5 and is levied in Country B, while the top-up tax imposed under the IIR after taking into account the tax imposed under the STTR is 12.5, levied in Country A.

Analysis

9. The STTR applies first, before any operation of the IIR. The payment received by C Co 1 is subject to an adjusted nominal tax rate of 5%, which is obtained by reducing the nominal CIT rate of 25% by 80% because of the exemption of 80% of the income.

10. Because the adjusted nominal rate is below 7.5%, and the payment is a covered payment under the STTR, the STTR applies in country B. B Co is required to withhold at the top-up rate of 2.5%, which is the difference between the minimum rate (7.5%) and the adjusted nominal tax rate (5%).

11. Hold Co is subject to an IIR in Country A. The IIR operates similarly to a CFC rule by requiring a parent company to bring into account and tax the profits of a subsidiary that are subject to an effective tax rate below the minimum rate.

12. The effective tax rate is determined by dividing the amount of covered taxes by the amount of profits. Covered taxes include withholding taxes imposed by source jurisdictions. The effective tax rate of C Co 1 is computed as follows:

- Covered taxes: 2.5 (2.5% of withholding tax under the STTR¹⁸¹ x 100) + 5 (CIT imposed in country C) = 7.5
- Tax base (assumed to be equal to the amount of the income for the purpose of this example): $100+100 = 300$.
- ETR = Covered tax / Tax base = 3.75%

13. The ETR of C Co 1 is below the minimum rate. Therefore, Hold Co is required to apply the IIR in respect of the income of C Co 1. The top-up tax percentage is $10\% - 3.75\% = 6.25\%$. The top-up tax imposed under the IIR is $6.25\% \times 200 = 12.5$.

¹⁸¹ The timing of recognition of the withholding tax is the same as that of the income, provided the payment is made no later than during the financial year that follows the one when the income was accrued for financial purposes. Therefore, even if the income was accrued for financial purposes the year preceding the one when the payment actually occurred (and the withholding tax was actually paid), the withholding tax would be considered as a covered tax during the same financial year.

Example 6.2.1B - Interaction between the subject to tax rule and the undertaxed payments rule

Facts

1. The facts are the same as in Example 6.2.1A, but Country A has not introduced the IIR, whereas Country B has introduced an undertaxed payments rule.
2. It is further assumed that the CIT rate applicable in Country B is 20%.

Question

3. How do the subject to tax rule (STTR) and the undertaxed payments rule (UTPR) interact under these assumptions?

Answer

4. The top-up tax imposed under the STTR is 2.5 and is levied in Country B, while the top-up tax imposed under the UTPR after taking into account the tax imposed under the STTR is 12.5, levied in Country B as well.

Analysis

5. The STTR applies first, before any operation of the UTPR. The payment received by C Co 1 is subject to an adjusted nominal tax rate of 5%, which is obtained by reducing the nominal CIT rate of 25% by 80% because of the exemption of 80% of the income.
6. Because the adjusted nominal rate is below 7.5%, and the payment is a covered payment under the STTR, the STTR applies in country B. B Co is required to withhold at the top-up rate of 2.5%, which is the difference between the minimum rate (7.5%) and the adjusted nominal tax rate (5%).
7. Hold Co is not subject to an IIR in Country A. The undertaxed payments rule serves as a backstop to the income inclusion rule by allowing other subsidiaries of the MNE Group to make an adjustment to intra-group payments and collect the top-up tax that was not collected under the IIR.
8. The effective tax rate is determined under the UTPR with the same mechanics as under the IIR, by dividing the amount of covered taxes by the amount of profits. Covered taxes include withholding taxes imposed by source jurisdictions. The effective tax rate of C Co 1 is computed as follows:
 - Covered taxes: 2.5 (2.5% of withholding tax under the STTR¹⁸² x 100) + 5 (CIT imposed in country C) = 7.5
 - Tax base (assumed to be equal to the amount of the income for the purpose of this example): 100+100 = 200.
 - ETR = Covered tax / Tax base = 3.75%
9. The ETR of C Co 1 is below the minimum rate. Therefore, B Co is allocated a top-up tax in respect of the income of C Co 1. The top-up tax percentage is 10% - 3.75% = 6.25%. The top-up tax imposed under the IIR is 6.25% x 200 = 12.5. The amount of deduction that needs to be denied is obtained by

¹⁸² The timing of recognition of the withholding tax is the same as that of the income, provided the payment is made no later than during the financial year that follows the one when the income was accrued for financial purposes. Therefore, even if the income was accrued for financial purposes the year preceding the one when the payment actually occurred (and the withholding tax was actually paid), the withholding tax would be considered as a covered tax during the same financial year.

dividing the amount of top-up tax allocated to the UTPR Taxpayer by the CIT rate to which this entity is subject. B Co is subject to a CIT rate of 20% and therefore Country B can deny the deduction of $12.5/20\% = 62.5$.