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Pillar 2 implementation: Latest updates and hot topics

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Session Co-Chairs and Speakers

- **Session Co-Chairs**
  - **Sylvia Dikmans** *Houthoff, Amsterdam*
  - **Jason Yen** *EY, Washington, DC*

- **Speakers**
  - **Devon Bodoh** *Weil Gotshal & Manges, Washington DC*
  - **Michael Hashemi** *Pillar Two Lead, HM Revenue and Customs, London*
  - **Nathaniel Carden** *Skadden, Arps, Slate, Meagher & Flom LLP, Chicago*
  - **Michael Nordin** *Schellenberg Wittmer, Zürich*
  - **Andreas Trost** *Cuatrecasas, Barcelona*
  - **Mariana Eguiarte Morett** *Sanchez Devanny, Mexico City*

Agenda

1. Recent OECD guidance & UK Implementation Update
2. US transactional issues
3. Switzerland Pillar 2 implementation updates
4. Spain Pillar 2 implementation updates
5. Mexico Pillar 2 implementation updates

01 Recent OECD Guidance & UK Implementation Update

Recent OECD guidance

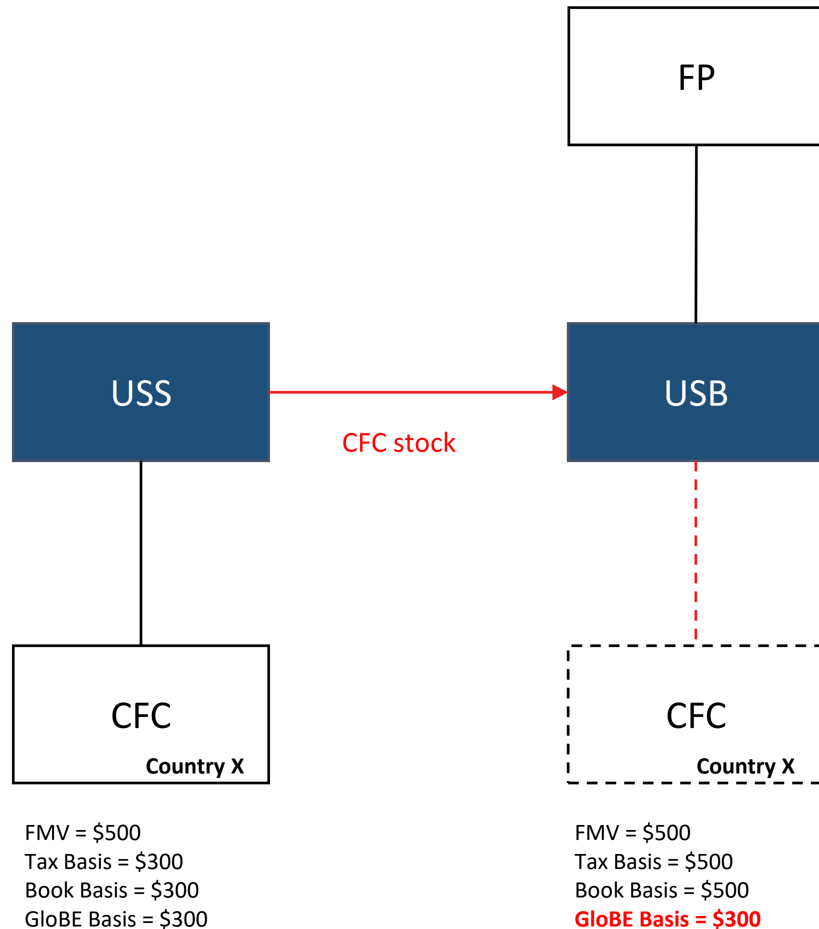
- “Safe harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two)” **approved** on December 15, 2022 → Not just any public consultation paper.
    - CBCR Safe harbor is designed as a **short-term measure**.
    - Permanent safe harbor and qualified domestic minimum top-up tax (QDMTT) safe harbor will be developed as part of administrative guidance.
- Globe information return – Public consultation document
- Tax Certainty for the GloBE Rules - Public consultation document
    - High-level summary of potential dispute prevention and resolution mechanisms to be explored by Inclusive Framework

02 US transactional issues

Prospective application, but current relevance

- Although the GloBE rules are not yet effective, transactions occurring today and before the effective date of the GloBE rules could impact the computation of GloBE income and loss, adjusted covered taxes, and the allocation of top-up tax once the GloBE rules are effective. As a result, it is critical to consider the GloBE rules when structuring transactions before the effective date of the GloBE rule and in determining their overall impact on the acquiring company's tax profile.
- Some key issues to consider are:
  - Disallowance of purchase accounting for sales of entities, even in the case of US tax elections that step-up basis for US tax purposes;
  - Application of transition rule to intercompany transactions occurring after November 30, 2021;
  - Elimination of the amortization benefit from the purchase of long-lived IP; and
  - Allocation under a UTPR of the top-up taxes to/from non-wholly owned entities.

Sale of CFC stock with §338(g) election



- **Facts**
  - On 10/1/22, USS sells all of the stock of CFC to USB for $500; USB makes a §338(g) election with respect to the purchase of CFC
- **GloBE Implications**
  - For purposes of computing GloBE income when effective, under Article 6.2.1(c), for all stock sales that occur on or after December 1, 2021, CFC's basis in its assets is determined without regard to purchase accounting
    - For transactions that occur prior to December 1, 2021, purchase accounting can be taken into account if the UPE's financial accounting standard permits push-down adjustments and the MNE group does not have sufficient records to determine historic carrying values
  - Therefore, CFC retains its historical carrying value of its assets ($300) for purposes of GloBE, and presumably GILTI if U.S. adopts Pillar Two
  - If U.S. does not adopt Pillar Two, Article 4.3.2(c), USB's GILTI taxes with respect to CFC may be allocated to CFC for the purposes of computing Country X top-up tax; but impact from deferred accounting unclear

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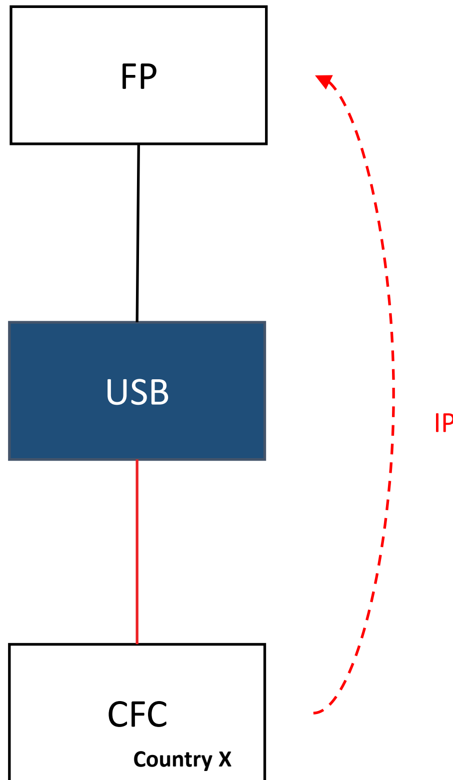
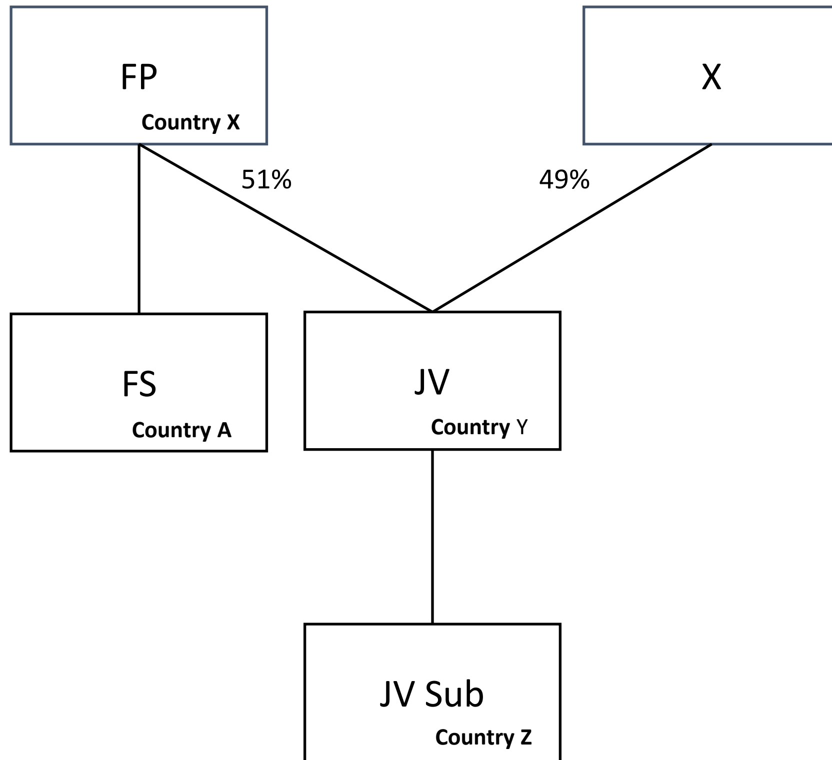
Transition rule



- **Facts**
  - On 10/2/22, after the acquisition described in the previous slide, USB causes CFC to sell the IP with a fair market value of $500 to FP. Assume that CFC's historic carrying value for the IP is $300, and its GloBE basis, after the acquisition described in the previous slide, is also $300.
- **GloBE Implications**
  - Under Article 9.1.3, in the case of transfers between constituent entities occurring after November 30, 2021, and before the effective date of GloBE, the GloBE basis in the acquired assets (other than inventory) are based on the disposing entity's carrying value of the transferred assets with any deferred tax items brought into GloBE determined on that basis.
  - Thus, regardless of whether the sale by CFC of the IP is taxable in Country X, FP takes a carryover GloBE basis in the IP ($300).
    - Notwithstanding FP's tax basis in the IP exceeds its GloBE basis, it is unlikely that FP can take into account a "GloBE DTA," where no actual DTA exists.

Allocation of top-up tax to consolidated owner

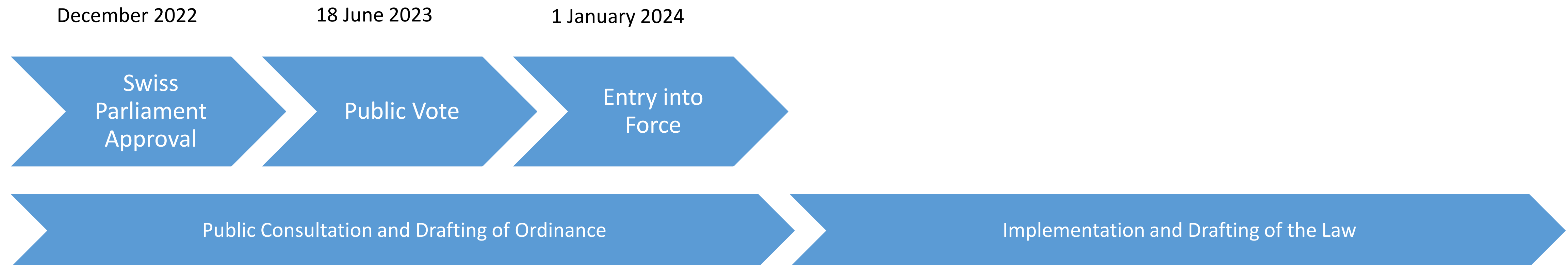


- **Facts**
  - FP and X own 51% and 49%, respectively, of JV, a holding company. FP also owns 100% of FS. FS, JV, and JV Sub are included in the consolidated financials of FP
  - Situation 1: Country A (FS) adopts the GloBE rules. Countries X (FP), Y (JV), and Z (JV Sub) do not. Country Z's tax rate is below 15%.
  - Situation 2: Countries A (FS) and X (FP) do not adopt the GloBE rules, while Countries Y (JV) and Z (JV Sub) do. Country A's tax rate is below 15%
- **GloBE Implications**
  - In both cases, JV is not a "joint venture" within the meaning of the GloBE rules because it is consolidated by the FP group.
  - Situation 1: Because Countries X, Y, and Z do not have QDMTT or IIR rules, the UTPR rules apply and 100% of the Top-Up Tax is allocated to Country A. FP gets 100% of the cost and only 51% of the related tax savings.
  - Situation 2: Because Countries X and A do not have GloBE rules, Top-Up Tax of FS will be allocated to JV in Country Y. FP gets 100% of the related tax savings but only 51% of the cost.

03 Switzerland Pillar 2 implementation updates

Implementation of Pillar II in Switzerland

- **Current Status**



→ Discussion topics in parliament:

- distribution and allocation of additional tax income
- use of additional tax income

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Implementation of Pillar II in Switzerland

- **Key Aspects of the Swiss Proposal**
  - Draft ordinance refers to OECD model rules dated 14 December 2021 (static)
  - Switzerland will levy a qualified domestic top-up tax and apply the income inclusion rule
  - Discussion ongoing with respect to the undertaxed payments rule
  - Not yet clear whether standalone/country-subgroup financials prepared in accepted accounting standard need to be audited

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Implementation of Pillar II in Switzerland

- **Practical difficulties**
  - Additional (digital) tax return
  - Material differences expected in tax basis between Swiss tax law and GloBE rules
    - due to different accounting standards
    - due to different taxation rules (e.g. participation exemption)

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Implementation of Pillar II in Switzerland

- **Main issues for Swiss banks**
  - Differences between GloBE rules and Swiss accounting law / tax law
  - Tax benefit for write-downs on participations
  - Recognition as equivalent taxes
    - US Base Erosion and Anti-Abuse Tax (BEAT)
    - Corporate Alternative Minimum Tax (CAMT)
  - Safe Harbor Rules

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04 Spain Pillar 2 implementation updates

Spanish tax law and Pillar 2

- **Current situation**
  - Minimum 15% CIT (18% for some sectors) since 1 January 2022.
  - Applies to CIT taxpayers with a net revenue of at least 20 MM € in twelve months preceding the tax period and to all tax groups irrespective of revenue.
  - Method of computation results in not being an effective minimum tax though.
  - Main consequence: counteracts effect of a number of tax deductions / incentives.

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Spanish tax law and Pillar 2

- **Current situation**
  - Strong CFC regime
  - No doubts about treaty compatibility.
  - General rule: inclusion of income of all CFCs taxed at less than 75% Spanish CIT (18,75% vs 25% for non privileged income) if not sufficient substance in CFC or foreign group entity or sound business reasons for existence of CFC.
  - Inclusion of passive and base erosion income even if substance.

Spanish tax law and Pillar 2

- **Future outlook**
  - EU 2022/2523 will need to be transposed.
  - No announcements, public consultation or draft legislation whatsoever.
  - Timing of legislative process uncertain.
  - Potentially some 120 taxpayers within scope of measures

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05 Mexico Pillar 2 implementation updates

Main tax challenges and benefits with the implementation of Pillar 2

- On October 2021, Mexico joined Pillar 1 and Pillar 2. According to the latest communications, Mexico expressed its intention to implement, within its tax domestic legislation, the GloBE Rules, since it may result in additional tax collection, either with the IIR, the UTPR or the Main STTR.
- Based on current revenue expectations, about 100 companies within Mexico -including publicly traded as well as private companies- are expected to be within the scope of Pillar Two.
- The maximum expected benefit of the unified proposal -Pillar 1 and 2- is up to **USD$1.8 billion** –more than MXP$37 billion-, which could easily cover the budget of various Government dependencies.
- It was Mexico –and other countries like Indonesia, Germany, South-Africa, etc.- intention that the tax rate (15%) to be higher, since the GloBE rules may apply to more MNE, which translated into higher tax collection.
- The main challenge, despite the difficulty of the technical and practical aspects, is to achieve the most number of countries to approve and implement the Pillar 2. If only a reduced number of countries implement the GloBE rules, a problem of tax competition between countries may arise.

Mexican tax challenges in connection with the IIR

- Since Mexico is a capital importer country, currently, within Mexican tax domestic legislation, there are certain regimes with beneficial/preferential tax treatment which may lead to an effective tax rate to be less than 15%.
  - Maquila regime
  - Border Region
- The above situation may lead to re-think if it’s necessary to perform activities within Mexican, since -with the implementation of the IIR- in the end the difference between the Mexican effective rate and the 15% rate, will be collected by the country of residence of the holding-company.

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Mexican tax challenges in connection with the UTPR

- As part of the Mexican Tax Reform effective since 2020, within the Mexican tax domestic legislation, a new similar rule to the UTPR was included, which currently remains in force.
- With the implementation of the UTPR rule, this current Mexican domestic rule will have to be analyzed, since the effective rate for the prohibition of the deduction is 22.5%, which is higher than the tax rate established in Pillar Two (15%). In this regard, the current Mexican domestic rule will have to be modified in order to eliminate the rate discrepancy. Likewise, Mexico will have to analyze if the economic substance exemption will remain in force.
- Such rule prohibits the deduction to the Mexican taxpayers of the direct or indirect payments/expenses made to related parties, when the income of the effective beneficiary of such payment is subject to a tax haven.
- In accordance with the Mexican tax domestic legislation, an income will be subject to a tax haven when if levied to an effective rate less than 75% of the rate that would have applied in Mexico (i.e., 22.5%).
- In some cases, if the effective beneficiary demonstrates economic substance and if its resident within a jurisdiction with which Mexico has a comprehensive information exchange treaty in place, the Mexican taxpayer may take the full deduction of the payment/expense.
    - This exception will not be initially applicable, if the payment/expense is subject to a hybrid mechanism or if the income is attributable to a branch or PE or exempt related party, in accordance with a structured agreement.

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Mexican tax challenges in connection with the STTR

- Derive from an October 2021 version of the STTR, the minimum rate (9%) should be applicable to interest, royalties and other payments and that source countries will be limited to the difference between the minimum rate and the source country rate.
  - **Royalties**: all Mexican tax treaties establish a reduced WHT rate of 10%, thus there is no modification expected since the WHT source-country rate (10%) is higher than minimum rate (9%).
  - **Interests**: Similar to royalties, almost all Mexican tax treaties established a reduced WHT rate between 10% - 15%, thus, no modification is expected. Nevertheless, for interests paid to Bank or Financial Institutions the domestic WHT rate and reduce WHT rate by tax treaties is between 4.9% - 5%. This specific situation may lead to modifications.
- Mexican tax treaties commonly contain restrictions that avoid certain situations that may lead to an ***(i)*** exemption, ***(ii)*** low tax or ***(iii)*** double exemption in the beneficiary residence country, in which cases the domestic WHT rates will be applicable. In such cases in which the domestic WHT rate is higher and/or less than the minimum rate (9%), the question remains as to whether Mexico would restrict the taxing power to tax only up to 9% and renegotiate these provisions or, reject the adoption of the STTR so that the current provisions would remain in place.

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Final conclusions

- There are certain items that must be clarified/addressed in connection with the determination of the rate of 15%, since it is based on financial profits, situation that may lead into distortions, since there is no full-harmonization in the rules issued in relation to the tax systems of the countries, which generates particularities in these countries that are not being taken into account in the design of the GloBE rules (Pillar 2).
- It is expected that within the implementation more points will arise that will need to be clarified; since the proposal for legislation made by the OECD -both its content and structure- must adhere to Mexican legislation without deviating from the principles agreed under the Inclusive Framework, which will represent an important challenge for these provisions to meet their objective and, in turn, observe the framework established by Mexican domestic legislation.

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