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New OECD administrative guidance provides additional detail regarding Pillar Two compliance

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Overview

On December 18, 2023, the OECD/G20 Inclusive Framework (IF) released Tax Challenges Arising from the Digitilisation of the Economy — Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two), December 2023 ("December 2023 AG" or the AG).

The publication of the December 2023 AG follows the release of the Model Rules in December 2021 and related Commentary in March 2022, the Safe Harbours and Penalty Relief document published in December 2022 (the "2022 SH Document"), Administrative Guidance released in February 2023 (the "February 2023 AG"), and July 2023 (the "July 2023 AG"). The newly released AG will be incorporated into a revised version of the Commentary that is expected to be released in the future.

Pillar Two consists of two interlocking domestic rules that together make up the GloBE regime. The Income Inclusion Rule (IIR) imposes top-up tax on a parent entity with respect to the low-taxed income of a member of its multinational entity (MNE) group (a "constituent entity" or CE). The Undertaxed Profits Rule (UTPR) denies deductions or requires an equivalent adjustment to the extent the low-tax income of a constituent entity is not subject to tax under an IIR or a "qualified domestic minimum top-up tax" (QDMTT). Countries also have the option to adopt a QDMTT as defined in the Model Rules and further clarified in both the February AG and the July AG. The QDMTT is credited against liability otherwise owed under an IIR or the UTPR, or, if certain conditions are met, may operate as a safe harbor that will preclude the application of an otherwise-applicable IIR or UTPR.

This alert sets forth the highlights of the December 2023 AG. The December 2023 AG provides guidance both with respect to certain aspects of the full GloBE Rules set forth in the Model Rules and related Commentary and administrative guidance (hereafter the "full GloBE Rules" or "Model Rules"), as well as the Transitional CbCR Safe Harbor introduced in the 2022 SH Document. The Transitional CbCR Safe Harbor operates through the use of

simplified jurisdictional revenue and income information contained in a MNE Group's Qualified CbC Report and tax information contained in the Qualified Financial Statements.[1]

Purchase price accounting adjustments in Qualified Financial Statements used to comply with the Transitional CbCR Safe Harbor (Section 1.3)

Background: The AG explains that, in accordance with a MNE Group's applicable accounting standard, in the case of an acquisition of a Constituent Entity, adjustments to the carrying value of the Constituent Entity's assets and liabilities attributable to purchase price accounting (PPA) may be: (i) held in the MNE Group's consolidation accounts; or (ii) directly incorporated into the financial accounts of the Constituent Entity used to prepare the Consolidated Financial Statements (CFS) (*i.e.*, the reporting package); or (iii) directly incorporated in the separate financial statements of the Constituent Entity (where pushdown of PPA adjustments is allowed).

Acceptable use of financial accounts that include the effect of PPA adjustments: The AG indicates that for purposes of the Transitional CbCR Safe Harbor a Constituent Entity may use its financial accounts that include the effect of PPA adjustments in the computation of Profit or Loss before Tax (PBT) under certain circumstances. Where the MNE Group allocated and incorporated the PPA adjustments into the financial accounts that are used in the preparation of the CFS or the separate financial statements of the Constituent Entity, those financial accounts or separate financial statements can be considered Qualified Financial Statements if the Constituent Entity meets the "consistent reporting requirement" and makes the "goodwill impairment adjustment." A MNE Group complies with the "consistent reporting requirement" if it meets the following two requirements. First, the MNE Group must submit all future CbCRs for tax years beginning after December 31, 2022, based on the Constituent Entity's reporting package or separate financial statements that include PPA adjustments. However, if the Constituent Entity was required by law to change its reporting package or separate financial statements to include such PPA adjustments, then the MNE Group will not meet this "consistent reporting requirement."

A MNE Group complies with the "goodwill impairment adjustment" by adding back to PBT any reduction in a Constituent Entity's income attributable to the impairment of goodwill related to transactions entered into after November 30, 2021 (but, for purposes of the effective tax rate (ETR) test, only if the financial accounts do not already have a reversal of a deferred tax liability or recognition or increase of a deferred tax asset with respect to such impairment.)

Tested Jurisdictions (Section 2.2)

The AG indicates that Constituent Entities, stand-alone Joint Ventures, and JV Groups that are located in the same jurisdiction are treated as being in separate Tested Jurisdictions for purposes of the application of the Transitional CbCR Safe Harbor. For example, if a MNE Group has 10 Constituent Entities and two different JV Groups located in jurisdiction A, then the MNE Group would

[1] Capitalized terms used herein have the definitions provided in the relevant GloBE documents to which they relate.

have three Tested Jurisdictions for purposes of the Transitional CbCR Safe Harbor in Jurisdiction A—one Tested Jurisdiction for the 10 Constituent Entities, and one Tested Jurisdiction for each of the two JV Groups.

Qualified Financial Statements (Section 2.3)

Section 2.3 of the AG modifies and expands on the definition of "Qualified Financial Statements" for purposes of applying the Pillar Two Transitional CbCR Safe Harbor.

Consistent use of data (Section 2.3.1)

Requirement to use the same source of data for an entity: The AG clarifies that taxpayers must use consistent sources of financial data to prepare the Qualified CbC Report with respect to a particular Entity/Permanent Establishment (PE). Specifically, all of an Entity/PE's data used to perform the safe harbor computations "must come from the same Qualified Financial Statements." To satisfy this uniformity requirement, a MNE Group must use either: (i) the accounts used to prepare the CFS of the Ultimate Parent Entity; or (ii) separate financial statements of the Constituent Entity (provided they meet the threshold requirements specified in the OECD guidance)

The AG also clarifies that if a MNE Group uses different sources of data for the same entity (or PE), the MNE Group will be disqualified from applying the Transitional CbCR Safe Harbor to the Tested Jurisdiction in which that entity (or PE) is located. The AG provides three examples of the application of this rule to hypothetical fact patterns.

Sources of data for CbCR items that are not directly relevant to Transitional CbCR Safe Harbor: The AG provides that, with respect to items required to be included in CbC Reports filed with tax authorities that are not directly relevant to the application of the Transitional CbCR Safe Harbor (such as Income Tax Paid, Income Tax Accrued, Stated Capital, Accumulated Earnings, etc.), the CbC Report filed with local tax authorities may be populated from "any source permitted under the Relevant CbCR Regulations," with the latter term defined as the CbC requirements applicable in the Ultimate Parent Entity's jurisdiction or the Surrogate Parent Entity jurisdiction.

Sources of data for distinct entities in the same Tested Jurisdiction: The AG also considers whether a MNE Group may use different sources of Qualified Financial Statements for distinct entities (or PEs) that are located in the same Tested Jurisdiction. The AG clarifies that it is necessary to use the "same type of Qualified Financial Statements (or the accounts used to prepare those Qualified Financial Statements)" for each Tested Entity within a jurisdiction. This new paragraph also provides that separate financial statements can be used for each entity in the same Tested Jurisdiction, provided that such Qualified Financial Statements are prepared in accordance with an Acceptable Financial Accounting Standard or an Authorized Financial Accounting Standard, and further provided that the information provided is reliable.

Sources of data for NMCEs and Pes: An exception applies if the Constituent Entities in a Tested Jurisdiction include one or more Non-Material Constituent Entities (NMCEs) or one or more PEs. In such cases, it is permissible to apply

the Transitional CbCR Safe Harbor based on any data source that is specifically permitted in the Commentary to the GloBE Rules or the Agreed Administrative Guidance. In all other cases, the failure to use the same type of Qualified Financial Statement will result in disqualification of that Tested Jurisdiction from the Transitional CbCR Safe Harbor. The use of management accounts (or other unacceptable source of data) for a Tested Jurisdiction would result in that jurisdiction being disqualified from the Transitional CbCR Safe Harbor.

Relationship between Qualified Financial Statements and statutory accounts:
The AG clarifies the relationship between Qualified Financial Statements and statutory accounts that are prepared for entities in certain Tested Jurisdictions. Qualified Financial Statements may include separate financial statements of a Constituent Entity, provided that such financial statements are prepared in accordance with an Acceptable Financial Accounting Standard or an Authorized Financial Accounting Standard. For this purpose, it is not relevant whether the separate financial statements were prepared for purposes of statutory reporting or for some other regulatory purpose.

Using different accounting standards (Section 2.3.2)

The AG clarifies that different Qualified Financial Statements may be used as the source of data for distinct Tested Jurisdictions in a Qualified CbC Report. Thus, for example, a Qualified CbC Report may be based on a combination of data from the Ultimate Parent Entity's (UPE) CFS for some jurisdictions and data from local GAAP accounts for other jurisdictions.

Adjustments to Qualified Financial Statements (Section 2.3.3)

The 2022 SH Document included references to Article 3.1.2 of the GloBE Rules, which seemed to indicate that adjustments to the financial statements of a Constituent Entity may be necessary in certain circumstances. Specifically, the Commentary to Article 3.1.2 made reference to "[i]tems of income and expense, other than those attributable to purchase accounting, that are reflected in the consolidated accounts, rather than a Constituent Entity's separate accounts," and noted the circumstances in which those items may be taken into account in computing the Constituent Entity's Financial Accounting Net Income or Loss and GloBE Income or Loss. The reference to Article 3.1.2 has been removed as part of this section of the AG. The AG considers whether a MNE Group may make adjustments to the data obtained from Qualified Financial Statements, if it considers such adjustments to be consistent with the GloBE Rules – for example, an adjustment to give effect to a post-year-end transfer pricing adjustment. Under the AG no adjustments may be made to the data contained in the Qualified Financial Statements – including adjustments intended to make CbCR "data more consistent with the GloBE rules." The sole exception to this rule pertains to adjustments that are specifically required in the Commentary to the GloBE Rules or in the Agreed Administrative Guidance.

MNE Groups not required to file CbCR (Section 2.3.4)

The AG addresses the scenario in which a MNE Group is not required to prepare and file CbCR data in its home jurisdiction but is potentially subject to the GloBE Rules in that jurisdiction or in another tax jurisdiction. This may result from differences in application of the annual revenue tests under CbCR

and GloBE, or it may result from other considerations. For example, in the United States, an entity designated as a "specified national security contractor" is excused from filing complete CbCR data, pursuant to IRS Notice 2018-31. The AG clarifies that a MNE Group may prepare and file CbCR data with its Globe Information Return for purposes of qualifying for the Transitional CbCR Safe Harbor, even if the MNE Group is not required to submit CbCR data in accordance with applicable provisions of domestic law in the jurisdiction of the UPE. A MNE Group can qualify for the Transitional CbCR Safe Harbor if it completes section 2.2.1.3(a) of the GloBE Information Return using data from a Qualified Financial Statement that would have been used to complete the CbC Report (*i.e.*, if the MNE Group had been required to file such a report).

Qualified Financial Statements for Permanent Establishments (Section 2.3.5)

A PE must use its own Qualified Financial Statements for the Transitional CbCR Safe Harbor computations. If, however, such statements are not available, the MNE Group may determine the portion of the Main Entity's (*i.e.*, owner of the PE) Total Revenue and PBT that is attributable to the PE using separate financial statements prepared by the Main Entity for the PE for financial reporting, regulatory, tax reporting, or internal management control purposes (see OECD BEPS Action 13 Final Report).

Guidance relating to PE, CFC, and Hybrid Entity taxes (Sections 2.4.2 and 4.1 through 4.3)

The December 2023 AG addresses a number of issues that arise as a result of the disparate treatment of CFC, Hybrid, and PE taxes between the Transitional CbCR Safe Harbor and the full GloBE Rules.

First, the AG confirms that for purposes of the Transitional CbCR Safe Harbor tax paid in the PE jurisdiction on the PE's income is included only in the PE Simplified Covered Taxes in the Simplified ETR test, and therefore not also in the Main Entity's Covered Taxes.

Second, the AG clarifies that, if a CFC/Hybrid/PE is located in a jurisdiction that does not qualify for the Transitional CbCR Safe Harbor, taxes paid by the owner of that entity on the CFC/Hybrid/PE income may be allocated to the CFC/Hybrid/PE under the full GloBE Rules and also taken into account by the owner in determining whether the owner's jurisdiction meets the Simplified ETR test under the Transitional CbCR Safe Harbor. Leaving CFC/Hybrid/PE taxes in the owner-jurisdiction's Simplified ETR calculation for purposes of the Transitional CbCR Safe Harbor likely will increase the effective rate for the United States under the Transitional CbCR Safe Harbor, due to the inclusion of subpart F, GILTI, and flow-through taxes, while also leaving those taxes available for allocation to non-QDMTT jurisdictions under the full GloBE Rules.

Finally, the July 2023 AG provided temporary rules for the allocation of so-called Blended CFC Taxes (*e.g.*, GILTI taxes) from the parent of a MNE Group (*e.g.*, a US parent entity) to its CFCs for purposes of the full GloBE Rules. Those rules require a US parent to determine the ETR of each CFC jurisdiction under the GloBE Rules as a step in the process of determining which CFCs receive what amount of an allocation of GILTI taxes under the full GloBE Rules. Under

the Transitional CbCR Safe Harbor, however, a MNE Group that qualifies for the Transitional CbCR Safe Harbor in a jurisdiction is not required to determine an ETR for that jurisdiction under the full GloBE Rules.

As explained below, the December 2023 AG provides administrative relief for US entities that otherwise may have been required to perform full GloBE calculations on Transitional CbCR Safe Harbor jurisdictions in order to determine the manner in which GILTI taxes are allocated under GloBE. Specifically, the December 2023 AG provides that when the jurisdiction meets the Simplified ETR Safe Harbor, the ETR under the Simplified ETR Test is used in place of the GloBE ETR. Because the jurisdiction has met the Simplified ETR threshold in that case (*e.g.*, has a Simplified ETR greater than 15% in 2024), the Blended CFC Allocation Key will be zero and no Blended CFC (GILTI) taxes will be allocated to that jurisdiction. For jurisdictions that qualify under either the routine profits or *de minimis* rules of the Transitional CbCR Safe Harbor, the MNE Group may determine the ETR for such jurisdictions using the Simplified ETR methodology instead of the full GloBE ETR. Further, for situations in which the QDMTT Safe Harbor applies in a jurisdiction, the MNE group will determine that jurisdiction's ETR using the income and taxes in the QDMTT base but will also include any QDMTT taxes paid to the extent creditable in the owner jurisdiction. Finally, the guidance addresses the manner in which an ETR is determined for the Blended CFC Allocation Key when there are multiple ETRs for a jurisdiction under the GloBE Rules or there are "non-GloBE" entities in that jurisdiction.

Treatment of hybrid arbitrage arrangements under the Transitional CbCR Safe Harbor (Sections 2.6.1 through 2.6.3)

The December 2023 AG explains that the IF had become aware of "certain avoidance transactions marketed to MNE Groups" that exploit either differences between the sources of financial information (local accounts versus consolidated financial accounts of the parent), or differences between the tax and accounting treatment of an item to permit an entity to qualify for the Transitional CbCR Safe Harbor. The AG continues that these transactions typically involve the use of arrangements where the Constituent Entities that are parties to the arrangement are able to account for the income, expenses, gains, losses, or taxes under that arrangement in an inconsistent or duplicative manner to purportedly allow one of the Constituent Entities to qualify for the Transitional CbCR Safe Harbor and thereby avoid GloBE Top-up Taxes that would otherwise arise.

The AG explains that where a Constituent Entity has entered into one of these hybrid arrangements, the Constituent Entity's eligibility for the Transitional CbCR Safe Harbor should be determined on the assumption that it has treated the relevant item of income, expense, or taxes in the same way as the counterparty. The Transitional CbCR Safe Harbor is not available, therefore, to a MNE Group to the extent that a hybrid arbitrage arrangement entered into after December 15, 2022 (the date of the release of the 2022 SH Document) results in a Tested Jurisdiction qualifying for the safe harbor.

A Hybrid Arbitrage Arrangement is defined as (i) a deduction/non-inclusion arrangement; (ii) a duplicate loss arrangement; or (iii) a duplicate tax recognition arrangement, each as further defined in the AG. For purposes of

determining whether a Tested Jurisdiction qualifies for the Transitional CbCR Safe Harbor, adjustments must be made to the Tested Jurisdiction's PBT and/or income tax expense with respect to any Hybrid Arbitrage Arrangement entered into after December 15, 2022.

Specifically, a Tested Jurisdiction's safe harbor calculation must be adjusted by:

- Excluding any expense or loss arising from a deduction/non-inclusion arrangement or duplicate loss arrangements from the Tested Jurisdiction's PBT, and
- Excluding any income tax expense arising from a duplicate tax recognition arrangement from the Tested Jurisdiction's income tax expense.

In addition to detailed definitions of the three types of Hybrid Arbitrage Arrangements described above, the AG contains other definitions and special rules, including special rules for determining the circumstances under which a Constituent Entity will be considered to have "entered into an arrangement" after December 15, 2022, and the circumstances in which a Constituent Entity will not be considered to have a commensurate increase in its taxable income for purposes of determining whether a particular arrangement is a "deduction/non-inclusion arrangement."

Finally, the AG notes that "further guidance will be provided to address hybrid arbitrage arrangements, including those addressed in this guidance, that may otherwise affect the application of the GloBE rules outside the context of the Transitional CbCR Safe Harbor."

Miscellaneous guidance with respect to the Transitional CbCR Safe Harbor (Sections 2.4.1 and 2.5.1)

The AG confirms that the definition of "Simplified Covered Taxes" for the Transitional CbCR Safe Harbor's Simplified ETR computation taken from qualified financial statements includes any adjustments for prior periods, so-called "return to provision" adjustments (but the effect of any uncertain tax position reflected in that adjustment must be removed).

In addition, the AG confirms that when calculating the routine profits test, the substance-based income exclusion amount should be calculated using the Model Rules' transitional rate applicable for the period, *i.e.*, 9.8% for payroll and 7.8% for tangible assets in 2024.

Consolidated revenue threshold (Section 3.1)

The GloBE Rules apply to MNE Groups that have revenues equal to or in excess of €750 million as further qualified in Article 1.1 of the Model Rules. Further guidance has been provided on the meaning of "revenue" for the €750 million consolidated revenue threshold. Revenue includes the "inflow of economic benefits arising from delivering or producing goods, rendering services, or other activities that constitute the MNE Group's ordinary activities" reflected in the profit and loss statement of the UPE's CFS. Revenue amounts shall be determined in line with the relevant accounting standard, which may allow for netting for discounts, returns and allowances, but in any event before

deducting cost of sales and other operating expenses. If different types of revenue are separately presented in the consolidated profit and loss statement of the CFS, they must be aggregated for purposes of determining revenue. Ancillary interest income outside of a group's ordinary activities is not included in revenue, whereas interest would be included if a business offers customer loans as part of its ordinary business and reports interest income in net revenues in the profit and loss statement.

Revenue includes both realized and unrealized net gains from investments reflected in the profit and loss statement of the UPE's CFS, as well as income or net gains separately presented as extraordinary or non-recurring items. Adjustments can be made for investment losses if they are shown separately from investment gains in the CFS to align with net treatment.

If a financial entity does not record gross amounts from transactions in its financial statements, the items considered similar to revenue under the accounting standards of the UPE should be used, *e.g.*, "net banking product" or "net revenues." For example, for a financial entity, revenue includes the net amount of income/gains from a financial transaction such as an interest swap.

Mismatches between financial reporting years (Section 3.2)

Where there is a mismatch between the financial reporting year of the ultimate parent entity and another group entity, the Pillar Two rules follow the approach taken in the UPE's CFS. Similarly, where there is a mismatch between the taxable period of a group entity and the financial reporting year of the MNE group, the group entity should apply the approach used in the UPE's CFS to determine its Adjusted Covered Taxes for the year.

Administrative relief for groups with short reporting years (Sections 5.1 through 5.3)

For groups with a short reporting year the due date for compliance and filing obligations under the full GloBE Rules will not be before June 30, 2026 (the earliest filing date for groups with full reporting years).

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