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European Commission's response to the OECD Pillar 2 model rules

Introduction

On December 22, 2021, the European Commission published a proposed EU directive to incorporate Pillar Two into EU law. The rules generally mirror the OECD model rules released on December 20, 2021 (see our previous memorandum and the more in-depth analysis authored by KPMG International member firms) but have a broader scope that includes large-scale purely domestic groups. The proposed Directive also clarifies the interaction between the Pillar Two income inclusion rule (IIR) and existing EU legislation on controlled foreign companies (CFCs). On the same date, the European Commission published its proposal for funding the EU budget for 2022. In particular, the Commission has proposed that 15 percent of the revenue generated under Pillar One of the OECD BEPS 2.0 proposals would be contributed by Member States to the EU budget, in lieu of the previously discussed EU COVID digital levy.

Pillar Two Implementation in the EU

In order to ensure a consistent and harmonized implementation across the EU, the EC has proposed that the agreement reached at OECD level would be implemented through a Directive, the proposal for which was tabled on December 22, 2021. In this regard, the Commission has noted that in an EU market of highly integrated economies, there is a need for common strategic approaches and coordinated action, to improve the functioning of the EU internal market and to maximize the positive impact of minimum effective taxation of business profits. In the Commission's view, this can only be achieved if legislation is enacted centrally and transposed in a uniform fashion across the EU.

The proposed Directive is closely aligned with the OECD model rules and seeks to implement the OECD rules in a manner which is compatible with the EU Treaties, as interpreted by the Court of Justice of the EU, and existing EU legislation. To achieve consistency with EU law, particularly the principle of freedom of establishment, the Directive is not limited to cross-border situations but also applies to domestic groups and requires the Member State of a constituent entity applying the IIR, which is usually the jurisdiction of the UPE, to ensure effective taxation at the minimum agreed level, not only of foreign subsidiaries but also of all constituent entities resident in that Member State and permanent establishments (PEs) of the MNE group established in that Member State.

General Scope

The Directive will apply to entities resident in a Member State and to non-EU resident entities of an EU parented entity that meet a revenue threshold where consolidated group revenue exceeds EUR 750 million in at least two of the last four consecutive fiscal years.

In addition, the Directive will also apply to large-scale domestic groups – groups in which all the group entities are located in a single EU Member State – that meet the scoping thresholds, with specific transitional rules included for large-scale domestic groups. The Commission notes that this framework should eliminate any risk of discrimination between cross-border and domestic situations.

Application of the Income Inclusion Rule (IIR) and the Under Taxed Payments Rule (UTPR)

- Where the Ultimate Parent Entity (UPE) is located in the EU, the UPE will be required to apply the IIR top-up tax in respect of its low-taxed constituent entities in other EU Member States and third countries. Where the UPE is itself located in a low-taxed jurisdiction, it will be subject to the IIR top-up tax together with its low-taxed constituent entities in the same Member State.
- Where the UPE is located outside the EU, the low-taxed constituent entities may be subject to the IIR top-up tax if the UPE jurisdiction applies the IIR. However, if an intermediate parent entity (IPE) or partially-owned parent entities (POPE) are located in the EU, then the IPE/ POPE will be subject to top-up tax in respect of any directly or indirectly owned low-taxed constituent entities.
- Provision is also made for cases where the POPE and UPE are both located in the EU. While the UPE would typically be required to charge the top-up tax, there may be cases where the primary taxing right lies with the Member State of a POPE. In this case, a bottom-up approach is required, the IIR top-up tax applied at the level of the lowest POPE in the chain, with other POPEs and the UPE receiving credit for the tax suffered by POPEs lower in the chain.

The proposed Directive provides an option for Member States to apply a Domestic Top-Up Tax to constituent entities located in that Member State. Where a Domestic Top-Up Tax is put in place, the parent entity applying the IIR under the OECD Pillar 2 model rules will be required to give credit for the Domestic Top-Up Tax when calculating the top-up tax payable for that jurisdiction. The proposed Directive provides that in circumstances where the UPE is located outside the EU in a jurisdiction that does not apply a qualifying IIR, all its constituent entities in jurisdictions with an appropriate UTPR framework will be subject to the UTPR. In this circumstance, constituent entities of such an MNE group that are located in a Member State will be apportioned, and will have to pay in their Member State a share of the top-up tax linked to the low-taxed subsidiaries of the MNE group. The calculation and allocation of the UTPR top-up tax in the Directive is based on the same two factors provided for under the OECD rules: number of employees and carrying value of tangible assets.

Calculation of the Qualifying Income or Loss

The rules for the determination of Qualifying Income and the determination of the Adjusted Covered Taxes are in line with the OECD Pillar 2 model rules.

Calculation of Effective Tax Rate (ETR) and the Top-Up Tax

The rules for the calculation of the ETR and the Top-Up Tax are in line with the OECD Pillar 2 model rules.

Special Rules for Mergers and Acquisitions

Similar to the OECD Pillar 2 model rules, the proposed Directive contains special rules in respect of mergers, acquisitions, joint ventures and multi-parented MNE groups, with specific rules on revenue thresholds in a merger / de-merger situation, value adjustments for components of the GloBE rules (e.g. eligible payroll costs, GloBE deferred tax assets), rules for recognizing gains or losses on asset and liability transfers and special provisions for joint-venture entities which would not otherwise be included in the definition of an MNE group for GloBE purposes.

Tax Neutrality and Distribution Regimes

In line with the OECD Pillar 2 model rules, the proposed Directive contains specific provisions to compute the income of a UPE where that UPE is a flow-through entity or subject to a deductible dividend regime. There are also specific rules and election options for determining the ETR of an investment entity. The treatment of distribution tax systems also follows the approach of the OECD model rules. Broadly, a distribution tax system means that the taxation of corporate profits is deferred until the profits are distributed. The Directive provides that, on making an annual election, a deemed distribution tax is included in the calculation of the adjusted covered taxes of the relevant constituent entities. There is a requirement to maintain a deemed distribution tax recapture account for each fiscal year for which the election is made. If, in a four-year period, no tax is paid at the minimum rate and the constituent entity has not incurred an allowable loss, then top-up tax is payable based on the outstanding balance of the recapture account for the year in question

Specific Application of the IIR to Large-Scale Domestic Groups

The proposed Directive provides that the UPE of a large-scale domestic group should be subject to the IIR top-up tax for its low-taxed constituent entities. However, transitional rules are provided for large-scale domestic groups whereby the top-up tax will be reduced to zero for the first five years in which the group comes within the scope of the Directive.

Final Provisions: interaction with US GILTI system

The provisions of the proposed Directive refer to the equivalence of the laws of certain third country jurisdictions to the IIR and sets out conditions which need to be fulfilled for granting equivalence. In particular, the equivalence of the US GILTI system and more specifically, its features as they will emerge from the currently pending US tax reform. After the US tax reform has been completed, the Commission notes in the Explanatory Memorandum that it will assess whether the US rules fulfil the conditions for equivalence.

Pillar One Implementation in the EU

While the 137 Inclusive Framework members also endorsed proposals for Pillar One of the BEPS 2.0 international tax framework on October 8, 2021, the OECD has conceded that the timeline for Pillar One is not as advanced as Pillar Two and that technical negotiations remain ongoing. Currently, it is expected that an OECD multilateral convention containing the Amount A rules of Pillar One, as well its explanatory statement and model domestic legislation and commentary, are expected in early 2022. Rules for Amount B of Pillar One are expected by the end of 2022. From an EU perspective, EU Commissioner for Economy – Paolo Gentiloni – has previously stated that for Pillar One, the Commission will "carefully examine whether a directive is needed to ensure its consistent and effective implementation at EU level". On December 14, 2021, the European Commission published its indicative work program for the first half of 2022 and the indicative deadline for a proposal to implement the OECD Pillar One proposals is currently listed as July 27, 2022.

On December 22, 2021, the EU Commission also published its budget plan for 2022, which includes certain tax measures that will be considered to be "own-resources" for the EU budget (i.e. amounts collected by the Member States but allocated to the central EU budget). Included within the budget plan is an EU own-resource whereby Member States would provide a national contribution to the EU budget based on the share of 15 percent of the taxable profits of multinational enterprises re-allocated to each Member State under Pillar One. The Commission's budget estimates that this could generate revenues of up to EUR 2.5 and 4 billion annually.

KPMG Meijburg & Co Comments

The proposed Directive is to a large extent similar to the OECD Pillar 2 Model rules. What is new is the fact that large domestic companies will also be covered by the rules and the fact that EU Member States may introduce a Domestic Top-Up Tax that could limit the revenue of jurisdictions further up the chain that apply the IIR. Further OECD Commentary on the Pillar 2 model rules are expected early in 2022. As regards Pillar 1, it is still unclear what the future may hold in store.

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