

Pillar Two Commentary and public consultation on the Implementation Framework

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Issue 4

In brief

Further to the BEPS 2.0 Pillar Two Global Anti-Base Erosion (GloBE) Model Rules released on 20 December 2021¹, the Organisation for Economic Co-operation and Development (OECD) released the Commentary and the illustrative examples to the GloBE Rules² on 14 March 2022. The Commentary provides technical guidance and elaborates on the application and operation of the GloBE Rules, which is intended to promote a consistent interpretation to facilitate coordinated outcomes for both tax administrations and multinational enterprise groups (MNE Groups). In the meantime, the OECD is also seeking public input on the GloBE Implementation Framework³, with comments due on 11 April 2022.

In detail

Background

There are 137 Inclusive Framework (IF) Members that have signed up to the 8 October 2021 *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*⁴ (the Statement). Following that, the OECD released the Model Rules covering the Income Inclusion Rule (IIR) and Undertaxed Profits Rule (UTPR)⁵ on 20 December 2021. The OECD further released the Commentary and the illustrative examples to the GloBE Rules on 14 March 2022. The Commentary provides technical guidance on the interpretation and application of the GloBE Rules, explains the intended outcomes and clarifies the meaning of certain terms under the GloBE Rules. The examples illustrate the application of the rules to certain fact patterns but they are intended to be used for illustrative purposes only and do not form part of the Commentary. Additional examples may be developed and published in the future as necessary.

The Model Rules and the Commentary are the first two of three expected sets of guidance on the GloBE Rules. The third will be the Implementation Framework, which remains to be developed and will cover administrative, compliance and coordination issues relating to the GloBE Rules.

In terms of timeline, Pillar Two is expected to be brought into law in 2022, with the IIR to be effective in 2023 and the UTPR to come into effect in 2024. Jurisdictions that decide to implement the common approach set out in Pillar Two will ultimately determine the time frames for their territory.

For the Subject to Tax Rule (STTR), more details are expected to come out soon with a public consultation on the draft model provision, commentary and the development of a multilateral instrument⁶.

Highlights of the Commentary⁷

1. Application of the UTPR

Article 2.4 of the Model Rules provides that for the purpose of collecting UTPR Top-up Tax, Constituent Entities of an MNE Group in a jurisdiction shall be denied a deduction for otherwise deductible expenses (or be subject to an equivalent adjustment under domestic law) in an amount sufficient to result in an additional cash tax expense equal to the UTPR Top-up Tax allocated to that jurisdiction.

The Commentary reinforces that the denied deduction need not be attributable to a payment made by the Constituent Entity collecting the UTPR Top-up Tax to the Low-Taxed Constituent Entity (LTCE) subject to the Top-up Tax nor a transaction with another Constituent Entity. In other words, such denial of deduction could include a denial of depreciation, amortisation or even purely 'notional expenses' provided under domestic law. Furthermore, there is no prescribed mechanism for an 'equivalent adjustment', which is a matter of domestic law implementation at the discretion of the jurisdictions. Examples of possible adjustments include:

- (i) levying an additional tax directly on a resident taxpayer;
- (ii) imposing a deemed taxable income; or
- (iii) reducing an allowance or deemed deduction.

Our observations: The Commentary appears to further broaden the already open-ended language in the Model Rules and may cause significant uncertainty to taxpayers on how the UTPR Top-up Tax will be imposed. Furthermore, the lack of any nexus between an LTCE and the Constituent Entity collecting the tax may give rise to questions concerning the legal basis for the tax and its compatibility with tax treaties. This in turn leads to the broader question as to whether the UTPR Top-up Tax will be a corporate income tax or a novel tax with its own collection mechanism and rules (with a potential effect on foreign tax credits).

2. Offset mechanism of the UTPR Top-up Tax

Article 2.5.3 of the Model Rules expands the scope of UTPR beyond the scope of IIR in certain cases where minority interest in an LTCE is involved. The UTPR operates in a manner that subjects all of an LTCE's income to Top-up Tax without having regard to the Allocable Share (i.e. the pro-rata share) held by the MNE Group. In certain circumstances, the MNE Group may need to bear the UTPR Top-up Tax that economically belongs to the minority shareholders.

The Commentary notes that this approach simplifies the application of the UTPR and allows for a greater tax expense than the Top-up Tax that would have been collected had the IIR applied at the Ultimate Parent Entity (UPE) level. Example 2.5.3-1 in the illustrative examples demonstrates the application of this provision.

Our observations: The Commentary identifies simplicity as the driving factor behind Article 2.5.3 even though from a policy perspective, the overall Top-up Tax under IIR and UTPR should be limited to the UPE's Allocable Share.

3. Arm's length requirement for cross-border and domestic related-party transactions

Article 3.2.3 of the Model Rules requires an adjustment to cross-border transactions between Constituent Entities that are (i) not recorded in the same amount in the financial accounts of each entity or (ii) not at arm's length. It also requires transactions between two Constituent Entities in the same jurisdiction to be priced at arm's length if such transactions involve a sale or transfer of an asset that produce a loss and that loss is taken into account in the computation of GloBE Income or Loss.

The Commentary clarifies that the requirement for cross-border transactions is intended to avoid situations where a difference between the financial accounts and taxable income (with respect to a related-party transaction) leads to double taxation or double non-taxation under the GloBE Rules. The Commentary further specifies when transfer pricing adjustments are needed and includes examples of the adjustments required under different scenarios, for example, where a bilateral Advance Pricing Arrangement has been agreed or a unilateral transfer pricing adjustment has been made.

With regard to domestic transactions involving a sale or transfer of an asset that produces a loss, the Commentary clarifies

that this requirement is intended to prevent MNE Groups from ‘manufacturing losses’ in a jurisdiction through sales or transfers at prices not at arm’s length. Further, the Commentary clarifies that transactions with Minority-Owned Constituent Entities (which are separately accounted for under the GloBE Rules) as well as Investment Entities (which are excluded from the computation of GloBE Income or Loss) in the same jurisdiction must be recorded at arm’s length.

Our observations: The arm’s length requirement under Article 3.2.3 is complex and may lead to inconsistent interpretation and application by different jurisdictions which could result in double taxation issue. To mitigate these potential problems, a mechanism should be put in place by the OECD to ensure consistent application of these concepts among jurisdictions.

4. Deferred tax attributes

Article 4.4.1 of the Model Rules provides that deferred tax attributes are taken into account at the lower of the statutory rate or the Minimum Rate of 15%. With respect to the deferred tax asset arising from tax losses, the Commentary has not prescribed a time limit for utilising the tax losses generated before the introduction of the GloBE Rules (as has been suggested for the tax base determinations of Amount A under Pillar One⁸).

Our observations: The Commentary does not elaborate further on the rationale for recasting deferred tax amount at the Minimum Rate. Constituent Entities in a jurisdiction using the statutory rate to calculate the deferred tax expense will suffer detriment when utilising tax losses as they will not get full recognition of the deferred tax asset for GloBE purposes.

Open issues

1. Safe harbour rules

While the GloBE Safe Harbour rules will only be developed as part of the Implementation Framework, the Commentary notes that such rules should exempt an MNE Group from computing the jurisdictional effective tax rate (ETR) and allow a tax administration to deem the Top-up Tax for the Constituent Entities located in the safe harbour jurisdiction to be zero for a fiscal year provided that the relevant conditions are met. The Commentary further notes that the Implementation Framework could explore whether a GloBE Safe Harbour could cover situations where no Top-up Tax would be due (for instance, in respect of a jurisdiction where MNE Groups are subject to a Qualified Domestic Minimum Top-up Tax).

Our observations: The development of broad, simple and administrable GloBE Safe Harbour rules is vital to the administration and implementation of the GloBE Rules by MNE Groups, in light of the overwhelming complexity and additional compliance requirements posted by the rules. The delay in releasing the Safe Harbour rules may significantly impede the MNE Groups’ implementation of the necessary system changes in order to meet the aggressive timeline under the GloBE Rules.

2. Policy-related issues

Article 4.1.5 of the Model Rules provides the possibility of a Top-up Tax in a year when there is no GloBE income while Article 4.4.1 provides that deferred tax should be recast at the Minimum Rate of 15% if the statutory tax rate exceeds 15%. The Commentary confirms that the rather surprising outcome of these provisions is the result of conscious design rather than unintended consequence.

Our observations: As pointed out by the Business at OECD (BIAC) in its 6 January 2022 public letter to the OECD⁹, it is a policy principle of Pillar Two to look at the ETR over a period of time to neutralise the consequences stemming from the application of the annual accounting concept. Articles 4.1.5 and 4.4.1 have fundamentally departed from this principle. The BIAC further identified Article 4.1.5 as being inconsistent with the overall policy goals articulated in the preamble of the Model Rules, which states that the minimum tax is applied to income and the Top-up Tax is imposed on profit.

Public consultation on the GloBE Implementation Framework

The OECD is seeking public input on the Implementation Framework. The focus is on issues around the administration, operation, compliance and coordination of the GloBE Rules rather than the policy choices in the Model Rules or Commentary. Comments are due on 11 April 2022 and a public consultation meeting will be held virtually at the end of April 2022.

The takeaway

While the Commentary attempts to explain the Model Rules in a more accessible way, there are still outstanding issues which hopefully will be addressed in the Implementation Framework to be developed.

As mentioned in the 2022/23 Hong Kong Budget delivered by the Financial Secretary on 23 February 2022, the HKSAR Government will maintain communication with the affected MNEs to enable them to familiarise with the new tax rules as soon as possible. The HKSAR Government's current plan is to submit a proposal to the Legislative Council in the second half of this year to implement the Pillar Two and other relevant requirements in accordance with the international consensus. Meanwhile, to safeguard Hong Kong's taxing rights, the HKSAR Government is also considering introducing a domestic minimum top-up tax from the year of assessment 2024/25 to ensure that the affected MNEs' ETR reaches the global minimum tax rate of 15%.

Endnotes

1. For details of the GloBE Model Rules, please refer to our *International Tax News Flash – Hong Kong, January 2022, Issue 1*, which can be accessed via this link:
<https://www.pwccn.com/en/tax/publications/intl-tax-newsflash-jan2022-1.pdf>
2. The Commentary and illustrative examples to the GloBE Rules can be accessed via this link:
<https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm>
3. The relevant press release from the OECD can be accessed via this link:
<https://www.oecd.org/tax/oecd-invites-public-input-on-the-implementation-framework-of-the-global-minimum-tax.htm>
4. 137 out of 141 member jurisdictions of the OECD/G20 Inclusive Framework on BEPS have joined the Statement as at the date of this publication. For details of the Statement, please refer to our *International Tax News Flash – Hong Kong, October 2021, Issue 4*, which can be accessed via this link:
<https://www.pwccn.com/en/tax/publications/intl-tax-newsflash-oct2021-4.pdf>
5. The acronym 'UTPR' is not actually defined in the Model Rules. While used to be called Undertaxed Payments Rule in the Blueprint, it is now generally referred to as the 'Undertaxed Profits Rule' as it no longer has any nexus with payments.
6. The details of the OECD's upcoming public consultation on tax matters can be accessed via this link:
<https://www.oecd.org/tax/planned-stakeholder-input-in-oecd-tax-matters.htm>
7. For a more detailed discussion of the Commentary, please refer to the *PwC Global Tax Policy Alert, 16 March 2022*, which can be accessed via this link:
<https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-oecd-pillar-2-commentary-and-public-consultation-on-the-if.pdf>
8. For details of the draft Model Rules on the tax base determinations of Amount A under Pillar One, please refer to our *International Tax News Flash – Hong Kong, March 2022, Issue 3*, which can be accessed via this link:
<https://www.pwccn.com/en/tax/publications/intl-tax-newsflash-mar2022-4.pdf>
9. The BIAC's 6 January 2022 public letter to the OECD can be accessed via this link:
<https://biac.org/wp-content/uploads/2022/01/01-06-2022-Business-at-OECD-BIAC-6-Jan-Pillar-Two-Issues-Letter-1.pdf>

Let's talk

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