Tax Policy Alert

EU Member States reach provisional agreement on proposed Pillar Two Directive

13 December 2022

In brief

On 12 December 2022 the Committee of the Permanent Representatives of the Governments of the Member States to the European Union (COREPER) agreed in principle on the introduction of a global minimum taxation proposal by the EU Member States (press release). The COREPER decided to advise the Council to adopt the draft Pillar Two Directive and approved the related Council statement. A written procedure for formal adoption of the Directive is expected to conclude on 14 December.

The Directive is being adopted as part of a package, together with decisions to financially support Ukraine (press release) and approve Hungary's national recovery and resilience plan (press release).

In detail

Recap on the developments so far

The original *Draft Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union* was proposed by the EU Commission on 22 December 2021 (see our original Tax Policy Alert for full details). It provides a mechanism by which the 27 EU Member States would implement the Pillar Two GloBE Model Rules published by the OECD Inclusive Framework (IF) on 20 December 2021. The EU proposal is based on the OECD rules, but with several key differences to account for EU law compatibility and to apply the rules to large domestic groups as well as multinationals.

The December 2021 draft Directive was debated and rejected at various ECOFIN meetings throughout 2022 - see our Tax Policy Alert following the March 2022 ECOFIN meeting. A number of compromise texts making changes to the December 2021 version were proposed, notably in March, April and June 2022, but all failed to reach unanimous support. Various EU Member States including Estonia, Malta, and Sweden raised objections to various elements of the rules and these were addressed in the compromise texts. By June 2022, only Poland withheld support for the Pillar Two proposal (citing concerns about the EU adoption of the two-pillar solution, including Pillar One). Poland's support was secured with the inclusion of a statement reaffirming EU support for Pillar One and undertaking to make progress on Pillar One in 2023 at an EU level if there was insufficient progress at a global level.

However, at the same ECOFIN in which Poland supported the proposal, Hungary withdrew the support it had previously given, noting the uncertain economic position, the war in Ukraine and concerns about the European Union being a 'first mover' on Pillar Two. See our Tax Policy Alert here. Until now, it has not been possible to secure Hungary's support for the proposal, despite the efforts of the French and later Czech Presidencies of the EU Council.

On 9 September 2022 five Member States (France, Germany, Italy, Spain and the Netherlands) issued a joint statement to express their full commitment to implement the global minimum tax.

The latest compromise text was published on 25 November 2022, with a view to securing a deal on the proposal before the Czech Presidency ends on 31 December 2022. This compromise text features a number of terminology changes compared to previous iterations, but no substantive changes.

COREPER Meeting of 12 December 2022

At the COREPER meeting on 12 December 2022 (agenda here) EU Permanent Representatives agreed to a package deal on several files under the Czech Presidency of the Council. The deal includes: an agreement on the draft Pillar Two Directive; unblocking financial aid to Ukraine; approval of the Hungarian Recovery and Resilience Plan; and the continuation of the conditionality mechanism for Hungary with a suspension rate of 55%. The package agreed yesterday will be formalised by written procedure (written procedure is used on grounds of urgency - this could be the case where an act must be adopted by a certain deadline but a Council meeting has not been scheduled and cannot be arranged in good time).

Regarding EU funds to Hungary, the COREPER advised the EU Council to adopt the implementing decision approving Hungary's national plan. Hungary will still need to effect 27 'super milestones' regarding institutional reforms to strengthen the rule of law. However, it should then be able to access €5.8bn of EU grants to support its recovery from the COVID-19 pandemic and finance the green and digital transitions. Hungary will not be granted €6.3bn of EU cohesion funds (or 55% of its total allocation) following a suspension of these funds last month by the EU Commission, which cited concerns about the risks of misappropriating the funds. The amount suspended decreased from 65% to 55% as a result of the decision made on 12 December 2022.

Observation: It is assumed that all four of these agenda items were interlinked and Hungary's support for the Pillar Two Directive was contingent on the release of the EU grant funds. The consecutive support for the Hungarian recovery and resilience plan, followed by Hungary's support for the draft Directive would appear to confirm this.

Key differences between the Pillar Two Directive and the OECD's Model Rules

There are several important differences between the Pillar Two Directive (25 November compromise text) and the OECD's Pillar Two GloBE Model Rules, including:

- The date on which Member States must transpose the Directive and make it effective is 31 December 2023. The effective date of the UTPR is pushed to 31 December 2024.
- Article 1(1)(a) provides that the rules shall apply to both MNE groups (with a presence in more than one jurisdiction) and also to large-scale domestic groups (where all of the constituent entities are located in the same Member State).

- Article 5(2) requires an ultimate parent entity (UPE) to apply the IIR to both itself (to the extent it is low-taxed) and all low-taxed constituent entities in its group that are located in the same Member State. The OECD Model Rules do not require this domestic IIR and merely provide that a country may introduce a domestically applicable IIR.

- Article 50 allows Member States with no more than 12 in-scope MNEs headquartered in their state to elect not to apply the IIR and the UTPR for six consecutive fiscal years beginning from 31 December 2023.

- Article 57 commits the Commission "by 30 June 2023 to submit a report to the Council assessing the situation regarding the implementation of Pillar One... and, if appropriate, submit a legislative proposal to address these tax challenges in the absence of the implementation of the Pillar One solution."

- Article 52 provides a list of conditions by which non-EU countries' legal framework will be assessed to determine whether it is equivalent to a qualified IIR. Article 52 also provides that the Commission is empowered to adopt delegated acts to determine the list of non-EU countries that have implemented a legal framework in their domestic law, which can be considered equivalent to a qualified IIR (although the Council can override that).

Council statement

The Council statement reaffirms the commitment of the European Union to the IF's October 2021 statement and invites all members of the IF to "live up to their commitment on both pillars." It goes on to confirm the Council's support of the IF and "commits to the successful accomplishment of the ongoing work on the elements of Pillar One, including the multilateral convention." It further commits the Council to monitor the ongoing negotiations of the multilateral convention on Pillar One to ensure that a swift solution on Pillar One is found.

The Council statement also mentions that the use of delegated acts in this specific file should not be interpreted as a precedent for other legislative instruments adopted under the special legislative procedure applied to tax matters.

Poland's position

The Polish representative is reported to have told COREPER at yesterday's meeting that Poland could not offer its support for Pillar Two at that time because it needed to conduct further analysis in the coming days. It expects to have this analysis completed by the evening of 14 December before the EU Heads of Governments meeting on 15 and 16 December.

Observation: It is not clear what outstanding analysis is required by Poland.

What to expect over the next few days

It is understood that Poland is expected to complete its 'analysis' by the evening of 14 December. The EU Council apparently interpreted the Polish position as an approval of the Directive, not hesitating to issue a press statement despite the study reservation. While we do not foresee Poland blocking the adoption of the Directive at this stage, we remind readers that the Directive should not be taken as agreed until the written procedure is complete.

Anticipated timeline for remainder of 2022

The Directive will enter into force on the day following that of its publication in the Official Journal of the European Union. The rules of this Directive have to be transposed into EU Member States' national law by the end of 2023, noting the exception for any Member States which avail themselves of the derogation to delay the introduction of the rules. The IIR is required to take effect for accounting periods beginning on 31 December 2023, which for most groups will mean FY24 is the first period for which Pillar Two rules will apply. It's also expected that Qualified Domestic Minimum Top up Taxes (QDMTTs) will apply from the same date to the extent they are introduced in a country. The UTPR should apply as of 31 December 2024.

If EU Member States fail to fully or partly transpose the provisions of the Directive, the Commission may launch a formal infringement procedure. The procedure follows a number of steps laid out in the EU treaties, each ending with a formal decision. Theoretically, it could end up with a financial penalty in case of non-compliance after referring the Member State back to the European Court of Justice for a second time.

Anticipated timeline for 2023

Following the publication of the Directive in the Official Journal, and its subsequent entry into force, it will need to be formally transposed into the various Member States' national laws. Some countries have already begun the process of consulting with stakeholders around how best to transpose and implement the rules, including Ireland and the Netherlands. This consulting phase is expected to be replicated across the EU Member States in 2023. Member States also will keenly anticipate further guidance from the OECD relating to the Implementation Framework as part of their domestic implementation process. This guidance is expected to be released from early 2023.

Observation: Recital 22 of the Directive refers to the additional (administrative) guidance that will be issued by the IF/OECD as a useful source of illustration and interpretation and suggests that Member States may consider incorporating this guidance into their domestic legislation. Recital 24 notes that in implementing this Directive, Member States should use the OECD Model Rules and the explanations and examples in the Commentary and the Implementation Framework as a source of illustration or interpretation (including yet-to-be-approved/released safe harbour rules). With respect to safe harbours, the Directive only contains a delegated act for the rules on safe harbours that are now under consideration in the IF/OECD. Apparently, EU Member States are not considering legislating the additional guidance via an additional Directive. This is a missed opportunity in our view, because this would have contributed to uniformity and tax certainty.

The takeaway

The deal to secure Hungary's support for the Directive through promising the release of EU recovery funds is a significant development in this long-running saga. The EU Council announced this agreement, albeit in principle, despite Poland's reservation. The Directive should not be considered adopted until such time as the written procedure is finalised and the Polish reservation is addressed.

If the written procedure is secured later this week as expected, the European Union will be the first block of countries that have adopted the Pillar Two minimum taxation rules. This will undoubtedly encourage other countries to adopt and implement the rules.

Let's talk

For a deeper discussion of how the EU Directive or OECD two-pillar approach might affect your business:

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