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Sylvia Dikmans, *Houthoff, Amsterdam*
Michael Orchowski, *Sullivan & Cromwell, London*
Gerry Thornton, *Matheson, Dublin*
Amanda Varma, *Steptoe & Johnson, Washington, DC*

Reporter
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Transitioning into a ‘Brave New World’ of Pillar II

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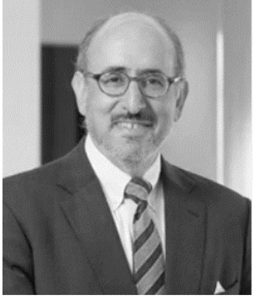

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Agenda

- Selected Pillar II issues for:
  - Investment Funds
  - Joint Ventures
  - International M&A
- Recent US Foreign Tax Credit Notice

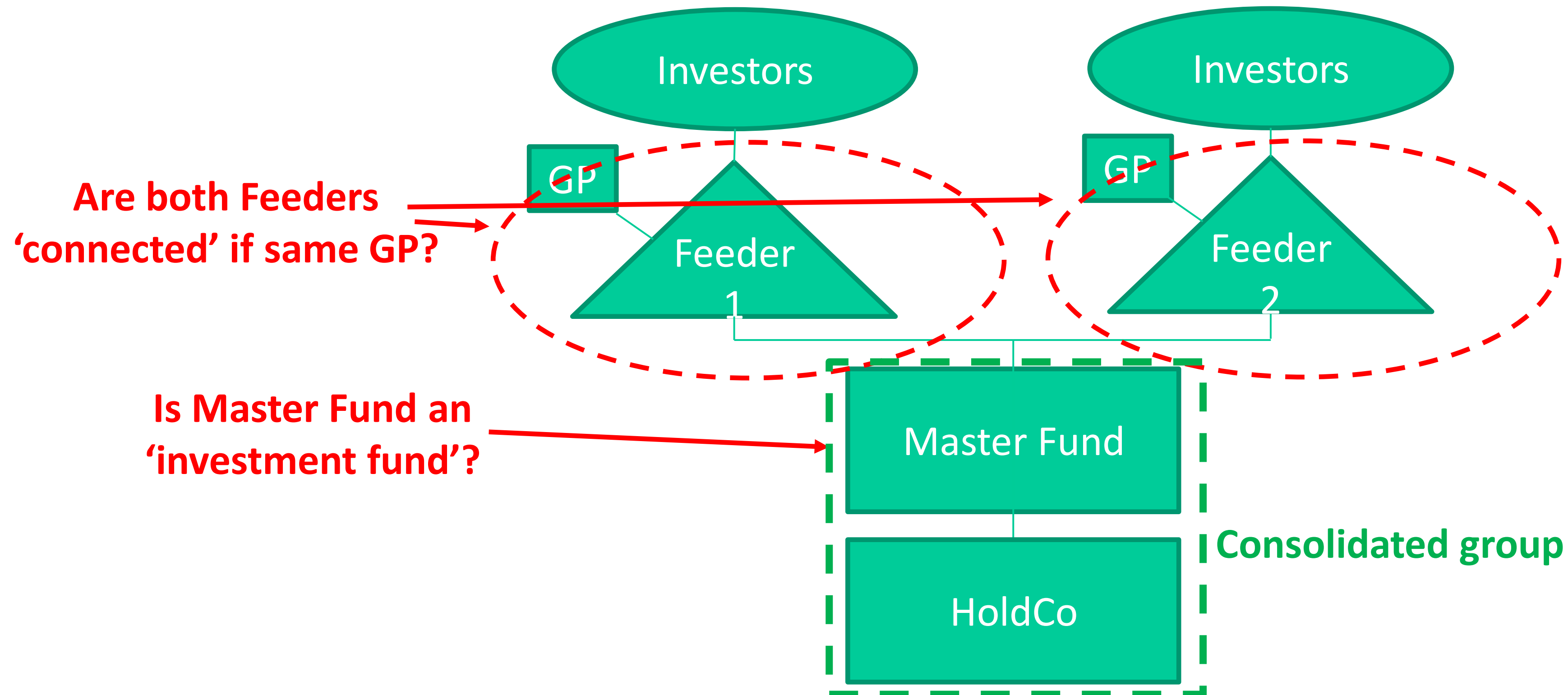
Investment Funds

Pillar II and Investment Funds

- 7 conditions to be an ‘investment fund’:
  - Designed to pool assets from investors “some of which are not connected”
  - Defined investment policy
  - Investors reduce their costs or spread their risk
  - Main purpose is to generate investment income or gains
  - Investors’ return is based on their contributions
  - The entity is regulated or the investment manager is regulated
  - The entity is managed by investment fund management professionals
- 2 conditions to be an ‘investment entity’ (other than an ‘investment fund’):
  - Must be 95% owned by an investment fund, or through a chain of such entities
  - Must operate exclusively or almost exclusively to hold assets or invest funds for their benefit
- To be an ‘excluded entity’ from Pillar II, it covers:
  - ‘Investment funds’ that are ‘ultimate parent entities’
  - Entities that are 95% owned by one/more entities described at #1, directly or through one/several excluded entities; and must operate exclusively or almost exclusively to hold assets or invest funds for the benefit of such entities

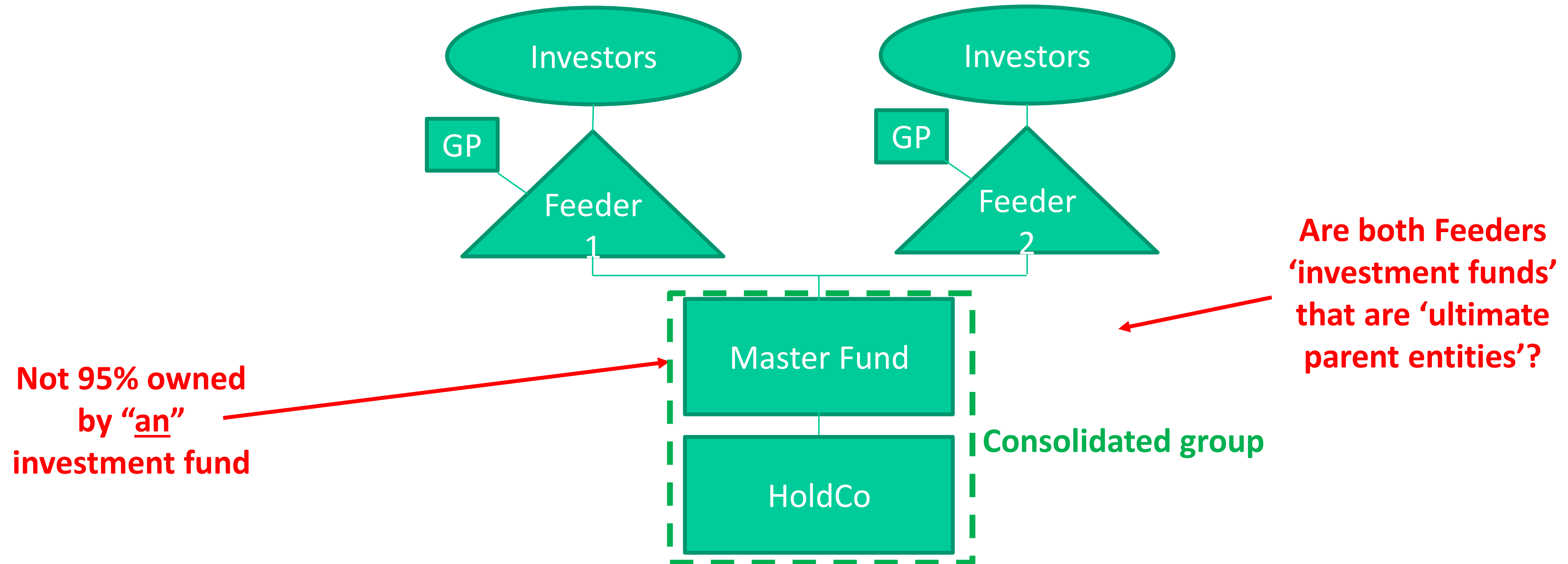
Pillar II, Funds – Topic 1: Unconnected Investors

- Issue: Whether a 'look-through' approach is acceptable in identifying unconnected investors, investing through a feeder fund?
- Article 5 of the OECD Model Treaty defines 'connected': persons who are "*under the control of the same person*" or common >50% ownership of equity interest.



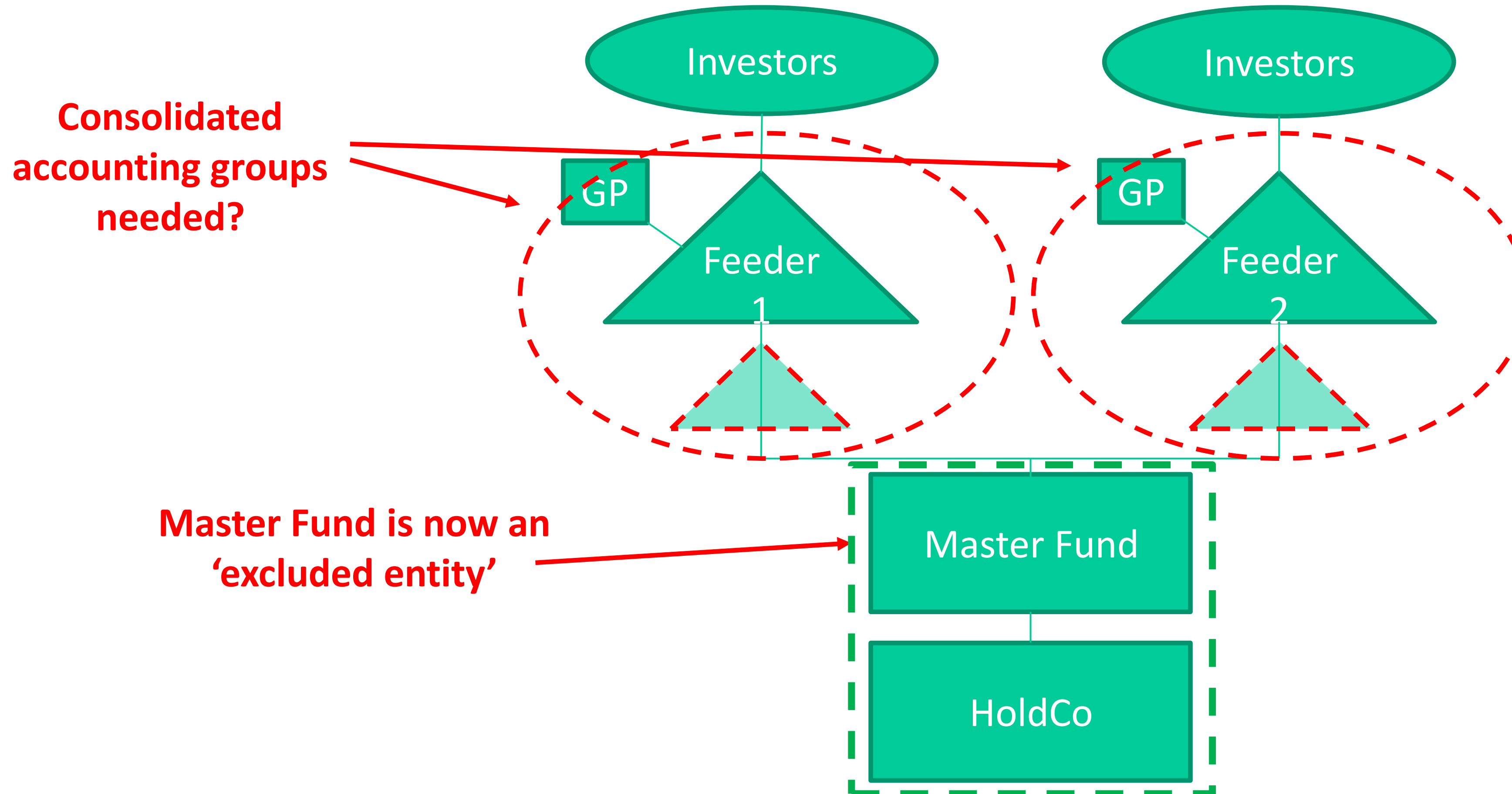
Pillar II, Funds – Topic 1: Unconnected Investors

- If not an 'investment fund', an entity can be an 'investment entity' (95% owned directly by an investment fund). But, Master Fund is owned by two Feeders …
- An entity is an 'excluded entity' if the entity is at least 95% owned directly by "one or more" entities that are "investment funds that are ultimate parent entities". But, are the Feeders 'ultimate parent entities'?



Pillar II, Funds – Topic 1: Unconnected Investors

- Result – is there a need to establish subsidiaries below each of the Feeders?



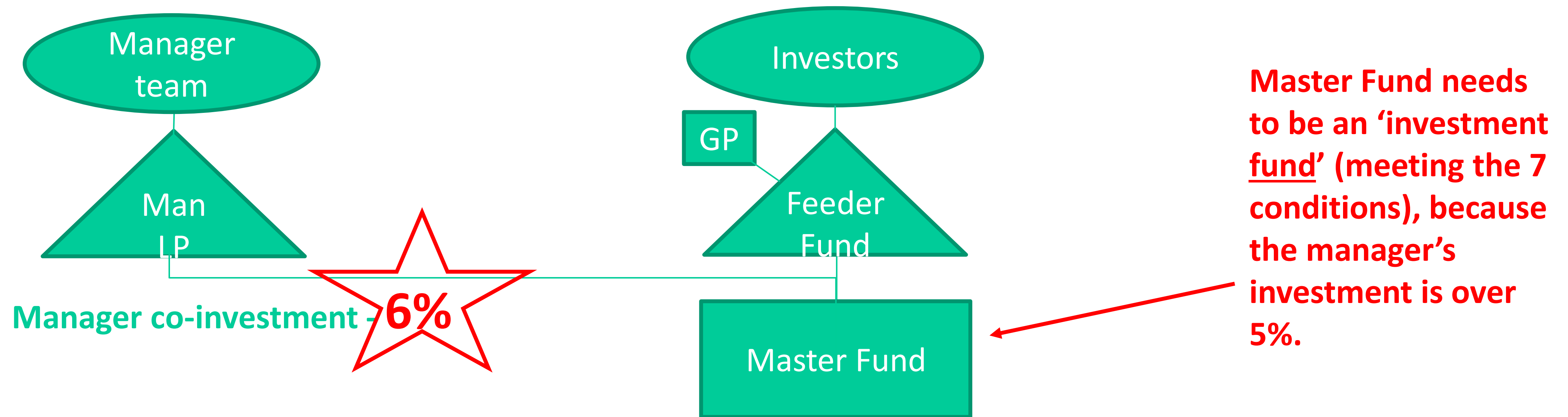
Pillar II, Funds – Topic 2: Managers' Co-investment

- Pillar II rules allow for a subsidiary of a fund to remain 'excluded' if it has up to 5% investment by entities that are not 'investment funds that are ultimate parent entities'. (This increases to 15% for private equity funds, where only returns are capital gains and dividends.)

*"An entity where **<u>at least 95% of the value of the entity is owned by</u>** one or more [investment funds that are ultimate parent entities], directly or through one or several excluded entities"*

Pillar II, Funds – Topic 2: Managers' Co-Investment

- If total management co-investment increases **over 5%**, then the Master Fund must itself qualify as an 'investment fund' (including having unconnected investors).
- Generally, should not be an issue for 'carry' entitlements, provided the Master Fund ceases to issue new shares to the Feeder before any value accrues to the carry entitlement. (Though different rules in some jurisdictions.)



Pillar II & Investment Entities

Excluding Entities

This Directive ***shall not apply*** *to the following entities ('excluded entities') unless the filing constituent entity has made an election not to treat such entities as excluded in accordance with Article 43(1): (a) a governmental entity, an international organisation, a non-profit organisation,* ***a pension fund, an investment entity that is an ultimate parent entity and a real estate investment vehicle that is an ultimate parent entity; or (b) an entity that is owned at a minimum of 95 % by one or more entities referred to in point (a), directly or through several such entities, except pension services entities, and that: (i) operates exclusively, or almost exclusively, to hold assets or invest funds for the benefit of the entity or entities referred to in point (a); or (ii) exclusively carries out activities ancillary to those performed by the entity or entities referred to in point (a); or (c) an entity that is owned at a minimum of 85 % by one or more entities referred to in point (a), directly or through one or several such entities, provided that substantially all of its income is derived from dividends or equity gains or losses that are excluded from the computation of the qualifying income in accordance with point (b) of Article 15(2).***

Group definition

'group' means: (a) a collection of entities which are related through ***ownership or control*** *as defined* ***by the acceptable accounting framework for the preparation of consolidated financial statements by the ultimate parent entity****, including any entity that may have been excluded from the consolidated financial statements of the ultimate parent entity solely based on its small size, materiality grounds or on the grounds that it is held for sale; and (b) an entity that has one or more permanent establishments, provided that it is not part of another group as defined in point (a);*

Impact on VC, PE, PF and SV – Controlling Interest

Impact of IFRS on Pillar II Investment Entities

IFRS 10

> In October 2012, the IASB amended IFRS 10 to provide a limited scope exception from the consolidation guidance for a parent entity that meets the definition of an investment entity (reasoning behind was that the industry felt that consolidating the financial statements of an investment entity and its investees does not provide useful Information).

> Therefore, entities that, meet the definition of an investment entity under IFRS 10, do not consolidate certain subsidiaries. This exception does not apply to subsidiaries which provide investment related services to the parent entity which will be consolidated.

> Then, such investment entity fall outside the scope of Pillar II and should be even disregarded for the “excluded entities” analysis (e.g. section 2.3 a) Directive) because it cannot be a UPE.

A parent shall determine whether it is an investment entity. An investment entity is an entity that:

(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;

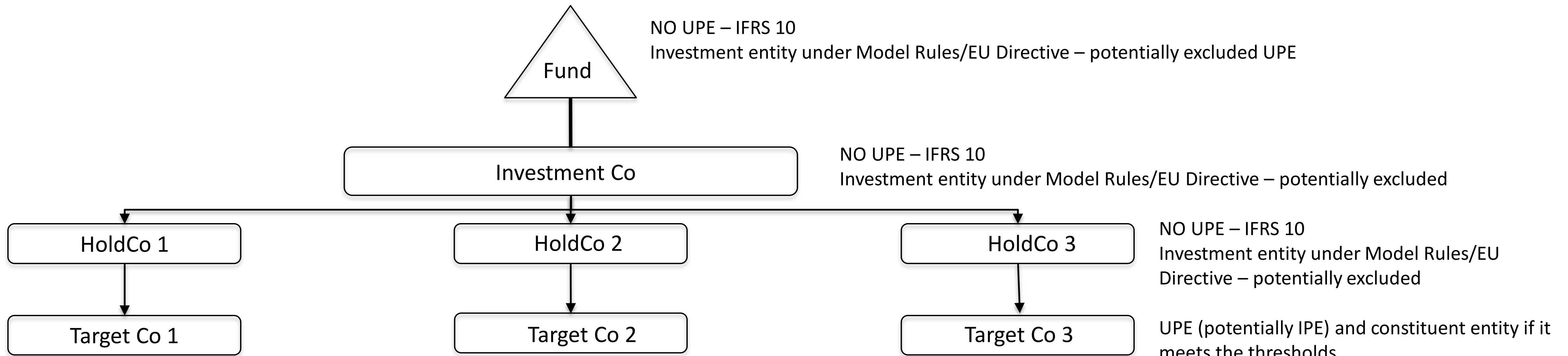
(b) (b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and

(c) (c) measures and evaluates the performance of substantially all of its investments on a fair value basis.

Pillar II & Investment Entities

Practical insight

Whilst individually for IFRS purposes HoldCo 1 – 3 would unlikely to qualify as investment entities, as a group however, they have all the typical characteristics of an investment entity not subject to consolidation rules.



If the entities constitute a group but are excluded → jurisdictional blending
If the entities do not constitute a group → no jurisdictional blending but consider Pillar II thresholds for Target Co

Pillar II and Joint Ventures

Pillar II & Joint Ventures – Basic Rules

The treatment of JVs under Pillar II depends on whether the interest in the JV is consolidated on a line-by-line basis or by the equity method

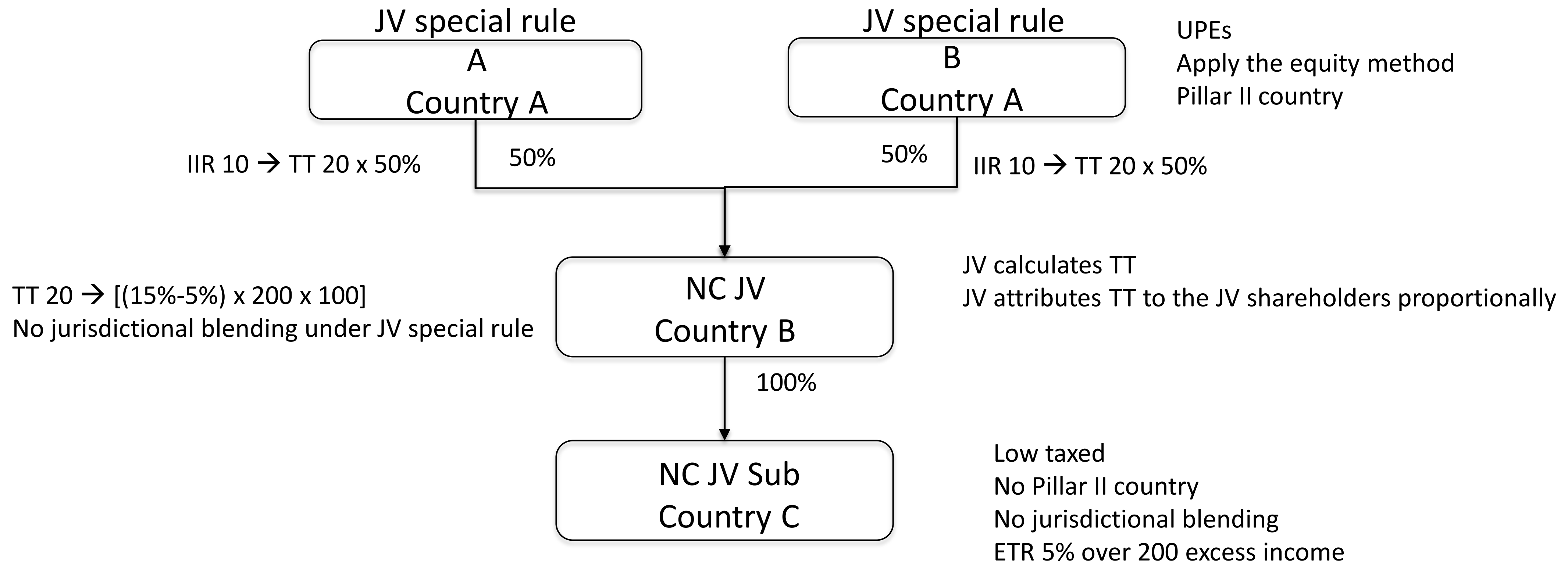
- Accounting key criterion: significant influence (IFRS 28) – 20%/50% voting rights – associated entities
- If the investor controls the investee the results of the investee would be consolidated in the consolidated financial statements (line-by-line basis) → Consolidated
- If there is a significant influence, the interest in the JV is accounted under the equity method and the results are not consolidated (equity method) → Not consolidated
- **<u>Exception/special rule</u>**: Pillar II provides for a definition of in-scope JVs (broader tan the accounting definition) to capture certain not consolidated JVs back, if:
    - JV results are reported under the equity method;
    - The UPE's (in)direct ownership interest in JV represents at least 50%; and
    - JV is not the UPE of an MNE in scope of Pillar II (i.e. JV and its (in)direct in scope subsidiaries do not meet the Revenue Threshold)

  If all the above is meet, ETR is computed as if the JV is the UPE of a separate MNE (provided that the JV shareholders are in scope of Pillar II).

Pay special attention to non-consolidated 50% stakes

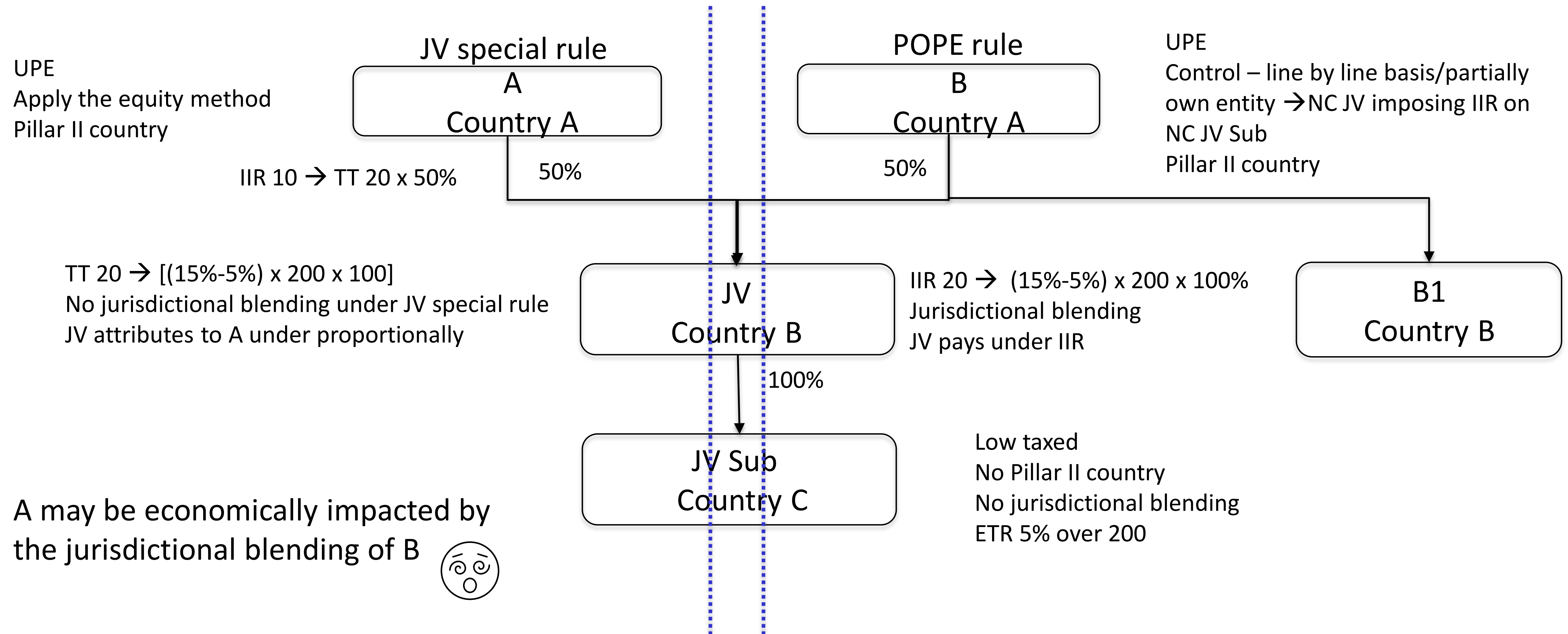
Pillar II & Joint Ventures – No Control

Practical insight – NC JV



Pillar II & Joint Ventures – B Controls

Practical insight – JV – control/no control



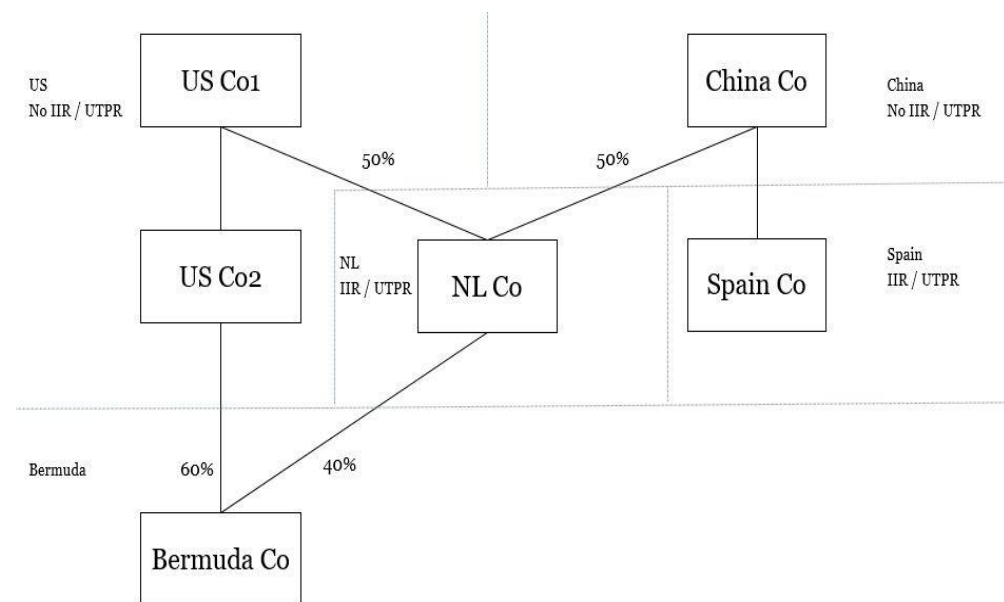
International M&A

Traditional Approaches to Tax Diligence & SPA

- Due diligence:
  - Focused on target group only; limited attention given to non-cash DTAs and DTLs.
  - Low-ETR businesses generally considered desirable.
  - Joint liability for fiscal unities and US consolidated returns; otherwise ring-fenced tax liability for target.
- Purchase price mechanism and accounting:
  - Closing accounts vs. locked box.
- Purchase agreement considerations:
  - "Our watch / your watch" vs. "non-recourse" / representation & warranty insurance.

General Tax Diligence Issues Under Pillar II

- Scope of Pillar II risks can be very broad:
  - Meeting the €750 million threshold:
    - multiple parent companies, joint ventures, (past) mergers and acquisitions, transfer of assets/liabilities.
  - Correct application of Pillar II rules. Due diligence may require in-depth analysis of the Pillar II calculations, like:
    - Meeting the €750 million threshold? Do any safe harbors apply?
    - Has the taxable income been calculated correctly?
    - Has the participation exemption been applied correctly?
    - Have permanent establishments and hybrids been taken into account?
    - Have other CFC regimes been taken into account correctly?
    - Have (deferred) local taxes been taken into account correctly?
    - Has the correct Pillar II rule been applied? Was there a correct allocation under the QDMTT, IIR and/or UTPR?
    - Have qualified refundable tax credits (QRTC) and non-qualified refundable tax credits (Non-QRTC) been correctly identified?

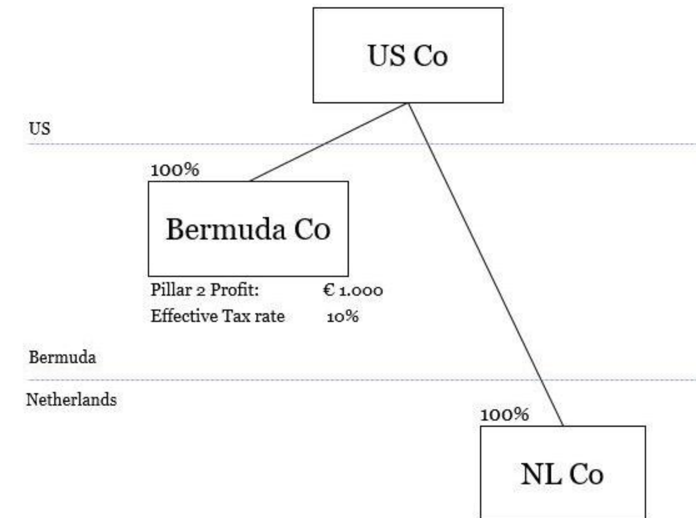


Who is Responsible for Pillar II Tax?

- Impact of incorrect Pillar II application can also be very broad:
  - Parent companies are primarily liable for Pillar II tax (IIR)
  - All group companies can be liable for a portion of the Pillar II tax under the UTPR
  - Individual group companies separately liable for QDMTT
  - Under Pillar II itself, no joint or several liability imposed among group companies.
  - BUT in the Netherlands, all group companies are jointly and severally liable for Pillar II tax levied by the Netherlands, effectively resulting in joint and several liability for Dutch Pillar II taxes. (See example)
    - Risk of this liability will be hard to determine and model
    - Any group companies failing to make the relevant Pillar II notifications may be subject to fines
  - Pillar II rules also requires correct transfer pricing between the relevant group companies – may also not be covered by a W&I.

Tax Diligence - Specific Dutch Implementation Issues

- Every Dutch company is required to file a notification if Pillar II applies to it, unless the parent company filed such a notification
  - Failing to meet this requirement may result in a fine of up to €1,030,000 (2024)
- There is a reporting obligation if a company is aware that the Pillar II rules were applied incorrectly
  - Reporting required within 2 weeks, fine is 100% of the Pillar II tax that was missed due to the mistake
- Each group company **is jointly and severally liable** for the Pillar II tax due by the Dutch group companies
  - If NL Co is liable for the entire Pillar II tax of the group (UTPR) in the below example, the Netherlands can hold other group companies (US Co and/or Bermuda Co) liable for these taxes as well
  - Can be easily effectuated in the Netherlands – Dutch government indicated that tax inspectors should collect in the Netherlands first
  - Collection abroad depends on the tax collection treaties in place between the Netherlands and the relevant jurisdiction



Additional Pillar II Tax Diligence Issues

- Scope of tax diligence:
  - Jurisdictional blending and the UTPR may mean that tax diligence may need to extend more broadly.
    - Access to GloBE Information Return?
  - Additional focus on deferred tax items.
  - Restructurings between November 30, 2021 and the first year when Pillar II takes effect may also need to be examined.
- Valuation considerations:
  - Low local ETRs are no longer necessarily desirable (but could still be).
  - Whether or not a buyer is above the €750mm threshold can have an impact on valuation.

DTAs and DTLs Important Going Forward

- Normally, purchase accounting gives rise to a “step-up” in the book basis of an acquired company’s assets. In general (absent, e.g., a Section 338(g) election in the US), no such step-up occurs for tax purposes in a stock purchase. As a result, purchase accounting gives rise to a DTL for the tax effect of the step-up.
- Assume that a Buyer acquires Target with an asset basis of 100 for 300. Buyer would record a step-up of 300-100 = 200. Assuming a tax rate of 15%, Buyer would also record a DTL of 200 x 15% = 30.
- The DTL would be recorded as follows:
    - Fair value of assets acquired 300
    - DTL (30)
    - Goodwill <u>30</u>
    - Book value (equal to purchase consideration) <u>300</u>
- If the assets of Target are later sold for 300, the 200 of gain would be recognized for local tax purposes and the 30 of tax would be paid.
- Normally, the 30 of the tax would be debited against the DTL and thus not be a tax expense included in the starting point for Covered Taxes. Under the GloBE rules, DTLs arising from purchase price accounting are ignored. Consequently, the 30 of tax paid would increase Covered Taxes in the year of the sale.

DTAs and DTLs

- DTAs arising from intra-group asset transfers between November 30, 2021 and the first fiscal year when the GLoBE rules are effective can be disallowed for GLoBE purposes.
  - This may reduce an entity's ETR and trigger a top-up tax.
- Temporary differences (*e.g.*, accelerated depreciation):
  - In general, these both (i) reduce current tax and (ii) give rise to a DTL.
  - This treatment applies under the GLoBE rules, but the DTL is limited to the lower of the applicable tax rate or 15%.
  - Could (if, e.g., credits are available) reduce an entity's ETR below 15%.
- DTLs (other than certain excepted DTLs) that do not reverse within 5 fiscal years can be recaptured, leading to a reduction in an entity's ETR.
  - This has the potential to create a post-closing Pillar II inclusion that arises from pre-closing events.

Covering Pillar II Risks in the SPA

- Ideally, buyers will want a specific tax warranty on Pillar II covering:
  - The target companies are not subject to the Pillar II rules until effective date / completion date, or the target companies have correctly applied all Pillar II rules until effective date / completion date, including notification obligations
  - If applicable: confirming the availability of Pillar II tax credits at the completion date
  - Confirmation of other specific relevant facts for Pillar II? E.g., real presence, specific exemptions, etc.?
- General tax indemnity in SPA's should cover pre-effective date/completion Pillar II taxation
  - Should also cover secondary tax liabilities
  - Cover the loss of a deferred Pillar II tax asset?
  - There has been a recent, growing trend toward more "no-recourse" / RWI transactions. Query whether Pillar II will change that.

Other Considerations for the SPA

- Wording on how to deal with the period between effective date and completion (locked box deals):
  - Parent may be liable for the Pillar II taxation of the target group (e.g, through the IIR), similar to the Dutch fiscal unity
  - Therefore, parent (or another group company that is not a target company) may have to be refunded for any Pillar II taxes borne by it for income of the target group between the effective date and the completion date
  - Similarly, the target group may have to be refunded for losses (if in the same jurisdiction) or qualifying tax credits used by the parent (or another group company that is not a target company)
  - What if the buyer is a non-Pillar II group? Which party should bear the Pillar II taxation?
- In a closing accounts transaction, the definition of "Indebtedness" (which normally includes income taxes) may also need to be adjusted to exclude taxes payable by the seller / UPE.
- Inclusion of Pillar II tax benefits in the general tax benefits definition?
  - Should tax benefits be capped at 15%? Or should a discount for Pillar II be applied?
- Inclusion of Pillar II tax assets in the Purchase Price? How are these taken into account for accounting purposes?
  - Is there a difference between accounts for entity that is envisaged to be subject to Pillar II rules vs. entity that is not?
- Termination of any Pillar II tax sharing agreements of the target group at completion

Rep & Warranty Insurance & Structuring Considerations

- R&W insurance:
  - Normally, RWI carriers will only cover warranties that have been investigated through tax DD.
  - Moreover, "secondary" tax liabilities and tax assets are generally not insurable.
  - Will carriers cover R&W made regarding whether, e.g., the seller is in-scope? Other Pillar II matters?
- Structuring considerations:
  - Potential mismatches between accounting and tax rules.
  - US tax overlay (e.g., 338(g) elections, check-the-box planning) and integration planning.

Considerations for Specific Transactions

- Pillar II has various rules on how to deal with different restructuring alternatives:
  - Mergers: the €750 million threshold is determined based on the turnover of the separate groups of the merging companies in the past 4 years.
    - Each group's past turnover must be assessed
    - Potentially requires wording in the SPA on how to deal with pre-Completion events that result in post-Completion Pillar II taxes levied from structure
  - Demergers: Pillar II applies if the €750 million threshold is met in the year of the demerger and in 2 of the 3 subsequent years.
    - Each group's expected turnover must be assessed
    - Potentially requires a post-completion tax indemnity by both parties for any Pillar II taxes, e.g., if no Pillar II taxation is envisaged due to the €750 million threshold not being met, but if there is a risk that the threshold is met after Completion by one of the two groups.
  - Asset/liability transfer: can result in a tax liability at completion
    - Tax risk to be assigned under the APA
    - Cash-out for increase in Pillar II tax book values?
  - How to deal with Pillar II corrections made in subsequent years that effectively refer to pre-completion events? Does this require additional wording in an SPA, e.g, in the conduct clauses?

Foreign Tax Credit Issues in the U.S.

Pillar II and U.S. Law – Current Status

- No U.S. legislative action to implement Pillar II reasonably expected in the near-term
- U.S. law does not currently include a qualified IIR, QDMTT, or UTPR
  - U.S. GILTI regime treated as CFC regime (for now, subject to simplified allocation formula to push down taxes to CFCs)
  - United States has a "corporate alternative minimum tax" ("CAMT") imposed on large companies, but the CAMT is not a QDMTT
- Recent guidance (Notice 2023-80) provided some guidance on the interaction of U.S. law and Pillar II

Pillar II and U.S. Law – Looking Forward

- As Pillar II is implemented outside the United States, a major issue for U.S. MNEs is the extent to which UTPRs may apply with respect to U.S. income
- Certain U.S. tax features can drive a U.S. MNE’s U.S. rate below 15%
  - General business credits, including the R&D credit, not treated as QRTCs or MTTCs
  - Reduced rate on FDII (set to increase in 2026)
  - Other base differences
- U.S. policy responses?

Pillar II Computational Ordering for U.S. Group (Simplified)

Local Tax

- Local country tax calculations
- Apply QDMTT (if enacted)

U.S. CFC Taxes

- U.S. parent determines its tax liability with respect to CFC income
- 21% tax on subpart F income
- 10.5% tax on GILTI

Attribution of CFC Tax to CFC Jurisdictions

- Taxes may be pushed down for IIR/UTRP purposes (not QDMTT)

IIR/UTPR Calculation

- Calculate jurisdiction GloBE ETR and apply IIR/UTPR
- GloBE ETR takes into account CFC taxes allocated

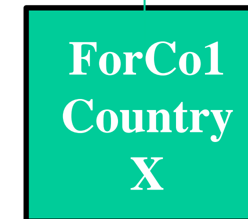
U.S. Guidance on Pillar II Issues

- Notice 2023-80, released December 2023
- Addresses several questions involving the interaction of U.S. law and Pillar II
- Key points –
  - No foreign tax credit is allowed if, under foreign tax law, any amount of U.S. tax would be taken into account in computing the final top-up tax
  - No major guidance on UTPR, which Treasury and the IRS continue to study

U.S. Guidance on Pillar II Issues – Foreign Tax Credits and IIRs

- Country X imposes an IIR
- USP is considered part of the same MNE Group as ForCo1 and ForCo2 and any U.S. tax liability of USP that relates to income subject to the IIR is taken into account in computing the IIR
- Under Notice 2023-80, no foreign tax credit is allowed to USP for the 4x of Country X IIR that USP is deemed to pay because, under Country X tax law, USP's U.S. federal income tax liability may be taken into account in computing the Country X IIR

USP is deemed to pay 4x of the Country X IIR under U.S. law – ***No foreign tax credit allowed***

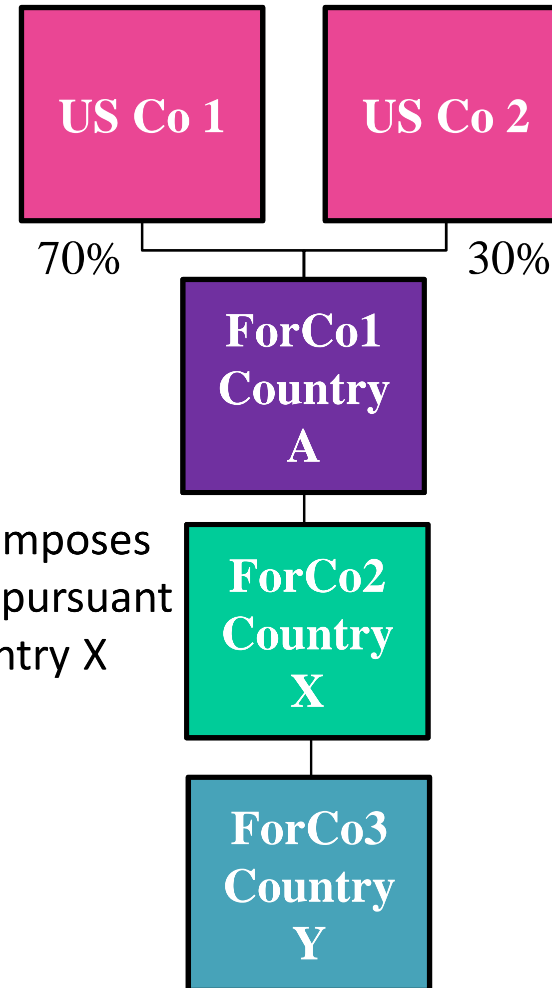


Country X imposes 5x of tax pursuant to the Country X IIR

U.S. Guidance on Pillar II Issues – Foreign Tax Credits and IIRs

- Same facts as prior example, except US Co 1 and US Co 2 together own a holding company, ForCo1, resident in Country A
- US Co 2 is a 30% owner of ForCo1 and is not considered part of the same MNE Group as US Co 1, ForCo 2, and ForCo 3 under Country X law

Deemed to pay 3.64x of the Country X IIR under U.S. law – ***no foreign tax credit allowed***

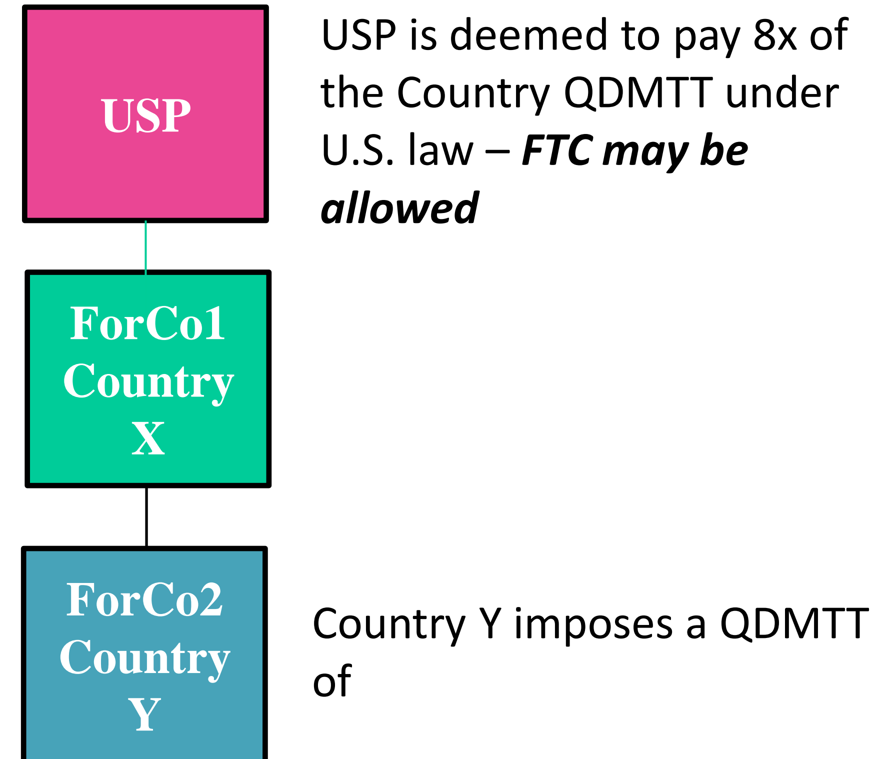


Country X imposes 6.5x of tax pursuant to the Country X IIR.

Deemed to pay 1.56x of the Country X IIR under U.S. law – ***Credit may be permitted because no amount of US Co 2's U.S. federal income tax liability can be taken into account in computing the Country X IIR as US Co 2 is not part of the same MNE Group***

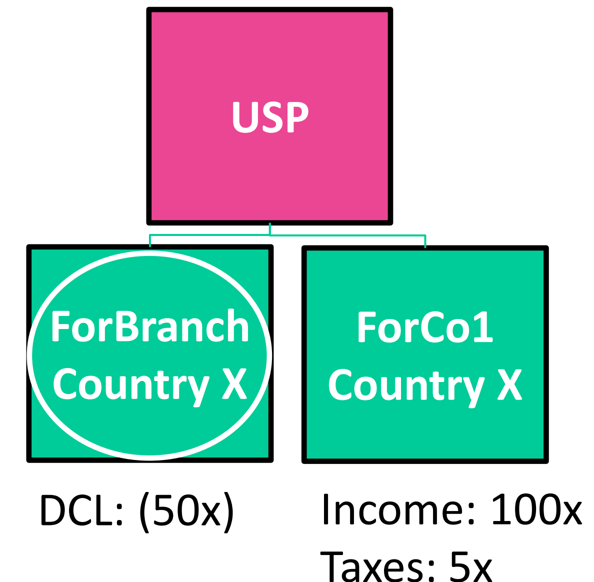
U.S. Guidance on Pillar II Issues – Foreign Tax Credits and QDMTTs

- Country Y imposes a QDMTT
- Under Country Y law, the foreign tax liability of owners of the entity subject to the QDMTT is not taken into account in computing the QDMTT
- Under Notice 2023-80, USP may be allowed a credit for the 8x of Country Y QDMTT deemed paid



U.S. Guidance on Pillar II Issues – Dual Consolidated Losses

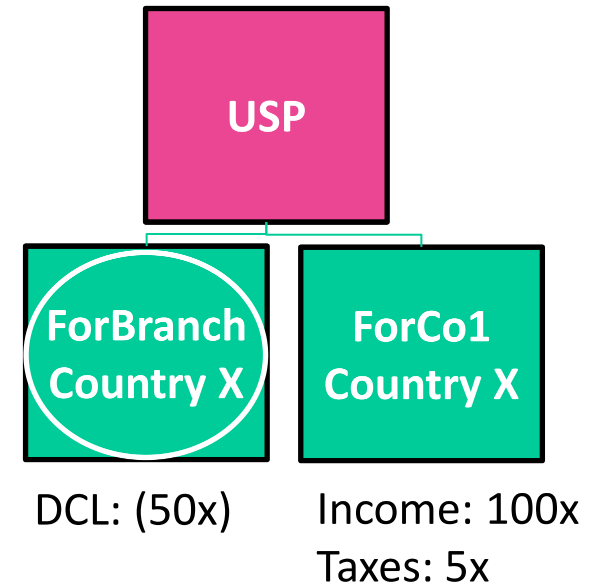
- The United States has "dual consolidated loss" ("DCL") rules to prevent "double dipping" of a single economic loss
- A U.S. person with a foreign separate unit (e.g., a branch) cannot use a loss attributable to that unit to reduce U.S. income
  - Exception for losses with no "foreign use"
- Pillar II raises a concern that a QDMTT (or other Pillar II tax) could be considered to give rise to a foreign use by combining a GloBE loss of one MNE Group entity with income of another entity



Country X has adopted a QDMTT – does netting of ForBranch's 50x loss with ForCo1's 100x income pursuant to the Country X QDMTT result in a "foreign use" of the DCL?

U.S. Guidance on Pillar II Issues – Dual Consolidated Losses

- Notice 2023-80 states that Treasury and the IRS are studying the extent to which the DCL rules should apply with respect to the GloBE Model Rules, including the extent to which aggregation should result in a foreign use of a DCL
- In the meantime, a foreign use will generally not be considered to occur with respect to a "legacy DCL"
- A "legacy DCL" is generally one incurred in taxable years ending on or before December 31, 2023



Country X has adopted a QDMTT – does netting of ForBranch's 50x loss with ForCo1's 100x income pursuant to the Country X QDMTT result in a "foreign use" of the DCL?