UPDATE

# Pillar 2 Mourant jurisdictional outlook

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In this update we explore key features of the BEPS Pillar Two, its calculation model and implementation advancements in Mourant jurisdictions.

## Model Rules

Pillar Two is part of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (**BEPS**) and represents a major international tax reform aimed at ensuring that multinational enterprises (**MNEs**) pay a minimum level of tax, regardless of where they are headquartered or operate.

Pillar Two is designed to address concerns about profit shifting and tax avoidance by large corporations that use lower-tax jurisdictions to reduce their global tax liabilities. The OECD Model was agreed in October 2021 and released in March 2022, with detailed guidelines on its application. The EU followed shortly after, implementing Pillar Two through Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational groups and large-scale domestic groups in the EU, with a transposition deadline of 31 December 2023 (however, some Member States applied for an extension).

Pillar Two relies on three key rules:

- The Income Inclusion Rule (**IIR**), which requires the ultimate parent company of an MNE Group (the **UPE**) to pay a 'top-up' tax if the effective tax rate in any jurisdiction where the group operates falls below the 15% minimum;
- The Undertaxed Payments Rule (**UTPR**), which allows jurisdictions to deny tax deductions or impose withholding taxes on payments made to related entities in low-tax jurisdictions if the minimum rate of tax has not been paid in those jurisdictions; and
- Qualified Domestic Minimum Top-up Tax (**QDMTT**), which allows individual jurisdictions to impose their own minimum tax to ensure that the effective tax rate on profits earned therein meets the 15% threshold. This ensures that any top-up tax is paid to the country where the profits are generated, rather than to the MNE's home jurisdiction under the IIR.

An additional feature of the Pillar Two framework is the Subject to Tax Rule (**STTR**), which addresses situations where certain types of payments, such as interest or royalties, are subject to very low or no tax in the recipient jurisdictions. Due to the limited impact of the STTR on the Mourant Group and its clients, we will not be analysing its details in this briefing.

It is worth mentioning that Pillar Two applies not only to corporations, but also to partnerships and trusts, as well as permanent establishments, which trigger a set of model rules for profit allocation and defining residency-like links to their home jurisdictions. Nevertheless, a definition of a 'constituent entity' of a group still requires group consolidation, which, in practice, will leave many trusts and partnerships outside the scope of the model rules.

The entry conditions for Pillar Two are similar to those designed for the Country-by-Country Reporting (**CbCr**) regime, introduced by BEPS Action 13, namely:

- defining an MNE Group through consolidation under applicable accounting rules;

- setting a minimum global consolidated annual revenue threshold of EUR750 million (or the equivalent in local currency) to place MNE Groups in scope of the rules; and
- defining an Ultimate Parent Entity and framing constituent, entities-based, relationships within in-scope MNE Groups.

However, whilst the CbCr was merely an exchange of information regime, Pillar Two will result in quantifiable tax liability for in-scope MNE Groups and therefore its impact is potentially much more tangible.

Unlike CbCr, the Pillar Two rules include defined categories of Excluded Entities (which are described in the table below, including investment funds), as well as attempts to sustain a form of tax neutrality for tax transparent entities, i.e. partnerships. The latter is addressed through a concept of 'flow-through entities' and a mechanism for allocation of their profits within the group.

The set of Pillar Two rules on identifying constituent entities, excluded entities, flow-through entities, permanent establishments and the residency of constituent entities is not straightforward and requires detailed analysis, in the light of specific circumstances, so to assist in understanding some of those concepts at a high-level we have set out the table below, summarising some of the relevant concepts and defined terms.

### Pillar Two Model calculation steps and definitions

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| Identifying MNE Groups in scope | Group: a collection of entities related through ownership or control such that the assets, liabilities, income, expenses and cash flows by being included in the consolidated Financial Statements or excluded on the basis of size or materiality or being for sale;<br>MNE Group: any Group that includes at least one entity or permanent establishment that is not located in the jurisdiction of the UPE.<br>In Scope MNE Group: an MNE Group with consolidated revenue >EUR750m in each of two out of four previous Fiscal Years |
| Identifying any Excluded Entities | • Government/s, International Organisations, Non-Profit Organisations<br>• Pension Funds<br>• Investment Funds which are UPEs<br>• Real Estate Investment Vehicles which are UPEs<br>• Entities of which at least 95% of value is owned directly or indirectly by an Excluded Entity, and which operate exclusively or almost exclusively to hold or invest on behalf of such Excluded Entity; or which only carry out activities ancillary to those of that Excluded Entity<br>(The OECD clarifies that indirect ownership may be dictated by 'regulatory or commercial reasons' so that's how this value ownership can be interpreted.)<br>• Entities in which at least 85% of value is owned directly or indirectly by Excluded Entities if all of the Entity’s income is Excluded Dividends or Excluded Equity Gain or Loss that is excluded from the computation of Global Anti-Base Erosion (GloBE) Income or Loss |
| Calculating the GloBE Income and Loss of each constituent entity in an MNE Group | This is the adjusted Financial Accounting Net Income or Loss as determined for the entity when preparing consolidated financial statement (before any consolidation adjustments eliminating intra-group transactions);<br>there are a number of GloBE adjustments that must be taken into account, such as net taxes expense, excluded dividends, excluded gains and losses, policy disallowed expenses, etc. – all defined by the Pillar Two model |
| Calculating the Effective Tax Rate of a constituent entity in an MNE Group at a domestic level | Formula: the Adjusted Covered Taxes of the constituent entity divided by its Net GloBE Income and Loss;<br>Adjusted Covered Taxes essentially constitute tax expense in Financial Accounting Net Income or Loss and they are defined in Article 4.2 of the Pillar Two model (NB they do not include Top Up taxes, such as QDMTT or top up taxes accrued and paid by the UPE) |

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| Arriving at the Top Up Tax position | • Identifying Low-tax Jurisdictions (Effective Tax Rate below 15%) in which constituent entities are resident<br>• Making adjustments for any applicable Substance Based Income Exclusions to arrive at the Excess Profit<br>• Calculating Top Up Taxes for each Low-tax Jurisdiction<br>• Multiplying the Top Up percentage (Minimum Tax Rate – ETR) by the Excess Profit<br>• Deducting any Qualified Domestic Minimum Top Up Tax<br>• Applying any de minimis exemptions (GloBE Revenue less than EUR10m and the average GloBE Income or Loss for that jurisdiction less than EUR1m, on annual election) |
| Filing Global Information Returns | All constituent entities in the MNE Group file a return, unless the UPE makes a filing and a Competent Authority Agreement applies (in which case, constituent entities only file notifications) |

## Country by Country Safe Harbor

Recognizing the complexity of the Pillar Two rules and information already collected under the CbCr regime, the OECD have offered temporary relief by way of simplified rules or exemptions from the full application of the Pillar Two tax calculations in specific cases, typically to reduce the compliance burden for taxpayers and tax authorities in certain jurisdictions.

Known as a 'Safe Harbor', the relief broadly applies if the CbCr reporting entity is 'qualifying' and one of three conditions is met by the relevant jurisdiction:

- *De minimis test*: The jurisdiction has CbCr revenue of less than EUR10m and a CbCr profit and loss before income tax of less than EUR1m (including a loss).
- *Effective tax rate test*: The simplified effective tax rate for the jurisdiction is at least 15% for 2024 (16% for 2025, 17% for 2026). The simplified effective tax rate is calculated as the Simplified Covered Taxes (income tax expense per the accounts, adjusted for non-Covered Taxes and uncertain tax positions) divided by profit/loss before income tax from the CbCr.
- *Routine profits test*: the profit/loss before income tax from the CbCr is smaller or equal to the Substance Based Income Exclusion calculated according to the Pillar Two model rules. This test will also be met for a jurisdiction where there is a loss per the CbCr.

## Countries update

All Mourant home jurisdictions have acknowledged the importance of the Pillar Two as a pivotal initiative to promote fairness in taxation of large multinationals. Their approach to implementation differs though, depending on the profile of their respective markets and their current tax regulatory framework and infrastructure. Below we have set out the key elements of the local approach to implementing Pillar Two in our jurisdictions, based on legislation already approved, draft legislation in circulation and public statements, as available.

## Jersey

Jesey has announced that it will adopt the Income Inclusion Rule (IIR) and a Multinational Corporate Income Tax (MCIT) through new legislation, both of which will be applicable for the fiscal year starting on or after 1 January 2025. Whilst the draft legislation implementing Pillar Two heavily relies on (and imports terminology from) the OECD Model (including the Consolidated Commentary of 25 April 2024 and the OECD Administrative Guidance published on 17 June 2024), Jersey has deviated from the model solution of addressing the domestic minimum tax through the QDMTT. Instead, it will introduce the MCIT at a rate of 15% which is applicable to relevant Jersey constituent entities which are not Excluded Entities nor subject to application of the de minimis exemption, which should exclude the majority of Jersey entities. The taxable base for the MCIT is calculated in accordance with GloBE rules but, unlike the QDMTT, Jersey MCIT results in an effective minimum tax rate at the stage of Covered Taxes and therefore brings Jersey, in respect of affected constituent entities, outside the Pillar Two Low-tax Jurisdiction category.

To accommodate the application of foreign Controlled Foreign Corporations (CFC) rules in the US, Jersey has opted to implement a credit for certain blended tax charged under those rules, with a 7.5% cap. This provision has been designed to address the application of, amongst others, the US GILTI regulations, which have been provisionally approved by the OECD as being in line with the Pillar Two creditable taxes.

Excluded Entities (including investment funds) are defined through the lens of the Pillar Two model rules definitions, however we expect further clarifications to follow to reflect domestic scenarios applicable in Jersey's significant funds industry. It will likely take some time to crystalize industry practice around the MCIT, as despite being intended as a set of tax rules in parallel to Jersey's existing income tax law, its wording relies on the Pillar Two model rules and, therefore, different terminology will be applied in tandem.

## Guernsey

On the 4th September 2024 the Guernsey States gave a green light to implementing local Pillar Two related regulations as an international tax measure under section 75CC(1C) of the Income Tax (Guernsey) Law, 1975. It has been proposed that the IIR and the QDMTT will be effective in Guernsey from 1 January 2025.

Unlike Jersey, Guernsey decided to apply the model-based QDMTT to address the domestic top-up requirement and the minimum rate of 15%. As a result, Guernsey will be treated as a Low-tax Jurisdiction under the model and local in-scope constituent entities will have to have their top-up tax calculated for the purpose of assessing any residual top-up taxes by their UPEs.

We understand that, for a transitional period, Guernsey QDMTT will benefit from the Safe Harbor and therefore, subject to its conditions, will benefit from a simplified calculation of any top up taxes.

Similar to Jersey, Guernsey QDMTT will rely heavily on the terminology provided by the Pillar Two model and therefore we expect additional work post implementation to develop industry practice.

## Luxembourg

As an EU Member Sate, Luxembourg has adopted Pillar Two through transposing the EU Directive 2022/2523 into the domestic law in December 2023. The law closely follows the EU Pillar Two Directive and the transitional safe harbour rules issued by the OECD in December 2022.The IIR and the QDMTT are applicable to fiscal years starting on or after 31 December 2023, whilst the UTPR on or after 31 December 2024.

Similarly to other jurisdictions implementing Pillar Two, certain entities are excluded from the scope of the rules: governmental entities, non-profit organizations, pension funds and investment funds that are ultimate parent entities, as well as real estate investment vehicles that serve as ultimate parent entities.

On 12 June 2024, the Luxembourg Government submitted a draft law to amend the law of 22 December which further specifies those exclusions. In particular, it clarifies that an investment fund or a real estate investment vehicle that is not considered an ultimate parent entity solely because the relevant financial accounting standard does not mandate the preparation of consolidated financial statements will still be treated as an ultimate parent entity when applying the excluded entity test for holding entities or special purpose vehicles. This clarification is particularly beneficial for entities established to acquire a target group as they may qualify as excluded entities, enabling them to pass down the Pillar Two compliance obligations to the operational entities.

The commentary on the draft law further specifies that the laws exempting Luxembourg investment funds, such as RAIF, SICAR, and SIF, from preparing consolidated financial statements should be recognized as valid exemptions under an acceptable GAAP. Therefore, entities relying on these exemptions are not required to conduct a deemed consolidation test. Additionally, the commentary states that consolidated financial statements prepared voluntarily not be regarded as forming a Pillar Two group.

The draft law also includes some guidance on, inter alia, the definition of revenue, QDMTT Safe Harbour, equity investment inclusion election and transitional period and filing deadlines.

The bill will follow the usual legislative process through parliament. The Pillar Two law is expected to be amended in the future to incorporate the fourth set of OECD's agreed administrative guidance released on 17 June 2024, along with any additional instructions that may arise.

## UK

The UK implemented Pillar Two through the Finance (No. 2) Act 2023, which received Royal Assent in July 2023. Having a developed domestic tax system, the UK has decided to address the minimum 15% effective tax rate two-fold through:

1. a Multinational Top-Up Tax (MTUT) which is effectively the IIR: if an MNE Group's overseas subsidiaries are taxed at less than 15% in any jurisdiction, the UK-based UPE will need to pay a top-up tax to bring the overall effective tax rate to 15%; and
2. Classic QDMTT: to ensure that UK operations of large enterprises meet the 15% effective tax rate, preventing other countries from collecting additional tax on profits generated in the UK.

Whilst the UK has a statutory corporation tax rate of 25% (19% for smaller operations, with under GBP19k of annual profits) that may raise questions about the role of the QDMTT in the UK system, given Pillar Two relies on effective tax rates instead, calculated in accordance with the Pillar Two model, and it is not impossible that, as a result of adjustments, a UK entity's effective tax burden may fall below 15%.

The UK has already published draft guidelines and made a registration portal available, where in-scope MNE Groups can register for Pillar Two top up taxes. The first Pillar Two returns are expected no later than:

- 30 June 2026, if the first accounting period the relevant entity reported for Pillar Two top-up taxes ended on or before 31 December 2024
- 18 months after the last day of the group's accounting period, if the first accounting period the relevant entity reported for Pillar Two top-up taxes ended after 31 December 2024.

It's worth noting that the UK implementation package also heavily relies on the Pillar Two model terminology and the OECD guidelines. Whilst locally applicable clarifications are helpful (such as clearly defining UK REITs as Excluded Entities), reliance on the model will help the MNE Groups to align their understanding of the rules in different jurisdictions they operate in.

## The Cayman Islands and the British Virgin Islands

Although committed to implementing international tax initiatives, both of these jurisdictions have different tax systems s and administrative resources relative to Jersey, Guernsey and the UK.

As a result, the British Virgin Islands are currently in the process of assessing the impact and potential options for implementation of Pillar Two, with help of independent advisory firms.

The Cayman Islands, which is largely a fund jurisdiction and therefore could expect limited impact of the Pillar Two to many of its entities due to the application of the Excluded Entities exemption, is also weighing-up its implementation options. At the time of publishing this briefing, there has been no final statement on the intention or form of implementation of those rules.

## Hong Kong

Another jurisdiction which is still in the process of consulting and drafting legislation for the Pillar Two is Hong Kong. It is however expected that the relevant rules will apply for fiscal year starting on or after 1 January 2025. A comprehensive consultation paper has been published in December 2023, and it points towards implementing the key aspects of Pillar Two, i.e. the IIR and the QDMTT, in line with the model. As the consultation concluded in March 2024, we expect the legislation to emerge later this Autumn.

## Singapore

On 9th September 2024, Singapore introduced the following legislation implementing Pillar Two: the Multinational Enterprise (Minimum Tax) Bill and, as subsidiary legislation, the Multinational Enterprise (Minimum Tax) Regulations 2025. The implementation model, similar to the Guernsey approach, relies on application of the IIR and the QDMTT. Both are proposed to be effective for financial years commencing on or after 1 January 2025, with filing deadlines aligned with the ones adopted in Jersey and Guernsey.

Unlike other Mourant jurisdictions, Singapore operates a territorial taxation system, so successful implementation the Pillar Two requires adjustment to the existing rules. Therefore, the implementation package triggers changes to the Income Tax Act 1947, to accommodate clarifications for eligible tax deductions, foreign tax credit and foreign-sourced income exemption which is relevant for the purpose of the concept of 'subject to tax'. Another novelty to the Singaporean system is the introduction of an investment tax credit, known as the Refundable Investment Credit (RIC) incentive scheme, in the 2024 Budget Statement on 16 February 2024. It has been designed to meet the Pillar Two requirements and help manage the overall tax burden resulting from the effective 15% minimum tax rate.

As RIC is a new and fairly complex concept in Singaporean tax system, we recommend to anyone involved in an in-scope structure which might benefit from it to seek domestic tax advice.

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