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Issue 1586 | 2 September 2022

## UK implementation of Pillar Two

Examining the draft legislation

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Analysis

# UK implementation of Pillar Two: where are we now?

Speed read

**The UK has published the first draft of legislation to implement OECD BEPS Pillar Two into UK law. The draft UK rules impose a multinational top-up tax regime on qualifying multinational groups, i.e. those operating in at least two jurisdictions and which have revenue which exceeds €750m in at least two out of the previous four accounting periods. As expected, the UK has opted for a two-phase implementation with the income inclusion rule expected to come into force on 31 December 2023 and the under-taxed profits rule coming into force at a later date. In addition to rules on the scope of the charge, the calculation of the top-up tax liability and when the liability becomes chargeable, there are administrative provisions on enquiries, assessment and penalties. The draft legislation is effectively a work in progress and contains numerous placeholders, including on de minimis exemption, multi-parented groups and eligible tax distribution systems. The UK government is yet to decide whether it will introduce a domestic minimum tax, but this seems likely given the 'strong arguments in favour' of its introduction. Comments on the draft rules are invited by 14 September.**

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## Background

A two-pillar corporate tax reform plan was agreed between OECD members in October 2021. The two-pillar plan forms part of the OECD's project tackling base erosion and profit shifting (or BEPS). Whilst Pillar One will only apply initially to MNEs with annual global turnover above €20bn, Pillar Two is expected to have a wider impact on businesses.

Pillar Two seeks to establish a global minimum corporate tax rate through a set of interlinked rules. Global anti-base erosion rules ('the GloBE rules') will impose top-up taxes where the effective rate of tax of a multinational enterprise in a jurisdiction is below the global minimum corporate tax rate (15%).

The UK government published a consultation in January 2022 on the implementation of the GloBE rules into UK law. A response to this consultation and initial draft legislation were published on 20 July 2022. As expected, the UK has opted for a two-phase implementation with the income inclusion rule (IIR) expected to come into force on 31 December 2023 and the under-taxed profits rule (or UTPR) coming into force at a later date. This new regime has been named 'multinational top-up tax' by the UK.

This article analyses the draft multinational top-up tax legislation and considers what developments are still to come.

## Guide to the draft multinational top-up tax legislation

The draft legislation is a comprehensive rewrite of the GloBE rules. Whilst when analysed, in most cases the provisions appear to be very similar in effect to the equivalent GloBE articles, different terminology has been used and some sections of commentary have been incorporated. The draft UK legislation also includes detailed administrative provisions at Schedule 1, including enquiries, assessment and penalties provisions which are in line with the administrative provisions in other parts of the UK tax code.

### Scope

The multinational top-up tax regime will apply to 'qualifying multinational groups'. These are groups that operate in at least two jurisdictions (whether through entities or permanent establishments) and which have revenue which exceeds €750m in at least two out of the previous four accounting periods. As is the case in the GloBE rules, the only excluded activity is international shipping.

An entity will be a member of a group if it is included in the consolidated financial statements of the ultimate parent (broadly, the entity at the top of the group structure). Members of qualifying multinational groups are simply referred to as 'members of the group' (rather than 'constituent entities' under the GloBE rules).

As is the case under the GloBE rules, certain entities are excluded from the ambit of the rules and will not be required to carry out an effective rate of tax calculation nor be charged top-up tax arising as a result of a low taxed entity elsewhere in the group. The types of excluded entities are governmental entities, international organisations, non-profit organisations, pension funds, investment funds, UK REITs or overseas REIT equivalents and certain holding entities.

The definitions of UK REITS and overseas REIT equivalents represent a slightly different approach to that set out in the GloBE rules which contain the concept of a 'real estate investment vehicle'. There were concerns about how UK REITs would fit into that definition, and so the UK's approach sidesteps that issue. The definitions of investment funds, pension funds, governmental entities and provisions relating to holding companies are very similar to the equivalent provisions in the GloBE rules. The issue resulting from the GloBE rules requirement for investment funds and real estate investment vehicles to be ultimate parent entities (which would not be satisfied where the relevant entity

does not produce consolidated accounts) has been largely resolved in the draft UK legislation. There are placeholders for the definitions of international organisation and non-profit organisation.

### Charge to tax

A UK person will be chargeable to multinational top-up tax if the person is:

- a member of a qualifying multinational group;
- a 'responsible member';
- located in the UK;
- a body corporate or a partnership;

and a member of the group for whom the person is responsible has a top-up amount.

There is also a back-up provision which applies where the responsible member is not a body corporate or a partnership. This back-up provision charges multinational top-up tax on the person to whom the profits of the responsible member would be attributed for UK tax purposes.

The responsible member definition incorporates into the draft UK legislation article 2.1 of the GloBE rules which determines which member of the group is chargeable to top-up tax under the IIR. The rules start at the top of the group (at the ultimate parent) and work down the corporate chain until there is a parent entity located in a jurisdiction that has implemented the IIR. There are also provisions to deal with parent entities that are partially owned by third parties.

**The draft multinational top-up tax legislation is very much a work in progress, which is perhaps indicative of how much of a challenge it is to implement the GloBE rules into domestic legislation**

### Top-up amount

Broadly, top-up tax will be payable if a member of the group's in-scope income and profits are subject to an effective tax rate of less than 15%.

In-scope income and taxes must be calculated for each member of the group (unless an exemption is available). The starting point for this calculation is the income allocated to the member of the group in the financial statements of the ultimate parent. These 'underlying profits' are then adjusted by a series of provisions to arrive at the 'adjusted profits' for the member of the group (adjusted profits are referred to as 'GloBE income' under the GloBE rules). For example, excluded equity gains (for example, a gain on the disposal of shares in which the member of the group holds a 10% or greater interest) must be deducted.

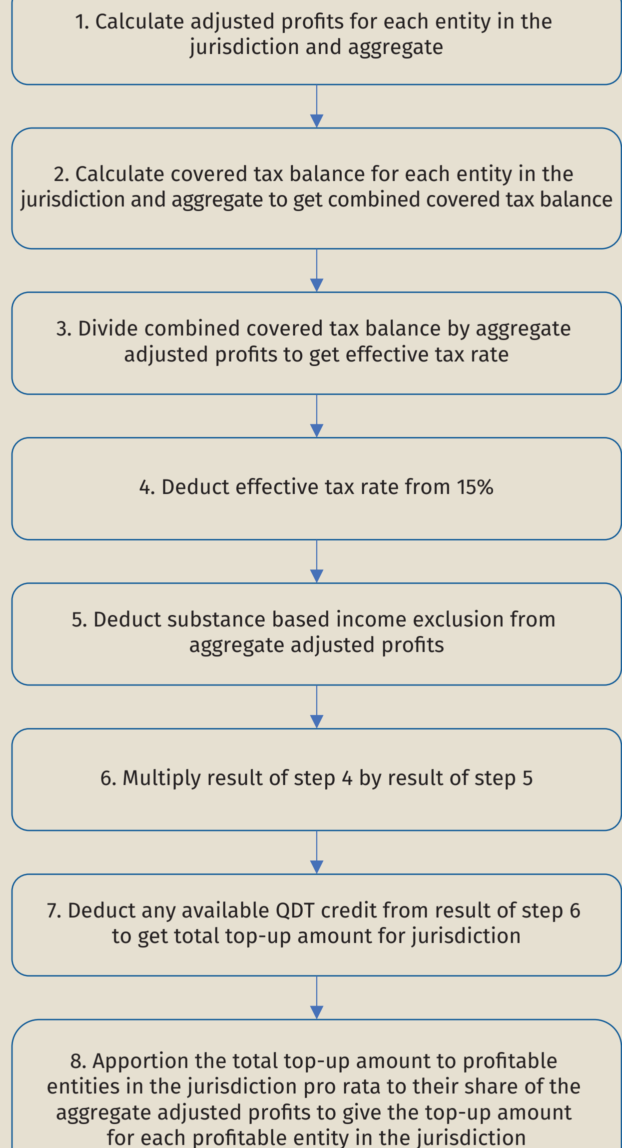
The next step is to determine the amount of in-scope taxes (referred to as 'covered tax balance' in the draft UK legislation and 'covered taxes' under the GloBE rules). Again, the starting point is the current tax expense allocated to the member of the group in the financial statements of the ultimate parent. Only taxes on income and profits (including withholding taxes and taxes levied under a controlled foreign company regime) are taken into account for the purposes of the top-up tax calculation – sales taxes (for example, VAT), payroll taxes and transfer taxes must all be stripped out. Tax on income that is not within scope – for example, tax on an excluded equity gain – must also be deducted.

The effective tax rate is calculated on a jurisdictional basis, meaning that income and taxes for members of a group in a territory are pooled together. Special rules apply to certain types of entities (investment entities and minority owned entities) which require their tax rate to be calculated on a standalone basis, rather than aggregating their figures with those of other members of the group in the same jurisdiction.

The aggregate covered tax balance ('combined covered tax balance') is then divided by the aggregate adjusted profits to give the effective tax rate.

The minimum tax rate is 15%. If the effective tax rate is lower than 15%, a top-up amount may arise. If the effective tax rate is 15% or higher, no further calculations are required in relation to the current year. However, multinational top-up tax may arise if a re-calculation is required in relation to a previous year.

Assuming the effective tax rate is lower than 15%, the next step is to deduct the 'substance-based income exclusion' from the adjusted profits (under the GloBE rules, the resulting amount is known as 'excess profit' but there is no special definition for it in the UK draft legislation). The substance-based income exclusion allows a fixed return on substantive activities to be carved out of scope. The substance-based income exclusion is 5% of eligible payroll costs plus 5% of



the carrying value of eligible tangible assets (both the UK draft legislation and the GloBE rules provide for higher percentages to apply in the first ten years that the rules are in force).

The difference (if any) between the minimum tax rate and the effective tax rate is applied to the sum of the aggregate adjusted profits for the jurisdiction less the substance-based income exclusion for the territory.

Credit is then given for any qualifying domestic top-up tax payable for the accounting period. A domestic top-up tax is an extra tax, levied under domestic tax rules to top-up the effective tax rate on excess profits of entities in a jurisdiction to the minimum tax rate of 15%. Introducing a domestic top-up tax ensures that any top-up tax for that jurisdiction goes to the jurisdiction's tax authority, rather than a tax authority elsewhere. A domestic top-up tax will only be 'qualifying' for the purpose of the UK rules if it is specified as such in a statutory instrument. The draft UK rules relating to qualifying domestic top-up tax credit embellish the equivalent provisions in the GloBE rules but do not seem to depart from the spirit of those provisions. The draft UK provisions are not fully written (there are some placeholders) but will cap the available credit for any qualifying domestic top-up tax paid in the period at the amount of the current year top-up tax plus any top-up tax resulting from a recalculation of amounts relating to a previous year (an 'additional top-up amount'). Where there is both current year top-up tax and an additional top-up amount, but the qualifying domestic top-up tax is less than the sum of these amounts, qualifying domestic top-up tax must be apportioned between these top-up tax amounts.

The resulting figure is then apportioned between members of the group in the jurisdiction in proportion to their share of the aggregate adjusted profits for the jurisdiction.

The GloBE rules provide for the ability to elect into a de minimis exemption where the jurisdiction in question had an average GloBE revenue of less than €10m and average GloBE income or loss of less than €1m. This exemption has not been written into the draft UK legislation, but there is a placeholder for the exemption, so it is likely that it will be included in a later draft.

### Allocation of the top-up amount

Top-up tax amounts are allocated to the responsible member(s) according to the relevant responsible member's 'inclusion ratio'. The inclusion ratio provision is complex but operates in a similar way to the equivalent GloBE rules provision. The provision uses hypothetical accounts to determine what proportion of the adjusted profits of the member of the group with the top-up amount is attributable to the responsible member's interest in that entity. The relevant top-up amount is then multiplied by the inclusion ratio.

There is also an offset mechanism to prevent double taxation arising from multiple levels of multinational top-up tax charges where there is more than one responsible member in relation to a top-up amount.

### Administration

Groups will need to choose a filing member that is responsible for registering with HMRC and filing returns. The default position is that the ultimate parent is the filing member, but groups will be able to nominate an alternative member to fulfil these responsibilities. Whilst it is possible for a non-corporate ultimate parent to be the filing member, if a different member of the group is nominated, that member must be a company.

The filing member must notify HMRC that the group is a qualifying group within six months of the end of the first accounting period in which the group becomes a qualifying group.

A GloBE information return must be filed by the group. This return will be in a standard template (to be developed at OECD level) and will contain information which shows how the top-up tax has been calculated in every jurisdiction. If the information return has been filed in a jurisdiction other than the UK, the filing member must notify HMRC that an overseas return has been made (an overseas return notification). The deadline for filing the information return or overseas return notification is 15 months from the end of the relevant accounting period, or 18 months where the accounting period is the first period in which the group was a qualifying group.

The filing member must also file a self-assessment return by the same deadline setting out which members of the group are chargeable to multinational top-up tax and how much multinational top-up tax is chargeable to each of these members.

> As the revenue threshold must be exceeded in at least two of the four previous accounting periods, businesses will need to look back across 2020 to 2022 to determine whether they will be in scope

Multinational top-up tax must be paid in a single annual payment by 15 months (or 18 months in the case of the first accounting period when the group is a qualifying multinational group) from the end of the accounting period in question. In the January 2022 consultation, the government mooted several different payment options including quarterly instalments or a payment date that was aligned with the standard corporation tax payment date (nine months from the end of the accounting period). These options would have been challenging for businesses to have complied with, as businesses were unlikely to have the necessary information to calculate the multinational top-up tax liability at that point. It is welcome news that the government has taken into account representations on this issue and opted for a single payment date which is aligned to the information return filing deadline.

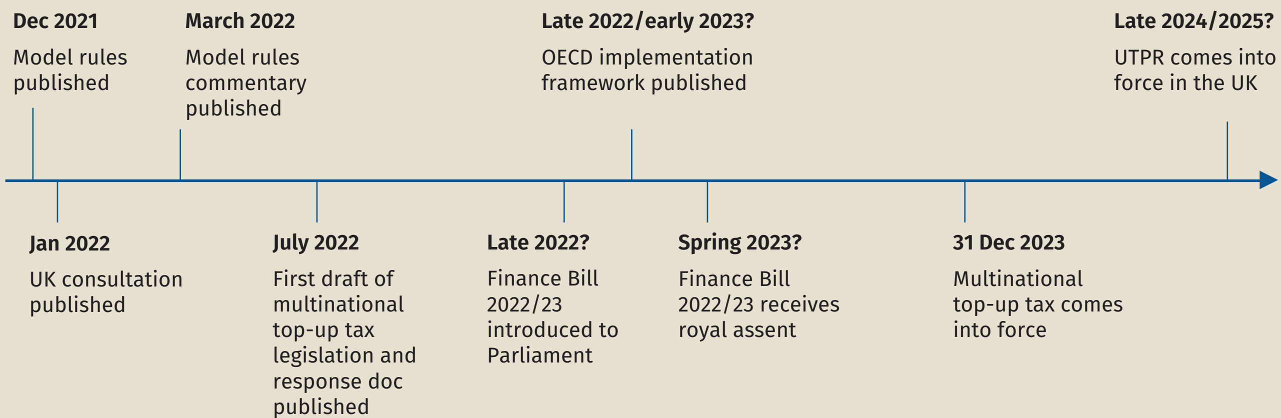
## Timing

As previously announced earlier this summer, the multinational top-up tax regime will come into force in relation to accounting periods starting on or after 31 December 2023. This is in line with the OECD's target 2023 implementation date for the IIR and the EU expected implementation date for the IIR (although the draft EU directive implementing the GloBE rules is yet to be agreed between EU member states).

There is no straddle period mechanism which would apply multinational top-up tax to the portion of earlier commencing accounting periods falling after 31 December 2023.

The response document states that no decision has been made on the timing of the introduction of the UTPR. In the original consultation document, the government stated that the UTPR would come into force in the UK on 1 April 2024 at the earliest. Given that the IIR portion of the rules now will not come into force until 31 December 2023 (as opposed to the original 1 April 2023 proposed effective date), it seems

### UK implementation timeline




unlikely that the UK would target a 1 April 2024 effective date for the UTPR. The OECD October 2021 statement on the two pillar plan states that the UTPR should be implemented in 2024, so it may be that the UK opts for a 31 December 2024 UTPR effective date.

### Comment

The draft multinational top-up tax legislation is very much a work in progress, which is perhaps indicative of how much of a challenge it is to implement the GloBE rules into domestic legislation. There are a fair number of placeholders for further provisions dotted throughout the legislation: for example, in relation to the de minimis exemption, multi-parented groups and eligible tax distribution systems.

It is possible that parts of the OECD Implementation Framework (which is still being negotiated between OECD members) could be included in the multinational top-up tax regime. For example, if a safe harbour is agreed at OECD level, this would need to be built into the UK implementing legislation. The OECD Implementation Framework may not be finalised until the end of 2022, perhaps not until early 2023. In view of the likely timings, it may prove challenging to include Implementation Framework provisions in Finance Bill 2022/23. However, the draft UK legislation includes a power for HM Treasury to make regulations amending the multinational top-up tax regime to ensure consistency with the GloBE rules, their commentary and any further OECD commentary or guidance. Assuming this power is enacted, it could be used to make changes to harmonise the UK rules with subsequent OECD developments.

Given that the rules are yet to be finalised at OECD level, one might question why the UK government has chosen to publish initial legislation this summer. The reason for early publication is two-fold. Firstly, the government is mindful of the need to give businesses as much certainty as soon as possible. Secondly, the publication of the draft multinational top-up tax legislation well in advance of the intended effective date gives the UK the opportunity to influence the direction of Pillar Two implementation internationally. The UK views itself as an 'international leader' in this regard and has committed to taking forward many of the points raised during the consultation process as part of the OECD Implementation Framework discussions.

A key question remaining is whether the UK will introduce a domestic minimum tax. In the response document, the government states that a decision is yet to be made on whether the UK will introduce a domestic minimum tax. Although as the government notes that there are 'strong arguments in favour' of the introduction of this tax, it would not be surprising if the government subsequently decided to introduce a domestic minimum tax. The government has also stated that it is supportive of a qualified domestic minimum tax safe harbour, which would switch off the GloBE rules in respect of a jurisdiction that has introduced a qualified domestic minimum tax. It will be interesting to see if international consensus can be reached in relation to such a safe harbour.

### Next steps

The closing date for comments on the draft UK legislation is 14 September 2022. It is expected that a later draft would be included as part of the Finance Bill 2022/23 when this is introduced to Parliament (likely late 2022); it is not clear whether there will be any further consultation on multinational top-up tax provisions before that point.

Multinational businesses will need to consider the extent of their group, and whether the group is likely to exceed the €750m revenue threshold. For most businesses, the multinational top-up tax regime will apply from 2024 onwards. As the revenue threshold must be exceeded in at least two of the four previous accounting periods, this means that businesses will need to look back across 2020 to 2022 (and monitor revenue in 2023) to determine whether they will be in scope when the regime comes into force.

It is recommended that businesses that are likely to be in scope and have the requisite UK nexus (and their advisers) begin to familiarise themselves with obligations under the draft UK legislation. They may also wish to consider which member of the group will act as the filing member and start putting in place procedures to capture the information necessary to calculate multinational top-up tax liability of members of the group. ■

- Pillar two and the future of tax incentives (B Salehy, 6.7.22)
- The impact of the OECD's pillar two on international M&A (B Rajathurai & M Smith, 30.6.22)
- How pillar two attacks multinationals' high tax subsidiaries (M Bevington, 20.4.22)
- The OECD's pillar two model rules: what do we know now? (J Hare, G Maffini & P Greenfield, 5.1.22)