European Commission's Directive proposal on implementing Pillar Two 15% minimum effective tax rate in the EU

22 December 2021

In brief

On 22 December 2021, the European Commission (EC) published its proposal for a Council Directive "on ensuring a global minimum level of taxation for multinational groups in the Union" (Draft Directive) aimed at implementing the OECD Pillar Two Model Rules on a 15% minimum effective tax rate (see our Tax Policy Alert of 20 December) in the EU Member States.

The Draft Directive closely follows the OECD Model Rules, which set out the rules of the so-called Income Inclusion Rule (IIR) and Undertaxed Payment Rule (UTPR). However it departs from the Model Rules "with some necessary adjustments, to guarantee conformity with EU law." The major key differences are:

- there is an extension of the IIR to 'large-scale' purely domestic groups with consolidated revenues of at least EUR 750 millions in at least two of the four preceding years (however, transitional rules provide for a zero-rate application of the top-up tax due for the first five years of application of the rule);
- the application of the IIR by an Ultimate Parent Entity (UPE), Intermediate Parent Entity (IPE) or Partially Owned Parent Entity (POPE) is extended also to the low-taxed constituent entities located in the same Member State (including the said UPE, IPE or POPE).

No EU Action is provided for at this stage with regard to the related OECD Pillar Two Subject-to-Tax Rule (STTR). The OECD is expected (see here) to release the draft model STTR provision and its commentary in March 2022.

In order to be adopted, the Draft Directive will need to be unanimously approved by all 27 Member States. If successfully adopted, Member States shall then implement the rules into their national systems by 31 December 2022 and apply the related implementing provisions starting from 1 January 2023 (for the IIR) and 1 January 2024 (for the UTPR).

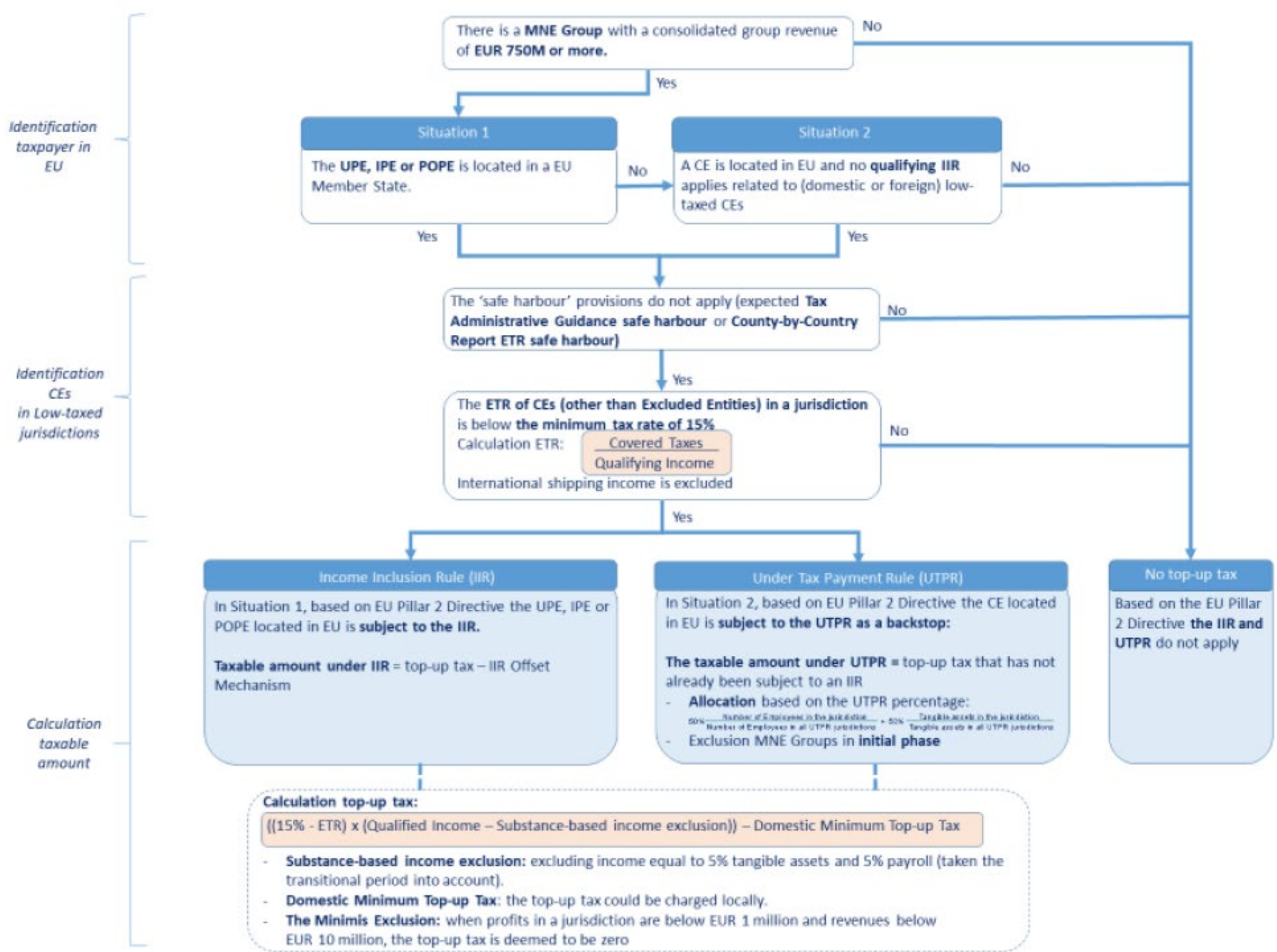
In detail

The Draft Directive: general architecture

Consistent with the OECD Model Rules, the Draft Directive provides for the application within the European Union of a set of rules aimed at ensuring a minimum level of taxation of 15% for large multinational enterprises by means of the interaction between the following two rules (jointly referred to as the 'EU GloBE rules'):

- an IIR imposing a top-up tax on a UPE in respect of the low-taxed income of constituent entities, and
- a UTPR, to be applied as a 'backstop' to the extent the low-tax income of a constituent entity is not subject to tax under an IIR, imposing a top-up tax for a jurisdiction in proportion to an allocation two-factor formula based on the value of tangible assets in the jurisdiction and number of employees in the jurisdiction. No explicit reference is made in the Directive on how the UTPR top-up tax will be levied (e.g. by way of denial of deduction or other means).

The EC has used this graphic to describe the broad steps and organisation of the EU GloBE rules endorsed in the Draft Directive:



Notably, consistent with the OECD Model Rules, the Draft Directive provides for the obligation of a constituent entity of an MNE group located in a Member State to file a top-up tax information return. An exception to this obligation is provided where the return is filed by the MNE group in another jurisdiction with which the Member State has an exchange of information agreement in place. The returns must be filed within 15 months (18 months for the first year) after the end of the fiscal year to which they relate.

The Draft Directive also lays down the obligation for the Member States to apply penalties in case of breaches of the national implementation rules and, with specific reference to the filing obligation, the said penalties shall include an administrative pecuniary penalty of at least 5 % of the constituent entity's turnover in the relevant fiscal year. The penalty shall not apply if the top-up tax information return is provided within six months of the request.

The Draft Directive does not currently set out any administrative simplifications to ease the compliance burden.

The Draft Directive: some key features

The implementation provisions of the Draft Directive closely follow the OECD Model Rules. However, they depart from that document in certain aspects, in the Commission's words, "with some necessary adjustments, to guarantee conformity with EU law» and «to provide taxpayers with legal certainty that the new legal framework is compatible with the EU fundamental freedoms, including the freedom of establishment."

Below are key features of the Draft Directive including some which differ from the OECD Model Rules.

The Draft Directive extends the application of the IIR to so called 'large-scale domestic groups'

The Pillar Two Draft Directive provides for the extension of the scope of the IIR not only to an MNE group having at least one entity or a permanent establishment not located in the same jurisdiction of the UPE, but also to a so called 'large-scale domestic group,' namely an MNE group of which all constituent entities are located in the same Member State with an annual revenue of EUR 750 million or more in its consolidated financial statements in at least two of the last four consecutive fiscal years.

In the explanatory memorandum to the Draft Directive, it is expressly stated that this extension was put in place "to avoid any risk of discrimination between cross-border and domestic situations."

A transitional rule is provided according to which the top-up tax due by an UPE on the basis of the application of the IIR to a large-scale domestic group is reduced to zero for the first five fiscal years, starting from the first day of the fiscal year in which the large-scale domestic group falls within the scope of this Directive for the first time. It is specified that for large-scale domestic groups that will be in scope of the directive at the date of its entry into force, the transitional period shall start on 1 January 2023.

This transitional period is probably necessary to ensure consistency with the one provided to an MNE in the initial phase of their international activity (see below) and therefore avoid a difference of treatment of comparable situations. However in doing so, it may create a difference between cross border and domestic situations.

The Draft Directive extends the application of the IIR by an UPE, IPE or POPE to the low-taxed constituent entities located in the same Member State

Based on the OECD Model Rules, the jurisdiction which applies the IIR shall apply the top-up tax only to the foreign low-taxed constituent entities.

The Draft Directive differs by providing in addition that where an UPE, or in certain specific cases, an IPE or POPE located in a Member State is itself a low-taxed constituent entity, it shall be subject to the IIR top-up tax together with its low-taxed constituent entities located in the same Member State of which it is a resident.

With respect to the application of the above additional rule to an IPE and POPE, specific exclusions are provided:

- as regards the application to an IPE, the rule will not apply if the related UPE is subject to a qualified IIR in the jurisdiction in which it is located or, as an alternative, when another IPE, located in a Member State or in a third State, where it is subject to a qualified IIR for the fiscal year owns, directly or indirectly, a controlling interest in the said IPE;

- as regards the application to a POPE, the rule will not apply if the said POPE is wholly owned, directly or indirectly, by another POPE that is located either in a Member State or in a third-country jurisdiction and which is subject to a qualified IIR for the fiscal year.

Note that the treatment of a domestic IIR under the OECD Model Rules is not entirely clear, i.e. is another jurisdiction applying the GloBE rules to treat it as a qualified IIR or as a domestic minimum tax. In practice it is possible that the end result is the same.

The Draft Directive extends the UTPR temporary exclusion in favour of MNEs in the initial phase of their international activity to the IIR as well

The OECD Model Rules provide for an exclusion from the application of the UTPR for small MNE groups in the initial phase of their international activity provided that such MNE Group: (i) has Constituent Entities in no more than six jurisdictions, and (ii) the sum of the Net Book Values of Tangible Assets of all Constituent Entities located in all the jurisdictions excluding the Reference jurisdiction (being the jurisdiction with the highest total of tangible assets) does not exceed EUR 50 million.

In the Draft Directive, the abovementioned exclusion is extended to the application of the IIR. This additional exclusion, whilst deviating from the OECD Model Rules ensures consistency with the ‘large scale domestic groups’ provision referred to above.

The Draft Directive sets out the rules under which the legal framework of a third country jurisdiction shall be considered as equivalent to the EU GloBE’s IIR

The Draft Directive specifies under which circumstances a foreign (i.e. non-EU) IIR implemented by a third country jurisdiction can be considered ‘equivalent’ to the EU GloBE’s IIR for purposes of the interaction between the two sets of rules. In particular, the equivalence assessment, which will be performed by the Commission, is met if the following conditions are fulfilled by the non-EU IIR:

- it provides for a set of rules where the parent entity shall compute and collect its allocable share of top-up tax in respect of the low-taxed constituent entities of the MNE group;

- it provides for a minimum effective tax rate of at least 15%;

- it allows only the blending of income of entities located within the same jurisdiction; and

- it provides for relief for any top-up tax that was paid in a Member State in application of the IIR set out in the Draft Directive.

The United States minimum tax rules (Global Intangible Low Taxed Income, or GILTI), currently use ‘global blending’ to determine the effective tax rate on foreign income. Amendment of the GILTI rules is currently being considered in the US Congress, including a proposal to calculate the GILTI ETR only allowing jurisdictional blending. The outcome of this legislation is unclear. In its current form GILTI may not be regarded as equivalent under the above conditions.

The Draft Directive provides an option for the Member States to adopt a 'qualified' domestic top-up tax

The Draft Directive provides an option for the Member States to elect to apply a 'qualified' domestic top-up tax. The definition of 'qualified domestic top-up tax' provided in the Draft Directive is consistent with the corresponding definition provided in the OECD Model Rules. In particular, it refers to domestic rules ensuring a minimum effective tax rate in accordance with the rules laid down in the Draft Directive without allowing for any additional 'benefits' related to the said rules.

Member States applying the election for the domestic top-up tax have to notify this choice to the Commission within four months following its adoption. If a constituent entity of an MNE Group is located in a Member State that adopts the qualified domestic top-up tax, such constituent entity shall pay the top-up tax to its Member State.

The Preamble to the Draft Directive specifies that this option was provided "in order to allow Member States to benefit from the top-up tax revenues collected on their low-taxed constituent entities located in their territory."

The domestic top up tax is thus intended to effectively switch off the application of other jurisdictions IIR's or UTPR's. Any excess top-up tax due after the application of the domestic top-up tax would be paid on the basis of the EU GloBE rules.

What's next?

The legal basis for the Pillar Two Draft Directive is Article 115 of the Treaty on the Functioning of the EU (TFEU) which requires the unanimous approval by all 27 Member States. Note that in view of the very tight implementation timeline the Commission has decided not to undertake a public consultation.

If adopted, Member States should bring into force the laws, regulations and administrative provisions necessary to implement the provisions as provided in the directive by 31 December 2022, and to apply the related implementing provisions of the IIR and the UTPR starting from 1 January 2023 and 1 January 2024 respectively.

Let's talk

For a deeper discussion of how the EC Directive might affect your business, please contact:

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