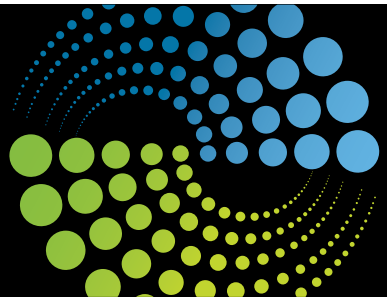
Deloitte.

M&A Tax Talk

Pillar Two

Navigating cross-border M&A in the Pillar Two world



Pillar Two is the OECD's approach to ensuring that multinational entities (MNEs) with a consolidated revenue of at least €750 million pay a global minimum tax of 15% in every jurisdiction where they operate. It is expected that some of the approximately 140 jurisdictions that have committed to introducing the Pillar Two rules will have rules in effect from 2024 onwards. Notwithstanding this, transactions happening now may already impact the MNEs' future Pillar Two position and potential Pillar Two (top-up tax) liabilities.

Key Points

- Acquisitions and dispositions may significantly impact a group's Pillar Two profile both positively and negatively
- Acquisitions can accelerate a company falling within the scope of Pillar Two
- Transactions carried out during the transition period (i.e., before the group is subject to Pillar Two) may affect a group's future Pillar Two liabilities
- Pillar Two considerations should be factored into a deal's cost, contractual documentation, and information sharing.

Who do the rules apply to?

For the purposes of the Pillar Two rules, a group is typically determined with reference to the preparation of consolidated financial statements under accounting principles. The entity preparing such consolidated financial statements will typically be the Ultimate Parent Entity (UPE) of the group, with each entity in the group being considered a Constituent Entity (CE).

The Pillar Two rules will apply where:

- at least one entity or permanent establishment of the group is located in a different jurisdiction from the UPE; and
- the consolidated group revenues within the consolidated financial statements prepared by the UPE are at least €750 million in two out of the previous four financial years. Specific rules apply where groups are combined, merged, or demerged.

Certain entities are excluded from the scope of the Pillar Two rules ("Excluded Entities"), e.g., investment funds and real estate investment vehicles that are UPEs, pension funds, governmental entities, international organizations, non-profit organizations. This means that these excluded entities may not be liable for top-up tax. However, MNE groups held by Excluded Entities may nonetheless be in scope. For instance, private equity funds usually do not consolidate their investment portfolios and in such cases the scoping determination should be performed at the level of investment portfolio groups. For any portfolio company that is an MNE group in scope of Pillar Two, the rules apply to such portfolio company group.

Groups within the scope of the Pillar Two rules will be required to pay additional tax where the effective tax rate (ETR) in a jurisdiction, calculated under the Pillar Two rules (which is calculated differently than domestic tax charges), is below 15%. Such tax may be paid by a low-tax subsidiary itself, a group's UPE, or an intermediate holding company in the group. However, in some circumstances, the tax might be collected by subsidiary companies under an alternative charging mechanism.

What Pillar Two M&A considerations are top-of-mind?

Acquisitions and divestitures may influence the group's Pillar Two profile and whether a group falls within the scope of the Pillar Two rules.

For illustration, a US corporation acquires a foreign MNE or another US corporation with foreign subsidiaries. Both the acquiring company and the target are not within the scope of Pillar Two before the transaction, however the group post-transaction (including an acquiring group and a target group) is expected to exceed the €750 million consolidated revenue threshold (which is to be met in any two of the four years preceding the tested year). Where two groups are combined to form a single group, the consolidated revenue for purposes of the Pillar Two rules are deemed to be the sum of the consolidated revenues of each group with respect to each tested year. Consequently, all constituent entities of the combined group are expected to fall within the scope of the Pillar Two rules. As far as the US profits of such combined

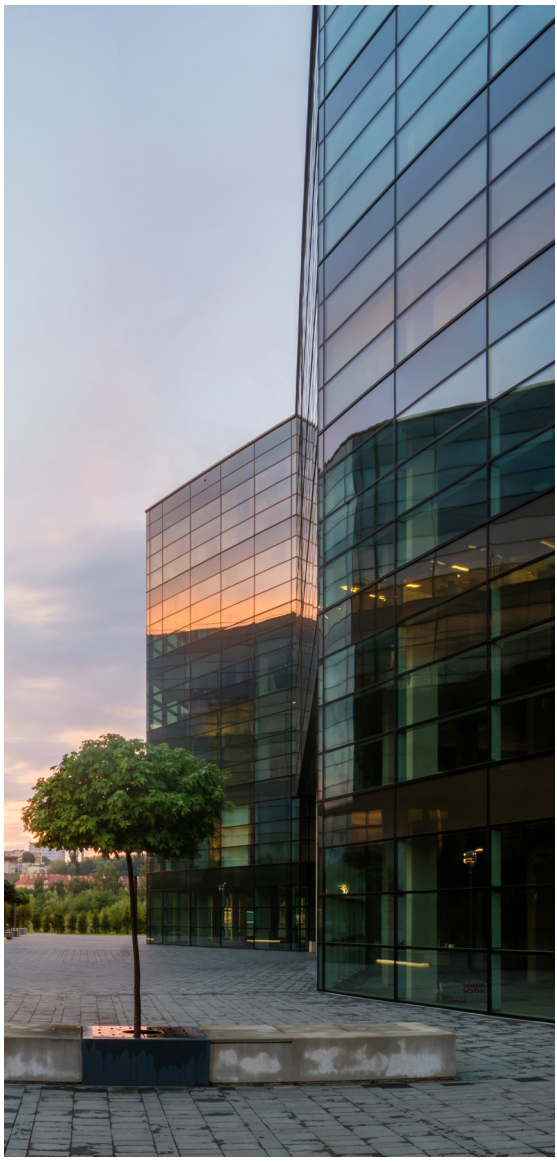
group are concerned, they are not expected to be subject to top-up tax in 2024 given that the US has not introduced Pillar Two rules yet. However, from 2025 onwards, some foreign subsidiaries of this combined group may potentially collect the top-up tax attributable to the US entities under the Undertaxed Profits Rule (UTPR). As a short-term measure, the US group may elect to apply one of transitional safe harbor rules granting a transitional relief from top-up tax liability as well as the compliance obligation of preparing full Pillar Two calculations.

In another scenario, an acquiring company already may be above the €750 million threshold when the target group, which is below the Pillar Two revenue threshold, joins the consolidated group. In this case, all constituent entities of the new MNE group are expected to fall within the scope of the Pillar Two rules immediately after an acquisition (assuming the Pillar Two threshold is met in any two of the four years prior to the tested year). Including the target and its subsidiaries (which could be in various jurisdictions) would impact the Pillar Two profile of such acquiring group, its ETR in various jurisdictions (due to jurisdictional blending), and reporting obligations.

Private equity purchasers may get a bidding advantage on a target that is below the Pillar Two threshold assuming they do not consolidate it with any other existing investment portfolios, thus the target should remain outside of Pillar Two. A corporate acquirer that is required to consolidate the target, would likely need to consider Pillar Two implications. Similarly, from private equity perspective, it may be harder to implement bolt-on acquisitions where the original portfolio investment is near the Pillar Two revenue threshold.

In the context of an M&A transaction, it is also important to consider any transactions carried out after November 30, 2021, and before the first year when Pillar Two applies ("Transition Period"), as certain attributes may carry over from such transactions and impact the combined group Pillar Two profile. This is because there is a special transition rule prescribing the use of the seller's historic carrying value in the acquired assets for Pillar Two where assets are transferred between any constituent entities in the Transition Period with the deferred tax assets and liabilities (DTA/DTL) brought into Pillar Two calculation determined on that basis. Further, DTA and DTL in the transition year should be recorded at the lower of the 15% minimum rate or the applicable domestic tax rate. In share deals, if the seller has had reorganizations, intellectual property transfers, carve-outs or executed any assets sales or deemed assets sales prior to the transaction, they could create a mismatch between the profit generated for accounting purposes and the tax books, and result in a lower ETR in the respective jurisdiction, thus impacting the buyer's Pillar Two position, top-up tax liability and cash taxes.

The new Pillar Two regime may significantly impact future jurisdictional ETRs, cash taxes, and compliance obligations; such impact should be considered by buyers and sellers early in the process of preparing for a transaction. These implications may even impact the return on investment in a transaction. By incorporating Pillar Two considerations into due diligence, deal modeling, and structuring, buyers and sellers can better understand Pillar Two tax implications and mitigate the impact of Pillar Two or even identify potential benefits that might have been overlooked. Both parties must navigate the timing differences and mismatches in recognition of income, particularly the losses in accounting and tax books. They must manage the timing and impact of various elections to be made for Pillar Two purposes (e.g., elections of



safe harbors, equity investment inclusion election, GloBE loss election). In some cases, an acquisition could have a beneficial Pillar Two impact for an MNE. For instance, from the acquiring entity's perspective, if the target group has a higher ETR in a particular jurisdiction than the acquiring group, such ETR may potentially increase the lower ETR of the acquiring group in this jurisdiction due to jurisdictional blending.

Tax modeling and due diligence is more complex with Pillar Two. Due diligence will be needed to gather the appropriate information in order to identify jurisdictions with potentially low ETR and to model top-up taxes. The key Pillar Two complexity for modeling is the need to overlay the limited information available about the target's and seller's Pillar Two profile with the Pillar Two model of the wider acquiring group, and in certain cases, with the Pillar Two position of the seller. Engaging tax teams with Pillar Two knowledge early in the transaction process is essential for collecting data required for due diligence of Pillar Two positions, assessing potential top-up tax liabilities, estimating the economic value of a potential tax shield, and determining the deal's pricing strategy.

A deal structure in the Pillar Two world must be tailored to the unique facts and circumstances of the acquiring, target and to certain extent the seller's groups. Particularly in cross-border transactions, the tax considerations are more complicated due to specific Pillar Two rules and differences in tax treatment in multiple jurisdictions within the transaction's perimeter. For example, considerations should be given to structuring acquisition type (assets vs. share deals), pre-packing the assets (carve-outs), intangible property (IP) transfers, split ownership deals, purchase price composition, choice of holding company jurisdiction, and acquisition financing structure, to mention a few.

There will be new risks to be allocated and negotiated between the parties. Contractual protections will be highly dependent on the structure of the transaction, jurisdictions involved in the transaction, and any due diligence considerations that arise. The buyers, at the minimum, would want to structure indemnities to protect their interests with regard to any top-up taxes incurred during the pre-closing period and any potential secondary tax liability, both of which may arise where an acquired target entity bears joint and several liability for the top-up tax obligations of the other seller's constituent entities.

Pillar-Two specific representations and warranties may include assurances regarding the accuracy of financial statements, the recognition of DTAs and DTLs, Pillar Two elections made by the seller and establish appropriate information-sharing rights in the post-close period. By carefully considering Pillar Two specific indemnities, representations, warranties, and information-sharing mechanisms, stakeholders can navigate the Pillar Two complexities in M&A transactions with greater confidence.

Finally, after the acquisition is complete, the entities should be integrated by the group into a comprehensive data-reporting and compliance system. The burden and cost of such integration efforts should be considered early and factored into the deal negotiations.

For a deeper understanding of Pillar Two aspects in M&A and insights into how Pillar Two could affect your transaction process please refer to exhibits to this article.

What can you do today?

The Pillar Two rules will continue to evolve. There will be more administrative guidance in the future and more countries will introduce Pillar Two rules in their legislation, likely with differences from country to country. Consequently, the parties will likely require more time to negotiate deal terms and transactional documents before the common-market standards for Pillar Two are widely established in cross-border deals.

To effectively address these challenges, it is advisable to initiate Pillar Two discussions early on with the companies' internal tax teams and external tax advisors. Aligning your M&A pre-deal planning and structuring with the overall group's Pillar Two considerations and integrating it into due diligence and deal modelling process can help the companies better navigate the impact of Pillar Two rules on deal economics and enhance efficiency and value of your investment.

Exhibits

1. Due diligence and modeling

Tax modeling is expected to be more complex with a Pillar Two overlay, not only because companies need to model deferred taxes, covered taxes, and top-up taxes, which are complex and subject to many adjustments under the Pillar Two rules, but also because there may likely be limited information available on the target's and the seller's Pillar Two profiles, and it has to be overlayed with the wider acquiring group's Pillar Two profile. Gathering information throughout the transaction process could be helpful for buyers looking to model Pillar Two tax liabilities and understand the group's Pillar Two tax profile post-close.

There are no historical Pillar Two liability and tax returns yet to assess in due diligence. When Pillar Two rules are enforced, there likely will be additional challenges in collecting relevant information and assessing the related tax implications. Particularly in early periods, the information required to determine historical exposures related to Pillar Two might not be readily available or might take time for the seller and target to prepare. Where a large multinational group is acquiring a smaller group, the purchaser may be within the scope of Pillar Two rules while the target group is not. It is likely that in these circumstances, the target's management may have very little awareness about the Pillar Two position of that group, which would likely affect the availability of information needed to assess the target's Pillar Two position. If the target group was carved out from a larger multinational group, the Pillar Two position of the target may depend on the wider Pillar Two position of the seller, which the seller may be unwilling to disclose.

Even where detailed information is available, undertaking a Pillar Two analysis to evaluate historical exposures is likely to be a time-consuming exercise due to the need to scrutinize additional documents that were not traditionally part of the tax due diligence process, e.g., statutory accounts working papers, calculations of deferred tax assets and liabilities (DTAs and DTLs), and Country-by-Country reporting (CbCR).

To effectively tackle these challenges, it is anticipated that buyers will, aim to identify some of the key aspects of the target's tax profile that could signal a low ETR in specific jurisdictions. Indicative factors may include the presence of entities operating in jurisdictions with tax rates below or close to 15%, the utilization of tax holidays and temporary tax reliefs within the target group, and instances where tax amortization or depreciation exceed accounting amortization or depreciation (which often result from asset basis step-ups). It is equally important to review permanent deductions in tax computations, such as those related to research and development tax incentives, innovation incentive regimes like patent boxes, environment, social, and governance (ESG) tax incentives, and enhanced fixed asset deductions or super-deductions. Further, it is imperative to scrutinize any cross-border and domestic asset transfers and transactions in the Transition Period that are treated like asset sales from an accounting perspective (e.g. prepayments of royalties or rents, capital leases, sale of a controlling interest, total return swaps, migration or relocation of an entity resulting in step-up in basis or carrying value of the relocated assets, or changes in fair value accounting).

2. Deal structuring

Incorporating the Pillar Two framework in the deal structuring process requires careful consideration of the unique circumstances at hand. Certain straightforward tax considerations, like tax deductions for amortization of IP or for interest expenses on debt financing, may yield different results when the Pillar Two implications are factored in. In cross-border transactions, the tax considerations are even more complicated due to specific Pillar Two rules and differences in tax treatment in multiple jurisdictions within the transaction's perimeter. For example, when structuring a transaction, you have to consider the interaction US tax rules that treat an acquisition of an entity as an asset acquisition (such as a sale of a DRE or a target to which a section 338 election applies) with the Pillar Two rules, which may treat the acquisition as a sale of stock and eliminate any increases in carrying value or DTAs. Further, purchase accounting adjustments in share deals are generally disregarded for Pillar Two purposes.

Safe-harbor rules

MNE Groups that are expected to fall within the scope of Pillar Two rules post-acquisition may benefit from the application of "transitional safe harbor" rules. The transitional safe harbor may provide a MNE group with a temporary exemption from top-up tax payments in certain jurisdictions. There are two rules: a transitional CbCR safe harbor available for years beginning on or before December 31, 2026, and a transitional UTPR safe harbor available in the fiscal years beginning on or before December 31, 2025. Further exclusion is available under the "permanent Qualified Domestic Minimum Top-up Tax (QDMTT) safe harbor." These safe harbor rules are subject to specific eligibility requirements.

Since acquisitions may impact a MNE's Pillar Two profile post-close, it may also affect its safe harbor eligibility in various jurisdictions.

Split-ownership structures

Some acquisitions may involve Joint-ventures (JVs), Partially Owned Parent Entities (POPEs) or Minority Owned Constituent Entities (MOCEs) within the target group and any potential co-investors. In this case, the parties must manage the Pillar Two implications for co-investor parties (e.g. the tax profile of one investor may impact taxes payable by the POPE, or the investor may be required to pay top-up taxes because of its investment in the POPE). As a result, the investors may need to determine whether such tax cost will be shared between investors, or whether a particular investor will bear the cost due to its own Pillar Two profile.

Because some investors may be potentially disadvantaged while investing in JV groups, particularly structures involving the POPEs (due to specific Pillar Two rules), the parties need to consider how that situation will be managed, often through drafting of the shareholders agreement.

Earnouts

In some deals, the seller may be entitled to an earnout. The tax treatment of such compensation is a complex area and depends on the language of the agreement and the local tax rules. This complexity may potentially lead to a mismatch in income recognition between accounting and tax books, thereby influencing the Pillar Two calculations.

Holding companies

One crucial consideration for acquisition structuring is the choice of the jurisdiction for the group holding company.

This decision can have far-reaching implications in the context of the evolving landscape of global taxation, including the implementation of Pillar Two.

In the early years, the timing of Pillar Two implementation by various jurisdictions may impact the choice of jurisdiction. For instance, Singapore, Hong Kong and other jurisdictions have stated their intention to implement Pillar Two legislation from 2025. This means that any top-up tax attributable to these jurisdictions with respect to 2024 could be collected through an Income Inclusion Rule (IIR) by other jurisdictions adopted Pillar Two. Alternatively, choosing a holding jurisdiction that has not yet implemented Pillar Two could help delay application for one extra year.

In later periods, jurisdictions that have not adopted Pillar Two may potentially become less attractive as holding jurisdictions because in the absence of safe harbour exemption additional top-up taxes may be levied at the subsidiaries level via UTPR. As a result, the top-up tax computations and compliance will become more complex where the holding company jurisdiction does not assess top-up tax and the UTPR apply.

Acquisition financing

When evaluating financing options, it is essential to take into account the Pillar Two implications. For example, consider how the choice of debt instrument or financing strategy (e.g., debt push-down) impacts jurisdictional ETRs, whether the financing structure facilitates the efficient reallocation of interest expenses and income between jurisdictions (including utilizing excess ETR capacities), whether the chosen structure may fall under Pillar Two anti-abuse rules, and how it interacts with local General Anti-Abuse Rules (GAARs).

Additionally, it's crucial to analyze the potential effects of foreign exchange (FX) differences on debt instruments and FX management on jurisdictional ETRs. For instance, a potential mismatch can occur when Pillar Two recognizes FX gains and losses in calculating GloBE income, while a domestic tax regime only expects tax to be paid upon realization. Depending on the broader group's tax profile under Pillar Two and the magnitude of FX gains and losses in future periods (which can be challenging to predict), these factors may lower the group's ETR, making it more likely to incur a top-up tax liability.

3. Contractual protections

Currently there is no universally accepted standard language to comprehensively articulate Pillar Two concerns. While general indemnities can provide a certain degree of protection, it is advisable to incorporate explicit provisions tailored to the specifics of Pillar Two.

At a minimum, indemnities should be structured to protect the buyer's interests with regard to any top-up taxes incurred during the pre-closing period. Additionally, provisions pertaining to secondary tax liability should be considered. For example, the target entities in share deals may potentially assume top-up tax liabilities associated with the seller's constituent entities. While the target entity itself might not be subject to top-up tax, it could bear joint and several liability for the top-up tax obligations of the seller's constituent entities.

From the buyer's perspective, representations and warranties should include Pillar Two-specific provisions to allocate the respective risks between the parties. The buyer would want to include assurances regarding the

accuracy of financial statements, the recognition of DTAs and DTLs, and any Pillar Two elections made by the seller. Further, transaction documents should establish appropriate rights for access to information during the post-close period to facilitate transparency and compliance with Pillar Two requirements.

4. Post-deal considerations

Once the deal is closed, the parties will have to continue cooperating at a higher level to comply with the Pillar Two reporting requirements, especially in light of potential future disputes with tax authorities.

Upon an acquisition, the entities should be integrated by the group into a comprehensive data-reporting and compliance system. Tax and finance will have to work together to determine the Pillar-Two relevant data of the acquired group and its location, identify potential enhancements to the existing systems, and determine whether tax technology systems should be updated to enable real-time capture of the data required to populate Pillar Two returns.

Finally, Pillar Two implications should be considered while developing a remediation plan for the tax risks identified during the transaction process and any future reorganization/integration plans should align with the MNE's global Pillar Two tax goals.

Want to learn more?
Reach out to our contacts below.

Estella Dzhantukhanova
International Tax
Managing Director
Deloitte Tax LLP
esdzhantukhanova@deloitte.com

Daniel Sirken
Mergers & Acquisitions
Tax Partner
Deloitte Tax LLP
dsirken@deloitte.com

Lindsay Wietfeld
Mergers & Acquisitions
Tax Partner
Deloitte Tax LLP
lwietfeld@deloitte.com