OECD Pillar Two: GloBE rules for New Zealand

An officials' issues paper

Inland Revenue
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OECD Pillar Two: GloBE rules for New Zealand – an officials' issues paper

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ABBREVIATIONS AND GLOSSARY

Abbreviations

BEPS	Base Erosion and Profit Shifting
CbCR	Country-by-Country Reporting
CE	Constituent Entity
DMT	Domestic Minimum Top-up Tax
ETR	Effective Tax Rate
GloBE	Global Anti-Base Erosion
IF	Inclusive Framework
IFRS	International Financial Reporting Standards
IIR	Income Inclusion Rule
IPE	Intermediate Parent Entity
JV	Joint Venture
LTCE	Low-Taxed Constituent Entity
MNE	Multinational Enterprise
OECD	Organisation for Economic Co-operation and Development
PE	Permanent Establishment
POPE	Partially Owned Parent Entity
UPE	Ultimate Parent Entity
UTPR	Undertaxed Profits Rule

Glossary

GloBE rules: Two interlocking rules (IIR and UTPR) which together form the primary mechanism of Pillar Two.

Model Rules: A 10-chapter document setting out model legislation for governments wishing to enact the GloBE rules domestically.

Pillar Two: One half of a 2-pillar solution formulated by the OECD-sponsored Inclusive Framework to address tax challenges arising from the digitalisation of the economy. Pillar Two is comprised of the GloBE rules (see above) and the Subject to Tax Rule, a treaty-based rule designed to allow jurisdictions to impose a top-up withholding tax on certain types of outbound payments that are made between related parties and are taxed at a nominal rate of less than 9%.

PART I: General

CHAPTER 1

Background

1.1 This document provides the basis for consultation on whether New Zealand should adopt GloBE tax rules and how it should implement those rules, if it does decide to adopt them. The rules are the main component of Pillar Two of the G20/OECD 2 Pillar solution to reform the international income tax framework in response to the challenges posed by the increasing globalisation and digitalisation of the economy.

1.2 In October 2021, this 2 Pillar solution was endorsed by over 130 countries in the OECD-sponsored Inclusive Framework, including New Zealand (this endorsement is referred to as the October Statement). This endorsement did not bind any country to adopt either Pillar. The Government has not decided whether to adopt either Pillar One or Pillar Two and has not ruled out adopting a digital services tax.

1.3 This is an officials issues paper, rather than a Government discussion document. The views expressed in this document are those of officials, and not necessarily those of the Government. Officials will report on submissions to the Government, and will consider the submissions when formulating their recommendations.

What are the GloBE rules?

1.4 The purpose of the GloBE rules is to ensure that in-scope multinational groups (MNEs) pay at least a 15% tax on their income in each country where that income is reported for financial reporting purposes. The rules operate not by way of a multilateral instrument but by incorporation by countries in their domestic law. They are intended to apply to every in-scope MNE in the world, no matter where it has its headquarters, operations or sales. The design of the rules means this intention can be achieved even if many or indeed most countries do not adopt the rules. But the design does require implementation by a critical mass of countries.

1.5 An important aspect of the rules is that they only apply to income in excess of the substance-based income exclusion ("excess income"). The exclusion is calculated under a formula which gives a percentage return on the value of tangible assets and payroll expense in the country. The exclusion is intended to focus the rules on the taxation of more mobile forms of income, such as interest or the return to intellectual property.

1.6 An MNE is in scope if its annual turn-over exceeds €750 million pa in two of the last four years. This scope means the rules are estimated initially to apply to approximately 1,500 MNE groups worldwide, of which 20–25 are based in New Zealand.

1.7 National sovereignty and competition for capital means it is not realistic to achieve the objective of the GloBE rules by getting all countries in the world to simply impose the required level of tax on entities over which they have residence or source taxing rights. The rules have to work on the basis that they will not be implemented by all countries.

1.8 There are two GloBE rules, each of which would require implementation into domestic law:

- An income inclusion rule (IIR). This rule imposes a top-up tax on the top company in an MNE (or in some cases lower tier holding companies) so that at least 15% tax is paid on the company's share of the excess income of its directly and indirectly owned subsidiaries and branches in each country where that income is reported. The IIR is similar to a CFC rule in that it imposes tax on a company in relation to the profits of its foreign subsidiaries (and branches), though there are also important differences. Countries that wish to adopt Pillar Two are supposed to bring this rule into effect in 2023.

- An undertaxed profits rule (UTPR), designed as a back-up to the IIR, intended to apply to the low tax excess income of an MNE group member in a country when that income is not subject to an IIR (because no direct or indirect group company shareholder of that group member is subject to an IIR with respect to the income). Like the IIR, this rule would impose sufficient additional tax on the group to increase the tax rate on that income to 15%, but the tax would be imposed on all group members resident in countries with a UTPR, in proportion to their substance in each country. This rule is supposed to be effective in 2024 for countries that wish to adopt Pillar Two.

1.9 A key aspect of the GloBE rules is that they apply on a jurisdiction by jurisdiction basis. Tax paid in a country where the rate is above 15% cannot be used to credit the liability for a country where the rate is below 15%.

1.10 The template for both rules is the Model Rules approved by the Inclusive Framework in December 2021.[1] By approving the Model Rules, Inclusive Framework countries have not agreed to implement the GloBE rules (though many are expected to do so), but rather have agreed that if they implement them, that will be in accordance with the Model Rules. This is critical to ensuring that the rules operate in a co-ordinated way to achieve the desired tax outcomes. The Inclusive Framework has also agreed a Commentary supporting the Model Rules.[2] The OECD plans to undertake further work in 2022 to develop a detailed Implementation Framework to deal with the practical implementation and co-ordination of the GloBE rules enacted by countries. The OECD has estimated global revenue gains under Pillar 2 to be USD$130-185 billion, or 6-7.5% of global corporate income tax revenues.

Aspects of this consultation

1.11 While the Model Rules with which each country's own IIR and UTPR must conform have been agreed, as has the accompanying commentary, there is still a degree of uncertainty in relation to the proposal:

- Areas of detail remain to be agreed, for example the nature of a safe harbour from the rules, and many of the issues that will be required to co-ordinate the application of the rules by different countries.

- It is not certain how many countries will be able to meet the 2023 and 2024 effective dates, nor how they will do so (for example, on a balance

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[1] The Model Rules can be found here: https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm

[2] The Commentary can also be found using the above link.

date basis, or applying a hard date for all MNEs regardless of balance date).

- There are some issues which have the potential to either defeat or substantially delay the implementation of the GloBE rules, for instance resolving the interaction of Pillar Two with the US global intangible low-taxed income (GILTI) rules. The GILTI rules are similar in their intent to the IIR rule, and the US is expected to continue to apply them rather than adopting an IIR.

1.12 Despite these uncertainties and continuing developments, officials are consulting now on the basis that if the required critical mass of other countries does adopt GLoBE rules, the Government will need to decide whether to join them in doing so. If the Government does decide to adopt the rules, then consistent with the October Statement it may be desirable for the IIR to apply in New Zealand from 2023 and it will certainly be desirable for it to do so from 2024. A similar approach is being taken by Canada (which included its proposal to implement the GloBE rules in its 2022 Budget), the United Kingdom (which published a consultative document in January 2022) and the European Union. Even if the rules applied from 1 January 2023, the first return would not need to be filed until sometime after the first quarter of 2025.

1.13 The purpose of this document is to consult on:

- Whether New Zealand should adopt the GloBE rules, assuming that a critical mass of other countries also does so.
- When any adoption should be effective, particularly in relation to the IIR.
- How best to translate the rules into New Zealand law.
- What areas of uncertainty there may be in applying the rules to New Zealand tax law, and how to resolve these.
- Whether tax paid to the Zealand Government under the rules should give rise to imputation credits.
- Administrative aspects, for instance return filing and timing of payments.

1.14 Although much of this document is devoted to explaining how the rules work, officials are not consulting on the elements of the rules which have been definitively agreed by the Inclusive Framework. This is for 2 reasons:

- New Zealand is part of the IF consensus which has approved the Model Rules and Commentary.
- If New Zealand does not have a complying IIR in place by 2024, it is likely that New Zealand headquartered groups will have to pay tax on any low-tax excess income under the GloBE rules in any case, by virtue of other countries enacting UTPRs. As a general proposition, an IIR will not be complying if it does not follow the Model Rules.

1.15 We are also consulting on whether New Zealand should apply the IIR to New Zealand source income of in-scope multinationals, by way of a domestic minimum top-up tax.

1.16 This consultation document is long and detailed. That is not surprising, given that it is attempting to both explain and consult on an entirely new income tax system. That system is designed to apply to the most complex businesses in the world, to be overlaid on top of every domestic income tax system in the world without giving rise to double taxation, and intended to be applied by potentially scores of tax administrations at the same time. Furthermore, it is a system which reflects its genesis in a consensus-based project involving over 130 different countries. Officials hope that readers find this document helpful, but expect it will take most some time to get to grips with what is being proposed and its implications.

Making a submission

1.17 Submissions are invited on any issues raised in this document, and on the specific questions posed in the document.

1.18 Submissions should include a brief summary of submitter's major points and recommendations. They should also indicate whether it is acceptable for officials from Inland Revenue to contact submitters to discuss the points raised, if required.

1.19 The closing date for submissions is **1 July 2022.**

1.20 Submissions can be made:

- by email to policy.webmaster@ird.govt.nz with "OECD Pillar Two: GloBE rules for New Zealand" in the subject line, or
- by post to:

  "OECD Pillar Two: GloBE rules for New Zealand"
  C/- Deputy Commissioner, Policy and Regulatory Stewardship
  Inland Revenue Department
  PO Box 2198
  Wellington 6140

1.21 Submissions may be the subject of a request under the Official Information Act 1982, which will result in their publication unless there are grounds for the submission (in whole or part) to be withheld. The withholding of responses on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you consider that any part of your submission should properly be withheld under the Act, please clearly indicate this.

CHAPTER 2

Summary of GloBE rules

Overview

2.1 This chapter provides a very brief summary of the purpose and scheme of the GloBE rules. It also explains how this issues paper is organised.

Purpose of the GloBE rules

2.2 As set out in Chapter 1, the GloBE rules are aimed at ensuring every in-scope group in the world pays tax at a rate of at least 15% on excess income in each country where income is reported. They do this by imposing a 'top-up tax' if an MNE's effective tax rate in a country is below 15%.

2.3 The purpose of the rules is to significantly reduce the opportunity for groups to avoid tax by moving mobile income into countries with low tax rates or with rules which allow that income to enjoy a low effective tax rate. The rules are not intended to prevent countries from providing tax incentives in relation to a reasonable return on tangible investment and activities. This is the reason for the substance-based income exclusion.

2.4 The GloBE rules are not concerned with the allocation between countries of taxing rights on the income of multi-national groups. That is the subject of Pillar One of the 2 Pillar solution.

Overview of the GloBE rules

2.5 This chapter provides a high-level overview of the GloBE rules, and an outline of the rest of this consultation document. The OECD has also produced an "Overview of the Key Operating Provisions of the GloBE Rules",[3] the first page of which is in **Appendix 1**.

2.6 **Chapter 3** discusses whether New Zealand should adopt the GloBE rules and the timing of that adoption if it does.

2.7 The GloBE rules only apply to MNEs whose consolidated annual revenues in two of the previous four years are at least €750 million. Details of the scope rules and exclusions are set out in **Chapter 4**.

2.8 The GloBE rules do not look at nominal or statutory tax rates, but effective rates. To work out if an MNE is subject to any top-up tax, the MNE has to calculate its effective tax rate (ETR) by comparing its tax in a jurisdiction with its accounting profit (with adjustments) for that jurisdiction. **Chapter 5** explains how an MNE's ETR is calculated, including how certain tax credits, such as Research and Development (R&D) tax credits and tax credits for supplementary dividends, are treated.

2.9 If an MNE's ETR in a jurisdiction is less than 15%, it must calculate the top-up tax it has to pay with respect to each group member in that jurisdiction. It does this by taking its adjusted accounting profit for the jurisdiction, subtracting the

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[3] The full 6-page document is available at https://www.oecd.org/tax/beps/pillar-two-GloBE-rules-fact-sheets.pdf

substance-based income exclusion (broadly, a 5%return on the tangible assets and payroll expenses in the jurisdiction[4]), and multiplying the result by the difference between its ETR and 15%. The resulting amounts are then allocated to the profitable group members in the country. These rules for calculating the top-up tax are explained in **Chapter 6**.

2.10 The obligation to pay top-up tax is then allocated between the MNE's entities in countries that have implemented the GloBE rules according to the rules explained in **Chapter 7**. In combination, these rules ensure that any top-up tax arising is paid by the MNE, without causing double taxation. In summary, the key rules are:

- *Income Inclusion Rule* (IIR). The IIR works on a 'top-down' basis, by imposing top-up tax on a parent entity in an MNE. The top-up tax will usually be imposed on the MNE's ultimate parent entity (UPE), if that parent is resident in a jurisdiction that has a qualified IIR.[5] There are also ordering rules that may apply if it does not, or if the group's low-taxed entities are more than 20% owned by minority investors outside the group.
- *Undertaxed Profits Rule* (UTPR). The UTPR is a backstop to the IIR. If top-up tax is not fully allocated to parent entities under a qualified IIR, the top-up tax may instead need to be paid by the group's other entities, located in jurisdictions with a UTPR. This ensures that if a jurisdiction decides not to implement the GloBE rules, MNEs cannot avoid paying the minimum 15% tax simply by moving their headquarters to that jurisdiction.

2.11 **Chapter 8** explains the transition rules that apply when the GloBE rules first come into effect, and when an MNE first comes within scope of the rules.

2.12 The OECD is expected to develop some simplification measures, including possible safe harbours, in 2022. **Chapter 9** covers this work, including a safe harbour based on Country-by-Country Reporting (CbCR) that has previously been discussed.

Implementation of the GloBE rules in New Zealand

2.13 **Chapter 10** discusses the options for how the GloBE rules could be implemented into New Zealand's domestic law and whether implementation should be by way of amendments to the Income Tax Act 2007.

2.14 **Chapter 11** discusses options for how the tax allocated to New Zealand under the UTPR should be brought to charge.

2.15 **Chapter 12** considers how the rules will be administered in New Zealand. It contains proposals for the returns required to be filed, as well as how and when the tax payable under the rules should be paid.

2.16 **Chapter 13** explains how the GloBE rules are proposed to interact with New Zealand's imputation system.

2.17 **Chapter 14** discusses a possible domestic minimum top-up tax, which would apply to low-tax New Zealand profits made by in-scope MNEs.

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[4] For an initial 10-year period the figures are higher than 5% and reduce over time to 5%.

[5] A qualified IIR is, broadly, an IIR or similar set of rules that conforms with the requirements of the OECD GloBE rules.

2.18 **Chapter 15** discusses how GloBE taxes paid to other countries should be treated for purposes of calculating income and tax liabilities of NZ taxpayers, on the basis that this may require some amendment to current law, whether or not New Zealand adopts GloBE rules.

CHAPTER 3

Should New Zealand adopt GloBE rules

Overview

3.1 This chapter considers whether or not New Zealand should adopt GloBE rules, if a critical mass of other countries does so. It also briefly considers the issue of timing.

Whether New Zealand should adopt GloBE rules

3.2 The GloBE rules will only work as intended if they are adopted by a critical mass of countries. A critical mass would be sufficient to ensure that MNEs generally cannot avoid the minimum tax by choosing where to locate themselves. This will be achieved, in relation to a particular MNE group, if the amount of tax that can be raised under the UTPR (that is, by denying deductions in Pillar 2 countries) is at least equal to the required amount of top-up tax. Therefore officials currently do not see much benefit in New Zealand "going it alone" and adopting GloBE rules without that critical mass.

3.3 The question of whether New Zealand should adopt GloBE rules therefore presents a somewhat different set of issues from those that usually arise in considering the desirability of a tax measure. Generally the issues involve a comparison between a world with and without the measure. This requires consideration of the position of both affected taxpayers (and potential taxpayers) and New Zealand as a whole. However, the GloBE rules, and particularly the UTPR, are designed so that all MNEs will be subject to the rules, regardless of whether the top entity in the group, or any other group entity, is incorporated or tax resident in a country that has adopted the rules.

3.4 Accordingly, in-scope MNEs, including those headquartered or operating in New Zealand, will have the same liability under the GloBE rules whether New Zealand adopts the rules or not. Provided a critical mass of other countries adopt the rules, for in-scope MNEs, there is no world without the tax and compliance costs imposed by the rules.

3.5 The only impact for New Zealand from not adopting GloBE rules is that it forgoes the possibility of receiving any revenue from them. Non-adoption will not increase the competitiveness or reduce the compliance costs of New Zealand headquartered groups. Nor will it make New Zealand a more attractive destination for foreign MNE investment.

3.6 The amount of direct revenue at stake for New Zealand may be modest. Officials expect that around 20-25 New Zealand groups will be in scope, and that there will be relatively few foreign MNEs with a material portion of their employees or assets in New Zealand that are not already subject to an IIR or the US GILTI regime.[6] However, while few in number the in-scope New Zealand groups are very large businesses in a New Zealand context. And they may find it much easier to pay Pillar Two tax only to New Zealand under the IIR than to many other countries under their UTPRs.

[6] It is likely that the GILTI regime will be treated as equivalent to an IIR, if the United States makes certain amendments to its regime. If it does not GILTI may instead be treated as a kind of CFC regime.

3.7 The same feature of the GloBE rules means that the rules will also provide a significant benefit to New Zealand even if we do not adopt them. This is the benefit of reducing the incentive for MNEs to shift profits out of New Zealand. Currently, MNEs can save as much as 28 cents in the dollar by moving income out of New Zealand into a zero tax country (imputation reduces the incentive for New Zealand groups to shift profits out of New Zealand, but has no effect on foreign groups operating in New Zealand). The GloBE rules should reduce this tax saving to a maximum of 13 cents in the dollar, and should thus reduce the incidence of such profit shifting. This is the main benefit of GloBE rules for New Zealand.

3.8 The above analysis assumes that GloBE rules will be enacted by a critical mass of countries, so that the UTPR is indeed an effective back-stop. The UK, Canada and EU countries are taking steps towards adopting the rules. If Australia also adopts the rules, that may constitute a critical mass, at least for New Zealand headquartered MNEs.

3.9 Another relevant consideration, particularly if there is some uncertainty about whether a critical mass of countries will adopt the rules, is that the GloBE rules are consistent with New Zealand’s approach to taxation of corporate income generally. The effect of the GloBE rules in reducing profit shifting is clearly in New Zealand’s interests, and this suggests that if New Zealand’s participation is of any significance, it should do its part to support adoption of the rules by enacting them itself.

3.10 Equity considerations may also be relevant. Both the current proposals, and the first round of BEPS reforms, are focussed on removing or reducing the tax planning opportunities enjoyed by MNEs by virtue of the fact that they are multinational, and can take advantage of tax-favourable regimes in a wide range of countries, as well as gaps where country rules are not co-ordinated. This is not the case for other businesses. The GloBE rules will reduce (though they will still not eliminate) the tax advantages enjoyed by MNEs over purely domestic New Zealand businesses. Reinforcing corporate taxation of MNEs will also play a role in ensuring that shareholders in these companies shoulder (indirectly) a greater share of national tax burdens.

Officials’ view

3.11 The Government has not decided whether to adopt GloBE rules. Officials’ current view is that if a critical mass of countries adopts, or is highly likely to adopt, GloBE rules, we would recommend that New Zealand take steps to join them. This will ensure New Zealand rather than other countries collects the revenue from any undertaxed constituent entities of New Zealand headquartered groups. It will also ensure that New Zealand is seen to be playing its part in the global minimum tax project, which New Zealand can expect to benefit from significantly.

Timing of adoption

3.12 According to the October statement, countries that wish to adopt Pillar Two should bring the IIR into law in 2022, to be effective in 2023, with the UTPR coming into effect in 2024.

3.13 If New Zealand decides to adopt GloBE Rules, legislation would need to be passed to incorporate the rules into domestic law. Options for how GloBE rules could be so incorporated are set out in Chapter 10.

3.14 It is hoped that a Bill would be enacted in 2023 following New Zealand's generic tax policy process and legislative process, if the decision is made to adopt the rules.

Questions for submitters

- Do you think New Zealand should adopt the GloBE rules, if a critical mass of other countries does or is likely to do so?
- Do you have any comments about what a critical mass of countries would be?
- Do you have any comments on the timing of adoption?

PART II: Explaining the Model Rules

CHAPTER 4

Scope

Overview

4.1 The GloBE rules only apply to MNEs that meet the €750 million revenue threshold ("large MNEs"). This is because large MNEs are generally more able to shift income to low-taxed jurisdictions. Limiting the scope of the rules to large MNEs can significantly reduce administration and compliance costs, while retaining most of the benefits.

4.2 The GloBE rules do permit New Zealand to apply the IIR to MNEs headquartered in New Zealand that fall below the €750 million revenue threshold. New Zealand could choose to apply a lower revenue threshold, or adopt an additional threshold based on other criteria such as assets or taxable income. The Government does not propose doing this. However, submitters' views are sought on the issue.

4.3 Even when an entity is a member of a group that is within scope of the GloBE rules, the entity itself may be excluded (meaning both that its low-tax income is not subject to top-up tax, and that the entity will not have GloBE tax imposed upon it). Examples of excluded entities are governmental entities, non-profit organisations and some investment funds. The gross revenue of these group entities is still counted for purposes of determining whether the group exceeds the threshold or not.

MNE groups and their members

4.4 An 'MNE group' is a group with at least one entity or permanent establishment (PE) that is not located in the jurisdiction of the UPE. A large group that is located entirely within one jurisdiction with no offshore subsidiaries or PEs is therefore outside the scope of the GloBE rules. On the other hand, a single company could be an MNE group if it has an offshore PE.

4.5 A member of an MNE group is referred to as a 'constituent entity' of the group. A PE can be a constituent entity, even though most PEs are not legally entities. In this consultation document, the term 'entity' includes PEs.

4.6 The UPE of a group is the entity that owns, directly or indirectly, a controlling interest in any other entity, but is not controlled, directly or indirectly, by another entity. The UPE is important because the IIR is applied at the UPE level in the first instance (if the UPE's jurisdiction has a qualified IIR), and the UPE's consolidated financial statements determine what entities are within the group.

4.7 Entities that are related through ownership or control such that their financial results are included in the UPE's consolidated financial statements on a line-by-line basis are included in an MNE group.[7] Interests in entities that the UPE does not control will therefore not be included in the UPE's MNE group (there are some special rules for joint ventures and minority owned entities).

[7] An entity that is excluded from the UPE's consolidated financial statements will still be part of the UPE's MNE group if it is excluded on materiality grounds, or if the entity is treated as being held for sale.

Revenue threshold

4.8 The GloBE rules apply to MNEs that have consolidated annual revenues of at least €750 million in at least two of the last four fiscal years. The fiscal year is the period covered by the group's consolidated financial statements.

4.9 The €750 million revenue threshold is the same threshold used to determine whether an MNE group has to comply with Country-by-Country Reporting (CbCR) rules. So MNEs that have to comply with CbCR will have to apply the GloBE rules.

4.10 Special rules exist to address situations where:

- an MNE does not prepare consolidated financial statements
- an MNE does not have four years of consolidated financial statements
- one of the preceding fiscal years taken into account for the revenue threshold is for a period other than 12 months, and
- an MNE has undergone a merger or demerger.

Alternative domestic threshold

4.11 Although the GloBE rules apply to MNEs that meet the €750 million revenue threshold, the October statement allows countries to apply the IIR to MNEs headquartered in their own country, even if they do not meet this €750 million threshold. New Zealand could therefore choose to set a lower revenue threshold (likely denominated in NZD), or a threshold based on different criteria altogether (for example, total assets or taxable income).

4.12 Setting an alternative domestic threshold would mean that if an MNE headquartered in New Zealand had foreign subsidiaries or PEs that were taxed below 15%, New Zealand could apply a top-up tax under the IIR to bring their effective tax rate up to 15% as long as that MNE met the alternative domestic threshold.

4.13 However, a key reason for implementing the IIR is to prevent other countries from taxing the profits of New Zealand MNEs under the UTPR or their own IIR. This reason does not apply to MNEs that do not meet the €750 million revenue threshold, as their profits would not be subject to another country's UTPR or IIR even if New Zealand did not apply the IIR.

4.14 Many countries considered that the €750 million revenue threshold struck the right balance between achieving Pillar Two's policy objectives and reducing compliance and administrative costs involved in applying the GloBE rules. For MNEs below the €750 million revenue threshold, these costs are more likely to be disproportionate to the tax revenue raised, particularly as these MNEs may not have developed systems for CbCR and applying the IIR is likely to be harder without such systems in place.

4.15 In addition, New Zealand has controlled foreign company (CFC) rules that already tax some profits of New Zealand MNEs' foreign subsidiaries as they are earned. Income taxed under the CFC rules is taxed at ordinary New Zealand income tax rates (28% if earned in a company), rather than the minimum 15% set by the GloBE rules.

4.16 The CFC rules balance competing considerations. On one hand, they reduce incentives for New Zealand MNEs to move profits that could be earned in New Zealand offshore. On the other hand, they seek to ensure that they do not disincentivise MNEs from being based in New Zealand. If it is considered that New Zealand MNEs' foreign subsidiaries are not sufficiently taxed, it may be better to amend the CFC rules than to create an alternative domestic threshold for the IIR.

4.17 Officials consider that applying the common €750 million revenue threshold, instead of an equivalent NZD threshold would improve co-ordination amongst countries.

4.18 For the above reasons, officials consider the €750 million revenue threshold is appropriate for applying the IIR in New Zealand and do not propose an alternative domestic threshold.

Questions for submitters

- Do you agree that New Zealand should not use an alternative domestic threshold to apply the IIR to MNEs headquartered in New Zealand? Why or why not?
- If you think New Zealand should use an alternative domestic threshold, what should the threshold be based on and why?
- Are there any difficulties in adopting a Euro threshold, rather than an equivalent NZ dollar threshold?

Excluded entities

Which entities are excluded

4.19 The following types of entities are excluded from the GloBE rules:

- Governmental entities
- International organisations
- Non-profit organisations
- Pension funds
- Investment funds that are UPEs
- Real estate investment vehicles that are UPEs

4.20 An entity owned by an excluded entity can also qualify as an excluded entity if it meets certain criteria relating to its ownership, assets and income.

4.21 An entity can elect not to be an excluded entity. An MNE may choose to do this so that the entity can apply the IIR to its subsidiaries instead of applying the UTPR to its constituent entities.

Reason for exclusions

4.22 Governmental entities, international organisations, non-profit organisations and pension funds are excluded because for various reasons they are often afforded tax exemptions or other benefits, so they may have a low ETR for reasons unrelated to tax competition and profit shifting.

4.23 The reason investment funds and real estate investment vehicles are excluded entities if they are UPEs is because they are passive investment vehicles whose purpose is not to make profits from operating a business, but rather to pool funds for investment purposes. Tax should be imposed either on the underlying businesses or on the real investors, rather than on the pooling vehicle. Generally tax on investment funds and vehicles is imposed at the investor level, rather than at the fund level.

Effect of exclusion

4.24 Excluded entities are not subject to the IIR or UTPR. If an excluded entity is the UPE of the MNE, the IIR must be applied by the next entity in the ownership chain that is not an excluded entity.

4.25 An excluded entity's financial results (including its profits, losses, taxes paid, tangible assets and payroll expenses) are also removed from most calculations required under the GloBE rules, including the ETR calculation. The exception to this is the revenue threshold described above.

4.26 The exclusions work on an entity basis, not a group basis. Other (non-excluded) entities in the same group as an excluded entity will still have to apply the GloBE rules if the group is in-scope. But if a group consists entirely of excluded entities, the group would not have to apply the GloBE rules at all.

International shipping exemption

4.27 The GloBE rules exempt international shipping. The exemption applies to shipping *income*, rather than to shipping entities or groups (though entities or groups whose income is solely shipping income will effectively fall outside the rules).

4.28 The reason for the exemption is because in many jurisdictions, international shipping income is taxed under a special tax regime (for example, tonnage tax) rather than under the corporate income tax. The OECD Model Tax Convention similarly has a separate Article for international shipping income, which provides for taxation on a residence basis only.

4.29 The effect of the exemption is that international shipping income, as well as taxes paid in respect of that income, is excluded from the ETR calculations. However, international shipping income is still taken into account for purposes of determining whether an MNE meets the €750 million revenue threshold.

CHAPTER 5

Calculating the effective tax rate

Overview

5.1 Pillar Two charges top-up tax where a MNE's excess profits in a jurisdiction are taxed below the minimum 15% rate. Calculating the ETR requires first a calculation of the income in a jurisdiction, and second a calculation of the tax on that income.

5.2 This chapter explains the different components of the ETR calculation in Chapters 3 and 4 of the Model Rules. It sets out the main features of the rules and notes special rules that apply in particular circumstances.

The Effective Tax Rate

5.3 The ETR for a jurisdiction is the total tax divided by the total profit in that jurisdiction. There are detailed rules prescribing what taxes can be included in this calculation, which are referred to as 'covered taxes', and how to calculate the profit in the jurisdiction, which is referred to as 'GloBE income'.

5.4 In-scope MNEs must calculate their ETRs for each jurisdiction annually. Calculating the ETR for a jurisdiction broadly involves four steps.

5.5 First, the MNE has to identify its constituent entities in the jurisdiction. The Model Rules set out how to work out which jurisdiction an entity is located in.

5.6 Second, the MNE has to work out the GloBE income or profit of each constituent entity in the jurisdiction. This starts with an entity's accounting profit. Adjustments are then made to the accounting profit to reflect the agreed GloBE base. Some adjustments are mandatory while others are elective. There are also rules for allocating income between jurisdictions.

5.7 Third, the MNE must determine the covered taxes of the constituent entities in the jurisdiction. This requires consideration of the types of taxes that count as 'covered taxes', and which year those taxes are allocated to. The starting point for calculating covered taxes is the accounting current tax expense. Adjustments are then made to the current tax expense, including an adjustment based on deferred tax to address timing differences between accounting and tax. There are also rules for allocating covered taxes between jurisdictions.

5.8 Lastly, the ETR is derived by aggregating covered taxes, and GloBE income and losses, of the constituent entities in a jurisdiction. The total taxes are divided by the total net GloBE income to get the ETR for the jurisdiction.

5.9 These steps are discussed in more detail below.

Step 1: Identifying the constituent entities in a jurisdiction

5.10 The GloBE rules calculate the ETR for a jurisdiction as a whole. This ensures that a MNE with a high ETR in a jurisdiction does not suffer a top-up tax because of an isolated low-tax entity whose low level of taxation could be a function of its relationship with other entities in the jurisdiction.

5.11 Chapter 10 of the Model Rules determines where an entity is located. Most constituent entities will be located in the jurisdiction where they are tax resident. Where a constituent entity is not tax resident in a jurisdiction, it will be located in the jurisdiction where it was created, for instance where it was incorporated.

5.12 Specific rules locate tax transparent entities, like partnerships and permanent establishments (PEs), for the purposes of the ETR calculations and charging provisions.

5.13 The Model Rules distinguish between transparent entities and their owners. Transparent entities are treated as constituent entities in the Model Rules and are generally treated as 'stateless' entities. This means their ETR is calculated separately and without blending their income or tax with other entities. There is an exception to this rule where the transparent entity is required to apply an IIR, or it is located at the top of the MNE group.

5.14 While transparent entities are treated as separate entities and included in the MNE group, there are rules for allocating their income and taxes which are covered below.

5.15 Permanent establishments are generally located in the jurisdiction where they are treated as a PE and subject to net basis taxation, but there are rules to address exceptional situations.

5.16 The Model Rules include a tie-breaker provision if a constituent entity would otherwise be located in more than one jurisdiction.

Step 2: GloBE income for each constituent entity

5.17 The next step is to calculate a constituent entity's GloBE income. The starting point is the entity's financial accounting profit, which is then subject to adjustments that Inclusive Framework countries agreed are desirable to reconcile the most important differences between accounting and tax definitions of profit. These adjustments are intended to bring the GloBE base more into line with a measure of taxable profit so that the ETR provides a reasonable measure of the level of effective taxation in that jurisdiction.

5.18 There are also rules to appropriately allocate certain types of income between jurisdictions.

Accounting profit

5.19 The calculation of a constituent entity's GloBE income starts from its financial accounting income. The general rule is that this income should be calculated according to the accounting standard of its UPE and therefore reflects the amount which feeds into the UPE's consolidated financial statements before consolidation adjustments.

5.20 This is subject to a requirement that the UPE prepares its accounts under an acceptable accounting standard, or that it adjusts any material differences in its accounting treatment of an item that could result in the MNE obtaining an unfair competitive advantage when compared with the IFRS treatment. NZ IFRS is an acceptable accounting standard for the purposes of the GloBE rules.

5.21 The Model Rules recognise there are situations where it may not be practicable to accurately calculate the entity's accounting profit in the UPE's accounting standard.

5.22 In these cases, the MNE is permitted to calculate the entity's income based on the accounting standard it uses to prepare its own financial statements. This is subject to the information being reliable, and an adjustment being made for any permanent differences in excess of €1m between the entity's accounting standard and the accounting standard of the ultimate parent.

Question for submitters

- Do you have comments on the practicalities of using a constituent entity's accounting profit as the starting point for calculating Globe income?

Adjustments to accounting profit

5.23 Once the MNE has computed the financial accounting income of the constituent entity, the next step is to make the required adjustments.

5.24 These adjustments generally reflect significant differences between accounting and tax measures of profit which do not reverse out over time. There are separate rules to address timing differences in when income and expenses are recognised for accounting and tax, which are covered further below.

Mandatory adjustments

5.25 These adjustments include:

- Adding back covered taxes, and some other amounts of tax, accrued as an expense.
- Removing dividend income from >10% shareholdings and <10% shareholdings which are held for more than 12 months.
- Removing gains or losses from changes in fair value of >10% shareholdings.
- Removing the profit or loss from an equity interest accounted for under the equity method.
- Removing gains or losses from the sale of >10% shareholdings.
- Including any revaluation gains or losses that are reported in other comprehensive income, where those gains and losses are on property, plant and equipment that is accounted for under the revaluation model.
- Removing gains and losses in relation to a reorganisation where the gain or loss is deferred for local tax purposes.
- Adjustments to deal with foreign exchange gains and losses created by differences between the tax and accounting functional currencies.
- Removing any deductions for illegal payments such as bribes and kickbacks, as well as fines or penalties greater than or equal to €50,000.
- Including prior period adjustments to accounting profit to correct accounting errors, provided the correction does not result in a material decrease in a prior year tax liability, and including prior period adjustments relating to a change in accounting principle or policy.
- Adjustments to address differences between the tax and accounting treatment of defined benefit pension schemes.

Elective adjustments

5.26 There are also certain elections available to the MNE group. These include elections to:

- Remove profits and losses from intragroup transactions within the same jurisdiction between entities included in a tax consolidated group.
- Replace the accounting expenses in relation to share-based payments (for example, for employee remuneration paid in share options) with the deduction for tax purposes in the relevant jurisdiction.
- Include gains and losses on assets and liabilities subject to fair value or impairment accounting on a realisation basis, and exclude any pre-realisation gains and losses from fair value movements or impairments.
- Offset a net realised gain on local tangible assets against a net realised loss on local tangible assets in the 4 preceding years, and spread any remaining net realised gain equally over the current year and 4 preceding years.

5.27 The election to spread back a net realised gain on local tangible assets should be useful in a jurisdiction such as New Zealand that does not tax some capital gains (though gains on sales of shares in companies more than 10% owned are already excluded from the GloBE base). The election will allow untaxed gains to be matched against prior year untaxed losses. It will also allow the imposition of tax in excess of the 15% rate in the look back years to reduce or eliminate any GloBE liability that would otherwise arise from the untaxed gain.

5.28 The policy justification for this election is that the increase in value of the asset likely accumulated over a period of years and therefore, spreading the gain over a maximum period of five years, and matching it with losses from similar property, provides a better measure of whether the MNE has been subject to a minimum level of tax in a jurisdiction over that period.

Special rule for incentive tax credits

5.29 There is a special rule that prescribes the treatment of government incentives delivered as credits via the tax system. This rule is intended to apply to incentives to engage in certain activities such as research and development.

5.30 Where an incentive tax credit is designed so that it must be paid in cash or cash equivalents within four years it can be treated as income for Pillar Two purposes instead of as a reduction to covered taxes. The policy reason for this is that these types of refundable tax credits share features of government grants which form part of income, and they should be treated in the same way given that they are in effect government support for a certain type of activity that can ultimately be received in cash or cash equivalents. This treatment results in a higher ETR than if the credit is treated as a negative tax. If a tax credit is designed so that it must partially be refunded within four years, it is only treated as income to the extent the refundability design requirement is satisfied. Whether a tax credit is designed so that it must be refunded within four years is determined under the laws of each jurisdiction at the time the credit is granted.

5.31 New Zealand's research and development tax credit is designed so that it must partially be refunded within four years. The portion that must be refunded within four years is the amount calculated under section LA 5(4B)(a) of the Income Tax Act 2007 and referred to as the 'maximum limit of the person's refundability cap' for the year in which the associated research and development expenditure is incurred. Officials' view is that under the Model Rules this amount can be treated as GloBE income and any remaining credit must be treated as a reduction to covered taxes (even if it gives rise to a tax reduction or other benefit within the 4-year period). This treatment is not expected to have a significant impact on the New Zealand ETRs for locally headquartered MNEs. Therefore we do not expect the GloBE rules to undermine the benefit of our R&D tax credit for locally headquartered MNEs.

Special rule for intra-group financing arrangements

5.32 The rules include an anti-avoidance rule designed to counter intra-group financing arrangements that attempt to inflate the ETR in a low-tax jurisdiction without increasing the taxable income in the other jurisdiction (for example, through exploiting mismatches in the accounting treatment in the debtor and creditor).

5.33 The remaining adjustments are described in Chapter 3 of the Model Rules.

Special rules for acquisitions and disposals

5.34 Articles 6.2 and 6.3 of the Model Rules provide special rules for calculating GloBE income (and covered taxes) when a constituent entity joins or leaves a group and when there are transfers of assets or liabilities.

Special rules for Ultimate Parent Entities that are subject to a tax neutrality regime

5.35 There are also special rules in Chapter 7 of the Model Rules for calculating the GloBE income of a UPE that is subject to a tax neutrality regime, that is, a regime that achieves a single level of taxation on business income. Article 7.1 applies to a UPE that is a flow through entity and Article 7.2 applies to a UPE that is subject to a deductible distribution tax regime.

5.36 Article 7.2 will be relevant to a New Zealand co-operative UPE. It allows such a UPE to reduce its GloBE income (but not below zero) by the amount that is distributed as a deductible dividend within 12 months of the end of a fiscal year if the dividend recipient is:

- subject to tax on the dividend at a nominal rate that equals or exceeds 15% within 12 months of the end of the group's fiscal year
- a natural person that is a tax resident in the UPE country and holds an ownership interest in the UPE of 5% or less, or
- resident in the UPE country and is a Governmental Entity, International Organisation, Non-profit Organisation or Pension Fund that is not a Pension Services Entity.

Questions for submitters

- Do you have comments on the practicalities of using a constituent entity's accounting profit as the starting point for calculating Globe income?
- Do you have comments on the adjustments made to the accounting profit?
- In particular, are there any uncertainties that could be clarified in New Zealand's domestic legislation while respecting the intended outcomes in the Model Rules?

Allocating income between jurisdictions

5.37 The GloBE rules are designed to ensure that MNEs pay tax at a rate of 15% on their profits in each jurisdiction (after taking into account a substance-based carve-out). This means tax imposed at a high rate on profits in one jurisdiction cannot be used to credit low-taxed profits in another jurisdiction. Allocating profits appropriately between jurisdictions is consequently integral to the GloBE rules.

5.38 The Model Rules achieve this through:

- Valuing cross-border intragroup transactions in accordance with the arm's length principle, where this is different to the transfer price used for accounting.
- Requiring financial accounting profits to be allocated between a PE and its head office entity based on the attribution of income and expenses to the PE for tax purposes (there are special allocation rules that apply to PEs of entities subject to a worldwide tax system such as New Zealand's).
- Allocating the income of a tax transparent constituent entity (when not attributable to a PE) to its owners to the extent that the owners also treat the entity as tax transparent (that is, tax the income) or are not members of the MNE group.

5.39 Further work is still to be done at the OECD to determine the interaction of Pillar 1 and the GloBE rules. The issue is deciding the jurisdiction in whose ETR taxes imposed on Pillar One income should be included, and ensuring that they are matched so far as possible with the income on which the taxes are imposed. Allocating Pillar 1 income to the country where the tax permitted under Pillar 1 is imposed would be the same treatment as applies to income earned through a branch. A possible objection to this is that it may not be possible to identify the entities whose income should, for GloBE ETR purposes, be reduced to compensate for this allocation. On the other hand, if it is not possible to identify those entities, then it seems difficult to envisage how double taxation of income taxed under Pillar One will be avoided. Officials welcome submissions on this issue.

Questions for submitters

- Do you have comments on the rules for allocating profits between jurisdictions including whether there are any uncertainties around how the rules operate that could be further clarified in domestic law?
- Do you have any comments on whether profits that have been reallocated for Pillar 1 purposes should be similarly reallocated under the GloBE rules?

Step 3: Determine the taxes paid by constituent entities

Covered taxes

5.40 The next stage in the ETR calculation is to determine the taxes paid by the constituent entity. These are referred to as covered taxes in the Model Rules and are generally limited to taxes on net income.

5.41 This limitation reflects that the GloBE rules are intended to ensure a minimum level of tax is paid on the profit in each jurisdiction. It follows taxes should only be included in covered taxes when they are levied on a measure of income.

5.42 This means corporate income taxes will generally be covered taxes. However, where an income tax is refundable or creditable to the beneficial owner of a dividend distributed by a constituent entity (for example, by way of imputation) it will only qualify as a covered tax if the credit is provided:

- under a foreign tax credit regime by a jurisdiction other than the jurisdiction which imposed the income tax
- to a beneficial owner of the dividend that is subject to tax on the dividend, at a rate that equals or exceeds the minimum rate, in the jurisdiction which imposed the corporate income tax
- to an individual beneficial owner of the dividend who is tax resident in the jurisdiction which imposed the income tax and who is subject to tax on the dividend, or
- to a governmental entity, international organisation, resident non-profit organisation, resident pension fund, resident investment entity that is not a group entity, or a resident life insurance company to the extent that the dividends are received in connection with a pension fund business and subject to tax in a similar manner as a dividend received by pension fund.

5.43 The Model Rules refer to an income tax that is charged under a qualifying imputation system as a Qualified Imputation Tax. New Zealand's corporate income tax meets the definition of a Qualified Imputation Tax and is therefore a covered tax. Australia's corporate income tax is similarly a covered tax.

5.44 Withholding taxes and other taxes which are imposed in lieu of a corporate income tax are also covered taxes. Taxes on payroll or sales will not be counted. New Zealand's goods and services tax is not a covered tax, as it is not charged on a measure of income.

Calculating covered taxes for the relevant year

5.45 Having established which taxes qualify, the next step is to determine the amount of those taxes in the relevant year. The Model Rules look first to the current tax expense recorded in the financial statements to determine the amount of covered taxes that have been paid.

5.46 This amount is adjusted, for example to exclude any tax which is paid in respect of income that has been excluded from GloBE income, to exclude current tax accrued in relation to an uncertain tax position, and to add any covered taxes that have been treated as an expense in the accounts.

5.47 An adjustment is also required where an amount of covered tax is refunded or credited to a group entity and the refund or credit is not treated as a reduction to the current tax expense in the financial accounts. An example of this in a New Zealand context is a tax credit for a supplementary dividend which is typically accounted for directly in equity instead of as a reduction to the current tax expense. An adjustment will be required for GloBE purposes to reduce the current tax expense by the amount of this credit.

5.48 The remaining adjustments are described in Chapter 4 of the Model Rules.

Refundable tax credits

5.49 As discussed above, the treatment of incentive tax credits in the Model Rules depends on their refundability. Tax credits that are designed in such a way that they must be refunded within four years are referred to as a Qualified Refundable Tax Credit and are treated as GloBE income. Refundable tax credits that do not satisfy this refundability requirement are referred to as Non-

Qualified Refundable Tax Credits and are treated as a reduction to covered taxes.

5.50 This means an adjustment must be made to increase covered taxes where a Qualified Refundable Tax Credit is accounted for as a tax credit or to reduce covered taxes where a Non-Qualified Refundable Tax Credit is accounted for as income.

Questions for submitters

- Do you have comments on the rules on Covered Taxes including whether there are any uncertainties around how the rules operate that could be further clarified in domestic law?
- Do you have any comments on the views outlined above on how tax credits for supplementary dividends are treated under the Model Rules?

Timing differences

5.51 The Model Rules also include rules that are designed to address circumstances where profits are taxed in a different period to when they are recognised in GloBE income. These differences typically arise from differences in when income and expenses are recognised for accounting and tax purposes. For example, capital assets are often depreciated at different rates.

5.52 Without rules to address these differences, a MNE could suffer a top-up because it appears to be low-taxed, when in fact the income has been taxed in a different period from the one in which it has been recognised for purposes of the ETR calculation. While this deferral can be of significant benefit if it is long term, the Model Rules have been designed generally (but not always) so that timing benefits do not give rise to the imposition of tax. At least in part this was to avoid the need to provide refunds of GloBE tax.

5.53 The Model Rules address this issue using an approach based on deferred tax accounting. Deferred tax accounting is an accounting concept which seeks to match taxes to the period when the income or expenses are recognised for accounting purposes. It does this by shifting the tax expense from the year the tax is paid to the years in which the income or expenditure is recognised in the financial statements.

5.54 In the Model Rules, this means the covered taxes are adjusted by the constituent entity's deferred tax income or expense in the period.

Example 1: Timing differences

A constituent entity accrues a current tax expense of $10 for Fiscal Year 1 and a deferred tax expense of $5 due to a temporary difference between accounting and tax which resulted in a deferred tax liability of $5 being recognised. The deferred tax expense of $5 is added to the current tax expense of $10 to give $15 of covered taxes for Fiscal Year 1.

The temporary difference reverses in Fiscal Year 2 resulting in an increase to the current expense for this year of $5 and a decrease to the deferred tax expense of $5, that is, the deferred tax liability of $5 unwinds. The decrease in the deferred tax expense in Fiscal Year 2 offsets the increase in the current tax expense. So if there was a current tax expense for year 2 of $10, the decrease in the deferred tax expense in that year would be deducted from this to give covered taxes of $5.

Recognising the deferred tax expense in each year effectively brings forward the $5 of tax relating to the temporary difference to the year when the deferred tax liability is first recognised (rather than the year when the tax is actually paid).

5.55 There are some modifications to an entity's deferred tax accounting used in its financial statements, which ensure the outcomes are appropriate for the GloBE.

Revaluing deferred taxes

5.56 The Model Rules require the deferred tax expense for financial reporting purposes to be valued at the lower of the minimum rate and the applicable tax rate. This ensures that there is no top-up in respect of the timing difference where the local tax rate is above the minimum rate, without enabling additional upfront credits for DTLs to shelter other exempt income in that year.

Example 2: Revaluing deferred taxes

A constituent entity has a temporary difference between accounting and tax of $100 for the Fiscal Year due to immediately expensing an asset under the local tax rules where it is resident. The local tax rate is 28% so the constituent entity recognises a deferred tax liability of $28 for accounting purposes which increases the deferred tax expense by $28.

This deferred tax expense must be recast to the minimum rate for GloBE purposes ($100 temporary difference x 15% = $15) which means covered taxes can only be increased by $15 due to deferred tax.

5.57 The Model Rules also exclude certain types of deferred tax movements. These include deferred tax movements in respect of income or expenses that are excluded from GloBE income and deferred tax from uncertain tax positions.

The recapture

5.58 There is a recapture rule for deferred tax liabilities (DTLs) which applies when a DTL has not unwound within five years of the Fiscal Year in which the DTL was originally recognised.

5.59 When the recapture applies, the MNE group is required to recompute its ETR in the year the DTL was originally recognised. This ETR is recalculated without the DTL. If the revised ETR results in a top-up, this top-up is added to the top-up in the current year.

5.60 Some types of timing difference are exempt from the recapture rule. These include those in respect of:

- Accelerated depreciation on tangible assets.
- Fair value accounting.
- Research and development expenses.

These timing differences do not need to be recaptured even if it takes longer than five years for the DTL to unwind.

Losses

5.61 The timing difference rules also address tax losses. These rules are similarly based on deferred tax accounting, which means covered taxes are reduced (potentially to a negative number) in the year the local tax loss arises and a deferred tax asset (DTA) is recognised. Covered taxes are then increased in the year that the loss is utilised, and the DTA unwinds. This is done by taking account of the deferred tax expense accrued in the financial accounts, which could be a positive or negative figure.

Example 3: Losses

A constituent entity has a tax loss and GloBE loss of $100 in Fiscal Year 1. The local tax rate is 15% so the constituent entity recognises a loss deferred tax asset in this year of $15 ($100 tax loss x 15%).

In Fiscal Year 2, the constituent entity earns $100 of net income for local tax purposes (before tax losses brought forward) and $100 of GloBE income. For accounting purposes, there is no current tax expense in Fiscal Year 2 because the tax loss brought forward of $100 reduces taxable income to zero, but a deferred tax expense of $15 is recognised because the loss deferred tax asset is written off when the tax loss is used. The deferred tax expense increases covered taxes by $15 in Fiscal Year 2. As a result, there would be no top-up tax in Fiscal Year 2 (or Fiscal Year 1)

5.62 As the DTA is based on the tax loss available under the tax rules of the local jurisdiction, there are further rules to ensure the appropriate relief is given.

5.63 For example, the DTA could be based on an economic loss which would also be recognised in the GloBE income or loss. These losses are rightly recognised in the Model Rules to prevent top-up taxes being applied in a later (profit) year when the MNE has not made an economic profit over time. The loss could also be created by a timing difference between the accounts and the local tax system, in which case the accounting will recognise both a DTA and a DTL. Again, it is appropriate to recognise this.

5.64 However, the local tax loss could also be caused by certain features of that jurisdiction's tax rules – for instance, if the jurisdiction exempted certain types of income from tax or provided tax deductions in excess of the cost incurred ('super deductions').

5.65 These local tax concessions are not intended to be recognised in the GloBE base and should ordinarily reduce the ETR when there is net GloBE income in the jurisdiction. However, without further rules, they would be incorporated in the GloBE base if they produced a local tax loss and the related DTA could be used for GloBE purposes.

5.66 There is consequently a special rule which identifies the amount of loss relief that would have been available in the jurisdiction if the DTA was based on the GloBE base rather than the local tax rules. Any losses in excess of that are deemed to be losses arising from permanent differences and give rise to an additional top-up for that year.

5.67 This ensures that MNEs receive appropriate relief in the GloBE rules for economic losses and for those created through timing differences, while preventing excessive relief when the loss arises from a permanent difference.

Example 4: Losses and permanent differences

An MNE has one constituent entity in a jurisdiction which has a tax rate of 15%. This constituent entity has a GloBE loss for the Fiscal Year of $100 but a local tax loss of $200 because $100 of income earned is exempt for local tax purposes. The constituent entity recognises a DTA of $30 ($200 tax loss x 15% tax rate) in the Fiscal Year.

Absent an adjustment, this DTA would increase covered taxes by $30 for GloBE purposes (when the tax loss is used in the future), sheltering $200 of GloBE income. This would not be appropriate because the constituent entity has only suffered an economic loss of $100. The Model Rules address this issue by charging additional top-up tax of $15 in the Fiscal Year (that is, in the year there is $100 of exempt income for local tax purposes).

5.68 There is also an election which allows an MNE to create a DTA for the purposes of the GloBE rules based on the GloBE loss in the jurisdiction multiplied by the minimum rate. This may be useful for MNEs with operations in zero tax countries, where the MNE would get no benefit under a system based on deferred tax.

Questions for submitters

- Do you have comments on the rules to address timing differences including whether there are any uncertainties around how the rules operate that could be further clarified in domestic law?

Assigning taxes to a jurisdiction

5.69 As with the rules allocating income between jurisdictions, the Model Rules contain similar rules allocating certain covered taxes. These generally seek to assign the tax to the jurisdiction to which the income is allocated so that all of the taxes paid on this income are taken into account.

5.70 For example, taxes paid by a (head office) entity on the profits of its permanent establishments are assigned to the jurisdiction where the permanent establishment is located. Similarly, CFC charges are 'pushed down' to the CFC so that the tax and income are aligned. There are similar rules to assign taxes for transparent entities, hybrid entities and reverse hybrids.

5.71 There is a limit on the extent to which CFC tax charges and taxes on hybrid entities can be pushed down where the tax is charged in respect of passive income. In these cases, the tax can only be pushed down to achieve the minimum rate on that income. Any tax that is not pushed down is included in the covered tax calculation for the owner that was subject to the tax charge.

5.72 Withholding taxes are generally assigned to the constituent entity who recognises the income in its financial accounts rather than the entity that deducts the tax on payment. There is an exception for withholding taxes on dividends paid to other constituent entities, which also applies to net basis taxes on dividend income. Both of these taxes are assigned to the entity that paid the taxable distribution. The logic is that these taxes can be seen as an additional tax on the profit of the distributing entity.

Question for submitters

- Do you have comments on the rules for assigning Covered Taxes to a jurisdiction?

Step 4: Calculate the ETR

5.73 Finally, the ETR for a jurisdiction is calculated by dividing the total covered taxes for a jurisdiction (the aggregate of covered taxes in Step 3 for each constituent entity) by the total GloBE income in that jurisdiction (the aggregate of the GloBE income or loss in Step 2 for each constituent entity).

Example 5: The ETR calculation

An MNE has two constituent entities in Jurisdiction A. Constituent Entity 1 has covered taxes of €6 million and GloBE income of €80 million for the current Fiscal Year, and Constituent Entity 2 has covered taxes of €4 million and GloBE income of €20 million. The MNE's ETR for Jurisdiction A is 10% (covered taxes of €10 million/GloBE income of €100 million).

On a standalone basis, Constituent Entity 1's ETR is 7.5% (€6 million/€80 million) and Constituent Entity 2's ETR is 20% (€4 million/€20 million). Constituent Entity 1's low ETR is due to tax concessions in Jurisdiction A that apply to its business activity. The GloBE rules permit outcomes within a jurisdiction to be blended which means Constituent Entity 2's excess taxes (that is, taxes in excess of 15%) are used to increase the ETR for jurisdiction A.

Further special rules for calculating ETRs

5.74 There are special rules for calculating the ETR of stateless entities, joint ventures and minority-owned constituent entities.

Stateless entities

5.75 The ETR is calculated for each individual stateless entity (for example, a reverse hybrid) without any blending with other entities.

Investment entities

5.76 Chapter 7 of the Model Rules provides different rules for calculating the ETR of investment entities (that is, investment funds, insurance investment entities and real estate investment entities) which do not qualify as excluded entities.

5.77 Investment entities are required to calculate their ETR on a standalone basis without aggregating their results with other constituent entities in the jurisdiction. There is an exception to this standalone treatment – where more than one investment entity is located in the jurisdiction their results must be combined to compute the ETR for those entities.

5.78 The ETR calculation is also based on the MNE's share of the GloBE income and covered taxes of the investment entity, and therefore excludes any income or taxes which belong to minority shareholders.

5.79 The MNE can elect to treat the investment entity as a transparent entity for the purposes of the GloBE where the owner of the investment entity is subject to tax on a mark to market basis on the fair value of its interest in the entity. Where the election is made, the income and any taxes associated with that income will be included in the owner jurisdiction's ETR calculation.

5.80 Alternatively, an MNE can elect to apply the Taxable Distribution Method to investment entities. Under this method, an investment entity owner includes distributions it receives of the investment entity's income in its GloBE income, and undistributed income is included in the GloBE income of the investment entity and subject to top-up tax at a rate of 15%. Further details of this method are in Article 7.6 of the Model Rules.

Joint ventures

5.81 The GloBE rules also apply to Joint Ventures which are at least 50% owned by the MNE group, unless the Joint Venture is an excluded entity or is itself an MNE group in scope of the GloBE rules.

5.82 Article 6.4 of the Model Rules requires the Joint Venture to calculate the ETR and any top-up taxes of its Joint Venture subsidiaries which together are referred to as the JV group. This includes the entities which are consolidated in the Joint Venture's consolidated financial statements or that would be if such statements were prepared.

5.83 The profits and taxes of the JV group are not blended with other constituent entities in the MNE group. The ETR of the JV group is calculated separately from the rest of the MNE group to address the practical challenges both the MNE Group and the Joint Venture would experience in computing a full jurisdictional ETR for entities both within and outside of the JV.

Minority owned constituent entities

5.84 Financial standards can require entities to be consolidated even though the parent has less than 50% of the rights to profits.

5.85 For example, a UPE could own 51% of a constituent entity which owns 51% of a second constituent entity, giving the UPE control of the second constituent entity for accounting purposes despite only owning 26%.

5.86 The Model Rules include special provisions for entities where the ultimate parent holds 30% or less of the ownership rights in an entity it consolidates.

5.87 These rules require the ETR of these entities and their subsidiaries to be calculated separately from any other constituent entities in the MNE group.

CHAPTER 6

Calculating the top-up tax

Overview

6.1 When the ETR in a country is below the 15% minimum rate, the next step is to determine how much top-up tax is owed in respect of each entity in the country.

6.2 To do this, MNEs must work out the top-up tax percentage, which is the difference between the minimum rate and the ETR in the jurisdiction. That top-up tax percentage is applied to the MNE's GloBE income in the jurisdiction, after deducting a substance-based income exclusion, to calculate the jurisdictional top-up tax. Finally, the jurisdictional top-up tax is allocated amongst the constituent entities located in the jurisdiction.

6.3 This chapter explains these rules for calculating the top-up tax and allocating it amongst low tax constituent entities, which are in Chapter 5 of the Model Rules.

The steps

6.4 There are several steps in the top-up tax calculation in the Model Rules:

- Identify whether there is net GloBE income in a jurisdiction.
- Calculate the ETR in jurisdictions with net GloBE income to identify low tax jurisdictions.
- Compute the top-up tax percentage.
- Calculate the substance-based income exclusion.
- Deduct the substance-based income exclusion from the net GloBE income in the jurisdiction to determine the excess income.
- Calculate the top-up tax in the jurisdiction by:
  - multiplying the excess income by the top-up tax percentage
  - adding any additional top-up tax calculated in respect of earlier years, and in respect of current year permanent differences when there is a GloBE loss in a jurisdiction, and
  - subtracting any taxes charged under a Qualified Domestic Minimum Tax in that jurisdiction.
- Allocate the top-up tax for the jurisdiction among the constituent entities in that jurisdiction.

6.5 These steps are explained in more detail in the remainder of this chapter.

Identifying the net GloBE income

6.6 As the GloBE rules apply a minimum tax on the profits in each jurisdiction, the first step is to determine the profit in a jurisdiction. This is calculated by simply adding together the GloBE income and GloBE losses of all the constituent entities in the jurisdiction.

6.7 If the result is positive, the ETR will need to be calculated for that jurisdiction. The only exceptions to this are when the jurisdiction qualifies for the de minimis exclusion (which will be the case when the average GloBE revenue (that is, gross income before expenses) and GloBE income (that is, net income) in the jurisdiction for the current and 2 prior years are below €10 million and €1 million respectively) or when the jurisdiction qualifies for a GloBE safe harbour (in Chapter 8 of the Model Rules and not yet developed).

Calculating the ETR

6.8 The next step is to calculate the ETR for the jurisdiction following the process discussed in the previous chapter.

The top-up tax percentage

6.9 The top-up tax percentage must be calculated when the ETR is below the 15% minimum rate. It is calculated simply by subtracting the ETR from the minimum rate and represents the additional tax rate that needs to be charged on the low taxed profits to bring the tax on those profits up to the minimum.

Example 6: The top-up tax percentage

This example is a continuation of example 5 in the previous chapter involving a MNE that has two constituent entities in Jurisdiction A. Constituent Entity 1 has covered taxes of €6 million and GloBE income of €80 million for the current Fiscal Year, and Constituent Entity 2 has covered taxes of €4 million and GloBE income of €20 million. The MNE's ETR for Jurisdiction A is 10% (covered taxes of €10 million / GloBE income of €100 million).

The top-up tax percentage for Jurisdiction A is calculated by subtracting the ETR of 10% from the GloBE tax rate of 15%. This results in a top-up tax percentage for Jurisdiction A of 5%.

Substance-based income exclusion

6.10 The top-up tax percentage is applied to the net GloBE income in the jurisdiction in excess of the substance-based income exclusion. This approach ensures that the substance-based income exclusion does not inappropriately increase the ETR in the jurisdiction.

6.11 The substance-based income exclusion is a formulaic carve out which excludes from top-up tax a reasonable return to the level of substance in the jurisdiction. This is based on a percentage of the MNE's payroll costs and tangible assets in the jurisdiction, on the grounds that employment costs and tangible assets tend to be relatively immobile factors of production and are therefore reasonable proxies for substantive economic activities.

The percentage

6.12 The substance-based income exclusion, or "carve-out" will be 5% of the carrying value of the payroll costs and tangible assets in the jurisdiction. There is an increased amount in the transition period which begins from 1 January 2023 and lasts for 10 years. In this period, the carve-out for payroll costs is

10% in the first year and then is reduced by 0.2% per year for the first 5 Fiscal Years and 0.8% per year for the remaining 5 Fiscal Years.

6.13 The carve out for tangible assets is 8% in the first year and then is reduced by 0.2% in the first 5 Fiscal Years and 0.4% for the remaining 5 Fiscal Years.

Payroll costs

6.14 The payroll carve out for a jurisdiction is based on payroll costs for a constituent entity that is located in the jurisdiction, for employees and independent contractors that perform activities for the MNE in that jurisdiction.

6.15 For this purpose, independent contractors include only natural persons and may include natural persons who are employed by a staffing or employment company but whose daily activities are performed under the direction and control of the MNE. Independent contractors do not include employees of a corporate contractor providing goods or services to constituent entities in the jurisdiction.

6.16 The payroll costs include employee benefits that provide a direct personal benefit to the employee like health insurance and pension contributions as well as wages and salary costs. Payroll taxes and social security contributions borne by the employer are also included.

Tangible assets

6.17 The tangible asset carve out is based on the average of the opening and closing carrying value (net of accumulated depreciation) of tangible assets in the financial statements. The tangible assets which qualify include property, plant and equipment, natural resources (including land not held for sale, lease or investment) as well as licences for the use of immovable property or exploitation of natural resources. The asset must be located in the jurisdiction of the constituent entity that owns it.

6.18 Assets which are leased also qualify for the lessee, which provides consistency between owned and leased assets. Where an asset is leased from another group member, the asset will only be included in the jurisdiction of the lessee.

6.19 There are special rules to determine how the carve-out is allocated for permanent establishments in Article 5.3.6 and for transparent entities in Article 7.4.6.

Example 7: Calculating the substance-based income exclusion

Continuing example 6, Constituent Entity 1’s payroll costs for activities performed in Jurisdiction A is €30 million for the current Fiscal Year, and its tangible assets located in Jurisdiction A have an average accounting carrying value for the current Fiscal Year of €170 million. Constituent entity 2 has no payroll costs or tangible assets.

The substance-based income exclusion for Jurisdiction A is calculated as follows* ((payroll costs of €30 million x 5%) + (tangible assets of €170 million x 5%)) = €10 million. Therefore €10 million would be deducted from the MNE’s GloBE income for Jurisdiction A for the purposes of calculating the income subject to top-up tax.

* The carve-out percentages have reduced to 5% in the year of the example.

Computing the top-up tax in the jurisdiction

6.20 The top-up tax for the jurisdiction is calculated by deducting the substance-based income exclusion from the Net GloBE income in the jurisdiction and then multiplying the result by the top-up tax percentage.

Example 8: Computing the top-up tax

Continuing example 7, the MNE's top-up tax for Jurisdiction A for the current Fiscal Year equals €4.5 million ((net GloBE income of €100 million – the substance-based income exclusion of €10 million) x the top-up tax percentage of 5%)

6.21 If an adjustment is made that results in a decrease to the liability for covered taxes in a prior year (for example, when a tax return is reassessed resulting in a reduction to the tax liability for a prior year), the GloBE rules require the ETR in the earlier year to be recalculated unless the decrease is less than €1 million, in which case it can be included in the current year. This includes when the recapture rule is applied to deferred tax liabilities which have not unwound within five years. When these recalculations result in an ETR falling below the minimum rate, the additional top-up tax for that year is added to the current year's top-up and charged in the current Fiscal Year.

Example 9: Decrease in covered taxes for a prior year

Continuing example 8, Constituent Entity 2's Jurisdiction A income tax return for a prior year has been reassessed, resulting in a reduction in its local tax liability for the prior year of €1.2 million but no change in its GloBE income for that year. The Jurisdiction A ETR and top-up tax is recalculated for this prior year resulting in additional GloBE top-up tax for the year of €1 million.*

This additional top-up tax of €1 million is added to the €4.5 million top-up tax for the current Fiscal Year resulting in total top-up tax for the current Fiscal Year of €5.5 million. The GloBE return for the prior Fiscal Year is not reassessed.

* The reduction in the prior year local tax liability doesn't result in a Euro-for-Euro increase in top-up tax because of the impact of the substance-based income exclusion in the prior year.

6.22 Some countries may decide to introduce a domestic minimum tax, or DMT, in response to Pillar Two, in order to collect themselves any top-up tax imposed on the profits of a group's domestic entities. The top-up collected under a qualifying DMT is subtracted from the top-up tax charged under the GloBE rules. This means the DMT has a very different place in the rules from ordinary income taxes, which are included in the ETR calculation. A qualifying DMT reduces any top-up tax on a dollar-for-dollar basis whereas ordinary taxes are diluted by the substance-based income exclusion.

6.23 A DMT will be qualifying if it imposes an additional top-up tax to domestic entities and the top-up is calculated on the same basis as the GloBE rules. The possibility of a DMT for New Zealand is discussed in chapter 14.

Allocation of a jurisdiction's top-up tax to constituent entities

6.24 The final step is to allocate the jurisdictional top-up tax to the individual constituent entities in the low tax jurisdiction. This paves the way for the final step in the process, which is for the tax allocated to the low tax entities to then be allocated under Article 2 of the Model Rules to the entities required to pay tax under the IIR and UTPR.

6.25 This allocation amongst the low tax constituent entities is necessary to deal with situations where some of the top-up tax is charged to an entity which is not the UPE. For example, if the UPE is not subject to a qualified IIR, the top-up tax may be collected through a combination of the IIR applied at different levels of the group structure and the UTPR (as described in the next chapter). Allocating the top-up tax to individual constituent entities ensures the different charging rules can be coordinated.

6.26 It is also necessary because the IIR is intended to collect top-up tax from a parent entity based on its interest in a low-taxed constituent entity. This means that where a parent applying the IIR does not wholly own a low-taxed constituent entity, it will only bear the cost of its proportional share of top-up tax. Allocating top-up tax to low tax constituent entities is an important step in achieving this outcome.

6.27 The GloBE rules generally allocate the top-up tax for a jurisdiction between the constituent entities located in the jurisdiction based on their proportion of the jurisdictional GloBE income.

Example 10: Allocating top-up tax to constituent entities

Continuing example 9, the total top-up tax for Jurisdiction A for the current Fiscal Year of €5.5 million is allocated to each constituent entity located in Jurisdiction A based on its proportion of the net GloBE income for Jurisdiction A.

Constituent Entity 1 is allocated €4.4 million (Constituent Entity 1 GloBE income of €80 million / jurisdictional GloBE income of €100 million x top-up tax of €5.5 million).

Constituent Entity 2 is allocated €1.1 million (Constituent Entity 2 GloBE income of €20 million / jurisdictional GloBE income of €100 million x top-up tax of €5.5 million).

6.28 There are special rules to deal with situations when top-up taxes are payable when there is no GloBE income in the jurisdiction, for example when all the top-up tax for the year relates to a recalculation of the ETR from an earlier year.

Question for submitters

- Do you have comments on the process for calculating top-up tax and attributing it to entities in a particular low tax jurisdiction?

CHAPTER 7

Imposition of top-up tax

Overview

7.1 As outlined in Chapter 2, the IIR and the UTPR both allocate the liability to pay top-up tax between the MNE's entities.

7.2 The 2 rules are designed to work together and are also coordinated to ensure the right amount of top-up tax is collected when multiple IIRs or UTPRs are applied at the same time in different jurisdictions. Therefore, both rules start from the same top-up tax calculation explained in Chapter 6, which allocates top-up tax amongst constituent entities in a low tax jurisdiction.

7.3 This chapter sets out the ordering rules that prescribe how the IIR and UTPR operate together, and how top-up tax is imposed on an MNE's entities. The rules are in Chapter 2 of the GloBE rules.

IIR ordering rules

7.4 The IIR takes the top-up tax calculated for a low-taxed constituent entity (LTCE) and then imposes this tax on a parent entity in the LTCE's group.

7.5 When a parent applies the IIR, the amount of top-up tax it is charged is based on the amount of top-up tax calculated for the relevant LTCE multiplied by the parent's allocable share of the LTCE's income.

7.6 The allocable share is a measure of the parent's rights to the profit of the LTCE and is calculated based on accounting principles. The test works by determining the proportion of the LTCE's GloBE income that is attributable to the parent (that is, after adjustment for interests held by other owners).

7.7 The IIR is conceptually similar to a Controlled Foreign Company (CFC) rule in that it charges a parent company tax which is calculated by reference to its subsidiary's profits. However, the IIR is different from a CFC rule in a number of important ways.

The top-down approach

7.8 There will often be MNE structures where more than one group entity has an interest in the LTCE. The GloBE rules establish:

- which entities in the group apply the IIR, and
- if more than one group entity applies the IIR in respect of the same LTCE, what adjustments are made to avoid over-taxation.

Which entities apply the IIR

7.9 The GloBE rules include a priority order for applying the IIR.

7.10 The basic structure is a top-down approach. This means the UPE jurisdiction will usually have the first priority to charge the top-up tax in relation to low tax jurisdictions (other than the UPE jurisdiction itself, unless it is in a country that has adopted a domestic IIR). If the UPE is not subject to a qualified IIR, intermediate parent entities located in other jurisdictions and held directly by it (second tier entities) will apply the IIR to LTCEs in other jurisdictions to the extent of their direct and indirect interest in those LTCEs. To the extent that this step does not result in the imposition of the full amount of top-up tax calculated under chapter 5 of the GloBE rules, third tier intermediate parent entities may have an IIR liability, and so on. Intermediate parent entities are entities that are controlled by the UPE and have an ownership interest in the LTCE, but investment entities are excluded.

7.11 Unless the split ownership rules apply (see below at [7.14]-[7.17]), an intermediate parent entity (*lower IPE*) will not apply its IIR if:

- the UPE is subject to a qualified IIR,[8] or
- another intermediate parent entity (*higher IPE*) that owns, directly or indirectly, a 'controlling interest'[9] in the lower IPE is subject to a qualified IIR.

7.12 If the higher IPE does not have a controlling interest in the lower IPE, the lower IPE's IIR will not be switched off. As explained below, the lower IPE will charge its IIR, but the higher IPE must reduce its share of the top-up tax by the tax charged by the lower IPE.

Adjustments if more than one group entity applies the IIR

7.13 If more than 1 parent entity in a group applies the IIR with respect to a LTCE, parent entities applying the IIR must reduce their own top-up tax liability by any top-up tax allocated to a parent entity further down the group structure. This prevents double allocation of the same top-up tax amount.

Example 11: Multiple intermediate parents

The amount of top-up tax calculated for an MNE's low-taxed constituent entity (LTCE) is $100. The LTCE is 100% directly owned by Parent B. Parent A owns 20% of Parent B – it does not have a controlling interest.

Both Parent A and Parent B are in jurisdictions with a qualified IIR. The UPE of the group is not in a jurisdiction with a qualified IIR.

Since Parent A does not have a controlling interest in Parent B, both parents apply the IIR. However, since Parent B's IIR will charge the full $100 of top-up tax, Parent A's share of the top-up tax is reduced from $20 to nil. The full amount of top-up tax is charged to Parent B under the IIR.

Exception: the split ownership rules

7.14 The split ownership rules are an exception to the IIR's general top-down approach. Under the GloBE rules, an intermediate parent entity that is more than 20% owned by minority investors outside the MNE group is called a partially-owned parent entity (POPE). The POPE definition is satisfied even if minority investors *indirectly* own more than 20% of the ownership interests in

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[8] The exception to this is when there is a partially-owned parent entity (POPE), lower down the group structure. A POPE is a parent entity where at least 20%is held by minority shareholders. The split ownership or POPE rules are explained at paragraphs 7.14 to 7.17.

[9] 'Controlling interest' is defined in the GloBE rules. Broadly, the GloBE definition means an ownership interest such that the parent is required to consolidate the subsidiary's financials on a line-by-line basis in accordance with an acceptable financial accounting standard (or would have been required to, had it prepared consolidated financial statements). It does not mean an ownership interest over 50%.

the parent entity. A parent entity owned by a POPE will therefore usually also be a POPE.

7.15 POPEs have the priority rights to apply the IIR notwithstanding the general top-down approach. The reason for this is that, where there are substantial minority interests, some amount of the top-up tax would not be collected at all if the IIR were only applied by parent entities higher up the ownership structure.

Example 12: Partially-owned parent entities (POPEs)

The amount of top-up tax calculated for an MNE's LTCE is $100. The UPE indirectly owns the LTCE through A Co. The UPE owns 60% of A Co and A Co owns 100% of the LTCE.

Under the GloBE rules, A Co (and not the UPE) would apply the IIR and pay $100 of top-up tax. By charging all the top-up tax to A Co, the top-up tax is effectively borne 60% by the UPE and 40% by the minority shareholders.

If this were not the case and only the UPE applied the IIR, the UPE would only be charged $60 of the top-up tax based on its allocable share. The remaining $40 would not be collected under either the UTPR or the IIR.

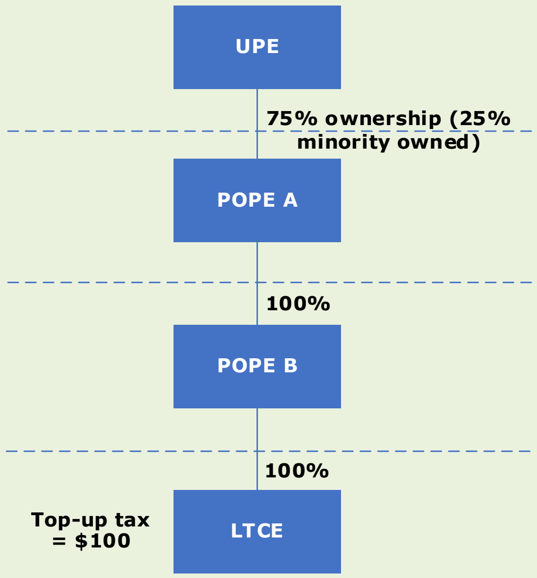
7.16 The ordering rules for POPEs require a lower-tier POPE to switch off its IIR only if it is wholly-owned by a higher POPE which is subject to the IIR.

Example 13: POPE rules and corresponding tax reductions

The amount of top-up tax calculated for an MNE's LTCE is $100. The UPE indirectly owns the LTCE through a chain of POPEs. The UPE directly owns 75% of POPE A, with the remaining 25% held by minority investors outside the MNE group. POPE A directly owns POPE B (ownership percentage varies under the two examples below). POPE B directly owns 100% of the LTCE.

POPE A owns 100% of POPE B

If POPE B is 100% owned by POPE A, POPE A would apply the IIR and be charged $100 of top-up tax. POPE B would not be required to apply the IIR.



POPE A owns 90% of POPE B, with remaining 10% owned by outside investors

If POPE B is only 90% owned by POPE A, both POPEs would apply the IIR.

POPE B would be charged $100 of top-up tax. POPE A would also apply the IIR but its top-up tax liability will be reduced to zero by the amount of tax charged to POPE B.

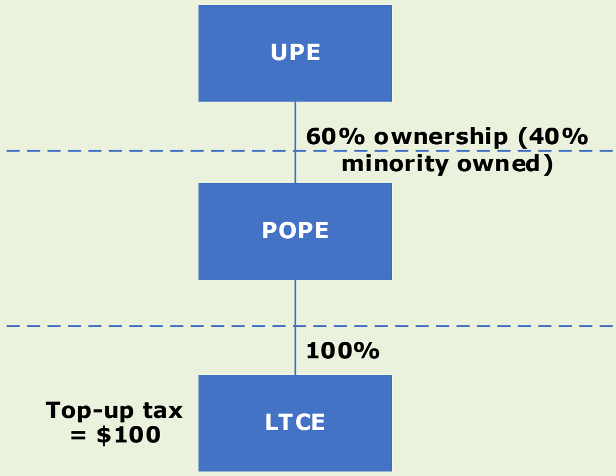
7.17 As noted above, if a parent entity further down the group structure has applied the IIR, the liability of any parent further up the group applying the IIR must be reduced. The amount of the reduction is the top-up tax paid by the lower parent under an IIR multiplied by the higher parent's ownership interests in the low taxed entity held indirectly through that lower parent. So for example if the lower parent pays top-up tax of $100 in respect of a low tax entity and the higher parent indirectly holds a 60% ownership interest in that same low taxed entity through the lower parent, then the amount of the reduction is $100 x 60% = $60.

Example 14: Reduction for top-up tax charged to lower parent

The amount of top-up tax calculated for an MNE's LTCE is $100.

The UPE indirectly owns the LTCE through a POPE

Assume the POPE directly owns 100% of the LTCE, and the UPE directly owns 60% of the POPE, with the remaining 40% held by minority investors outside the group.

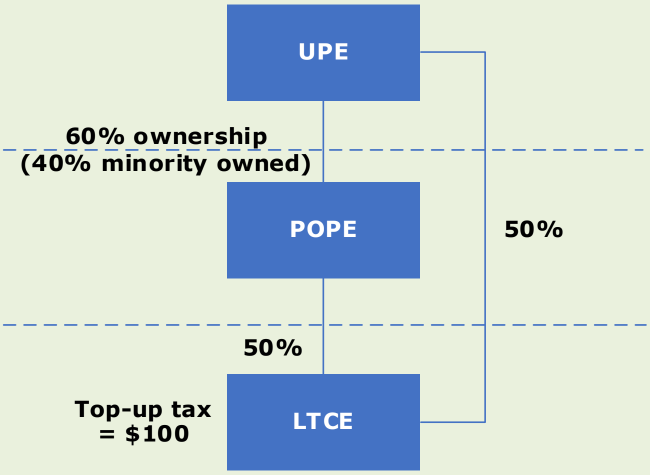


Both the UPE and the POPE apply the IIR:

- The POPE's allocable share of the top-up tax is $100.
- The UPE's allocable share is initially $60 but this is reduced by the top-up tax paid by the POPE multiplied by the UPE's ownership interest in the LTCE held indirectly through the POPE. This reduction equals $60 ($100 x 60% = $60), meaning the UPE has zero allocable share. This is appropriate because the top-up tax has already been fully charged to the POPE.

The UPE owns the LTCE both directly and indirectly through a POPE

Assume the POPE owns 50% of the LTCE, and the UPE owns the other 50%. AS above, the UPE also directly owns 60% of the POPE with the remaining 40% held by minority investors outside the group.



Again, both the UPE and the POPE apply the IIR:

- The POPE's allocable share of the top-up tax is $50.
- The UPE's allocable share is initially $80, being $50 from its direct interest in the LTCE plus $30 from its indirect interest through the POPE (60% * $50 = $30). The UPE reduces its top-up tax liability by $30 to $50, as the $30 from its indirect interest through the POPE has already been charged to the POPE.
- The result is that the full $100 of top-up tax is collected.

UTPR interaction with IIR

7.18 Like the IIR, the UTPR allocates top-up tax. The UTPR primarily functions as a backstop to the IIR.[10] It aims to ensure that top-up tax for an LTCE is paid even if its parent entities are located in jurisdictions without a qualified IIR. This eliminates the incentive for an MNE to headquarter in a country without an IIR.

7.19 As the UTPR is a backstop, the GloBE rules give the IIR priority over the UTPR in charging tax on low-taxed profits outside of the UPE jurisdiction. The UTPR therefore does not apply when all of the interests in the LTCE are held by parent entities subject to a qualified IIR.

7.20 The UTPR applies if some of the interests in an LTCE are not held by parent entities which are subject to a qualified IIR. However, any top-up tax collected under the UTPR is reduced by the amount which is charged under an IIR. This ensures the IIR takes priority.

[10] It also ensures that any LTCEs in the UPE's jurisdiction are subject to top-up taxation.

Example 15: Interaction between IIR and UTPR

The amount of top-up tax calculated for an MNE's LTCE is $100. The MNE's UPE indirectly owns 100% of the LTCE, through two companies – A Co (which owns 60%) and B Co (which owns 40%). A Co is in a jurisdiction with a qualified IIR, B Co and the UPE are not.

Applying the IIR, A Co's allocable share of the top-up tax is $60. The remaining $40 of top-up tax is allocated to the MNE's constituent entities under the UTPR.

How the UTPR allocates top-up tax to different jurisdictions

7.21 Unlike the IIR which allocates top-up tax to entities by allocable share or ownership, the UTPR allocates top-up tax to *jurisdictions* based on where the group's tangible assets and employees are located.

7.22 The UTPR uses an allocation key to allocate the top-up tax between the different jurisdictions in which the MNE has constituent entities. The top-up tax is only allocated to jurisdictions that have implemented a qualified UTPR (a 'UTPR jurisdiction').

7.23 The allocation is calculated at a jurisdictional level. The top-up tax is allocated based on the proportion of the tangible assets and number of employees in each UTPR jurisdiction. There are equal weights for the asset and employee factors.

Example 16: UTPR allocation

An MNE consists of one company (ParentCo) in jurisdiction P with permanent establishments in jurisdictions A, B, C, D and E.

Jurisdiction P has not adopted the GloBE rules. Jurisdictions A, B, C, D and E have all adopted the GloBE rules and implemented the UTPR.

The value of tangible assets and number of employees owned by the MNE located in each jurisdiction are:

- Jurisdiction A: $400 million tangible assets, 500 employees
- Jurisdiction B: $400 million tangible assets, 300 employees
- Jurisdiction C: $100 million tangible assets, 200 employees
- Jurisdiction D: $100 million tangible assets, no employees
- Jurisdiction E: No tangible assets or employees.

The MNE's total value of tangible assets in all UTPR jurisdictions is $1 billion, and the total number of employees in all UTPR jurisdictions is 1,000.

Jurisdiction P has not adopted the GloBE rules. Jurisdictions A, B, C, D and E have all adopted the GloBE rules and implemented the UTPR. The PE in Jurisdiction A is low tax, having a top-up tax amount under Article 5 of $100,000.

The share of Jurisdiction A top-up tax allocated to Jurisdictions A, B, C and D under the UTPR is calculated as follows:

- Jurisdiction A: 50% x (400m/1b) + 50% x (500/1,000) = 45%
- Jurisdiction B: 50% x (400m/1b) + 50% x (300/1,000) = 35%
- Jurisdiction C: 50% x (100m/1b) + 50% x (200/1,000) = 15%
- Jurisdiction D: 50% x (100m/1b) + 50% x 0 = 5%
- Jurisdiction E will not be allocated any top-up tax as it has no tangible assets or employees, even though it is a UTPR jurisdiction.

7.24 The data for this allocation can be taken from the MNE's CbC report, provided the report is prepared in accordance with the GloBE rules' definitions for Number of Employees and Tangible Assets. This will minimise the additional compliance burdens on MNEs and improve coordination by basing the calculation on existing, readily available, and objective data.

7.25 Once top-up tax has been allocated to a jurisdiction under the UTPR, the jurisdiction must decide in its own domestic laws how to collect that top-up tax from the MNE's constituent entities in that jurisdiction. A proposal for how this could be done in New Zealand is outlined in Chapters 11 and 12.

Questions for submitters

- Do submitters have any comments on how the IIR ordering rules should be implemented in New Zealand?
- Do submitters have any views on information or administration challenges with the split ownership POPE rules and how these challenges could be addressed in the implementation framework?
- Do submitters have any comments on the interaction between the IIR the and UTPR and how it should be addressed in implementation?

CHAPTER 8

Transition

Overview

8.1 Chapter 9 of the Model Rules sets out transitional rules. Some of these rules apply to all MNEs as they address transition issues arising from the fact that the GloBE rules are new. Other transitional rules apply to entities and groups when they first come within scope of the GloBE rules (for example, through organic growth or a merger), even if that occurs after the GloBE rules have been in place for some time.

8.2 An MNE's transition year is determined on a jurisdictional basis. For a jurisdiction, the first fiscal year that the MNE comes within scope of the GloBE rules in respect of that jurisdiction is a "Transition Year". An MNE may therefore have different Transition Years in respect of different jurisdictions.

8.3 The transitional rules described in this chapter:

- Allow higher percentages to be used in calculating the substance-based income exclusion in the first 10 years of the GloBE rules.
- Allow for a longer filing deadline in an MNE's Transition Year.
- Address the treatment of losses and other timing differences.
- Provide temporary relief from the UTPR for MNEs in the initial phase of international activity.

Substance-based income exclusion

8.4 As described above in Chapter 6 the percentages used in the substance-based income exclusion are higher for the first 10 years of the GloBE rules.

8.5 The percentages start at 10% for payroll costs and 8% for tangible assets, and taper down to the 5% rates over a 10-year period. For the fiscal year beginning 2033, the percentages are both 5%.

Longer filing deadline in Transition Year

8.6 An MNE is normally required to file its GloBE return and other notifications within 15 months after the end of its accounting period. In an MNE's Transition Year, this deadline is extended to 18 months.

Losses and timing differences

8.7 Once an MNE becomes subject to the GloBE rules it will have to calculate its ETR in each jurisdiction where it operates. There may be losses and accounting-tax timing differences occurring before an MNE's Transition Year that affect its ETR calculation in its Transition Year and later years.

8.8 For example, if an MNE's pre-Transition Year losses were not taken into account at all, the MNE could have an inappropriately low ETR in a year when those losses are used to reduce local taxable income.

8.9 To prevent this, where there are losses and other timing differences arising before a Transition Year the MNE will generally be treated as though it were already subject to the GloBE rules at the time the losses or timing differences arose. This is done by taking into account existing deferred tax accounting attributes (including deferred tax assets from earlier losses) in the ETR calculation described in Chapter 5. Consistent with that treatment, deferred tax assets and deferred tax liabilities are generally taken into account at the lower of 15% and the applicable domestic tax rate.[11]

8.10 The treatment of losses under the GloBE rules is described at paragraphs 5.61 onwards in Chapter 5.

8.11 Deferred tax assets generated after 30 November 2021 from items that are excluded from the GloBE base must be disregarded for GloBE purposes. In addition, the GloBE tax basis in assets acquired in an intragroup transaction after 30 November 2021 must be based on historical carrying values and related deferred tax assets and liabilities must similarly be determined based on historical carrying values. The purpose of this is to defeat inappropriate tax planning transactions.

MNEs in the initial phase of international activity

8.12 There is temporary relief from the UTPR for MNEs in the initial phase of international activity. An MNE is in its "initial phase of international activity" if it has constituent entities in no more than six jurisdictions and has less than €50 million of tangible assets (by book value) outside of the jurisdiction in which it has the most tangible assets (again, by book value). The relief applies on an annual basis.

8.13 Because it does not apply for the IIR, this relief is only relevant for groups that are headquartered in a country that does not have an IIR, and even then, will be somewhat undercut if the group has a lower tier parent company in a country with an IIR.

8.14 The temporary relief expires after the MNE has been in scope of the GloBE rules for five years. This five-year period is not suspended if, for example, the MNE's revenues decline so that it falls outside the scope of the rules during those five years.

Example 17: Five-year limit to initial phase relief

A multinational group (NewGroup) crosses the €750 million consolidated annual revenue threshold for the first time in its fiscal year ended 31 December 2030. Its consolidated annual revenues for the following four fiscal years are as follows:

- 2031: €780 million
- 2032: €600 million
- 2033: €640 million
- 2034: €720 million

[11] If a deferred tax asset is recorded at a rate less than 15%, it may be taken into account at 15% if the MNE demonstrates that it was attributable to a loss under the GloBE base.

As explained in Chapter 4, the GloBE rules apply to MNEs that have consolidated annual revenues of at least €750 million in at least two of the last four fiscal years. The first year in which the GloBE rules apply to NewGroup is therefore 2032.

Assuming NewGroup meets the other requirements for the initial phase relief from the UTPR, it will qualify for the relief in 2032 and the last year it can obtain the relief is for the 2036 year. It does not matter that NewGroup's annual revenues fell below the €750 million threshold from 2032 to 2034.

Optional provisions

8.15 The Model Rules contain an optional provision in Article 9.3.5 for implementing jurisdictions that is intended to reduce the risk of locally-headquartered MNEs establishing a new UPE in a jurisdiction without an IIR in order to take advantage of the initial phase relief.

8.16 Because the temporary relief only applies to the UTPR, a New Zealand-headquartered MNE in the initial phase of its international activity with LTCEs would still be charged top-up tax in New Zealand under the IIR (if New Zealand were to adopt one). If, however, it established a new UPE in a jurisdiction without an IIR, and transferred the LTCEs to that new UPE, it might not be charged top-up tax in respect of its LTCEs at all during the 5-year period it qualified for temporary relief.

8.17 The optional provision is intended to address this risk. If an MNE in the initial phase of international activity has most of its tangible assets in New Zealand, New Zealand would be the "Reference Jurisdiction" of the MNE Group. The optional provision would allow the Reference Jurisdiction (that is, New Zealand) to collect the full amount of top-up tax arising in a low tax jurisdiction under the UTPR, no matter where the UPE is located. This is shown in example 18.

Example 18: Inversion risk from initial phase relief

NZGroup is a multinational group that started out in New Zealand. The UPE of the NZGroup is in New Zealand. Most of the group's tangible assets by value are also in New Zealand, such that New Zealand is the Reference Jurisdiction for the group.

The UPE of NZGroup has two wholly-owned foreign subsidiaries, Sub A in Jurisdiction A and Sub B in Jurisdiction B.

NZGroup becomes subject to the GloBE rules for the first time for the fiscal year ended 31 March 2030 and qualifies for initial phase relief.

Sub B is a low-taxed entity and the top-up tax for Sub B is $100. Assume that New Zealand and Jurisdiction A have implemented the GloBE rules (both the IIR and the UTPR) but Jurisdiction B has not.

If NZGroup's UPE remained headquartered in New Zealand, the full $100 of top-up tax would be charged to the UPE under New Zealand's IIR.

Assume NZGroup moved its UPE to Jurisdiction B:

- If New Zealand did not adopt the optional provision in Article 9.3.5, NZGroup could avoid all liability for top-up tax during the initial relief phase. The IIR would not apply (as Jurisdiction B has not implemented the GloBE rules), but New Zealand and Jurisdiction A would not be allowed to collect the top-up tax in respect of Sub B under the UTPR either if NZGroup qualifies for initial relief.
- If New Zealand adopted Article 9.3.5, New Zealand could collect the full $100 top-up tax under the UTPR as it is the Reference Jurisdiction for the Group. Moving the UPE to Jurisdiction B therefore does not change group's top-up tax liability – it just means the top-up tax will be collected under the UTPR rather than the IIR.

8.18 Officials consider the optional provision in Article 9.3.5 should be adopted to mitigate the risk of New Zealand MNEs establishing UPEs in low-tax jurisdictions to take undue advantage of the temporary relief.

Further sub-option

8.19 If New Zealand decides to adopt the optional provision in Article 9.3.5, there is a further sub-option in Article 9.3.5(a) of the Model Rules for New Zealand to limit the application of the UTPR to top-up tax arising in jurisdictions other than New Zealand. Adopting this sub-option would mean that, where New Zealand is the Reference Jurisdiction for an MNE, New Zealand will be able to collect top-up tax under the UTPR in respect of the MNE's low-taxed entities located in any jurisdiction other than New Zealand. But top-up tax in respect of any low-taxed entities in New Zealand will not be collected by New Zealand, or any other jurisdiction.

8.20 The effect of this sub-option is to preserve the tax outcomes that arise under New Zealand tax law, even if those outcomes mean that a New Zealand MNE's ETR is less than 15%. If this sub-option were not adopted, top-up tax arising in New Zealand during an MNE's initial phase would be collected by New Zealand under the UTPR, even though no other country would be allowed to collect that tax. This is illustrated in example 19.

Example 19: Effect of further sub-option in Article 9.3.5(a)

- Assume the same facts as in Example 18, with the UPE in Jurisdiction B.
- Sub B is still a low taxed entity and the top-up tax for Sub B is $100. However, assume now that Sub A is located in New Zealand and is also a low-taxed entity with top-up tax of $50. This happened even though New Zealand's 28% company tax rate is well above the minimum 15% rate, because Sub A earned capital gains that are treated as GloBE income but are not taxed in New Zealand.
- If New Zealand adopted Article 9.3.5 without the sub-option in paragraph (a), New Zealand would collect top-up tax for both Sub A and Sub B, totalling $150, under the UTPR as it is the Reference Jurisdiction for the Group. This effectively taxes the capital gains earned by Sub A.

- If New Zealand also adopted the sub-option in paragraph (a), New Zealand would collect $100 of top-up tax in respect of Sub B only. The top-up tax calculated for Sub A would be reduced to zero, because Sub A is also located in New Zealand. This preserves the non-taxation of the capital gains for Sub A.

8.21 Given the reality of the New Zealand economy and tax system, whether or not this provision should be adopted is a largely academic question. Officials suggest that in the interests of simplicity it be adopted, since it produces the same result as would have applied if the MNE were headquartered in New Zealand (the UTPR would not have applied due to 9.3.1, and the IIR does not apply to domestic profits). This is without prejudice to the question of whether New Zealand should adopt a domestic top-up tax, considered in a later chapter.

Questions for submitters

- Do submitters have views on how the transitional rules work?
- Do submitters agree that New Zealand should adopt the optional provision in Article 9.3.5? If no, why not?
- Do submitters agree that, if New Zealand adopted the optional provision, it should also adopt the further sub-option in Article 9.3.5(a) if it does not adopt a domestic top-up tax? Why or why not?

CHAPTER 9

Simplification

9.1 The OECD will be developing an implementation framework for the GloBE rules during 2022. Part of this work will consider the possible use of safe harbours to simplify both compliance by MNEs and administration by tax authorities.

9.2 The general idea would be that where a business qualifies for an agreed safe harbour, the MNE group would not need to provide the full ETR calculation for a jurisdiction but would instead provide a simpler computation or certain information to evidence eligibility for the safe harbour.

9.3 The programme of work on the implementation framework is still to be agreed, but this chapter explains one of the simplification approaches that have been considered in OECD discussions.

9.4 Submissions received in response to the questions raised in this Chapter will assist in upcoming OECD discussions on simplification measures. However final decisions on safe harbours will rest with Inclusive Framework and not the New Zealand Government alone. Officials do not propose to consult again on simplification measures once the OECD has finished designing them, but will discuss the measures further with affected taxpayers.

A safe harbour based on CbCR

9.5 There have previously been discussions about using a simplified ETR calculation based on data in a MNE's CbC report to approximate the risk the full GloBE ETR is below the minimum rate.

9.6 The group would qualify for this safe harbour when the simplified ETR is above a certain CbCR safe harbour minimum rate. This could be higher than the 15% minimum rate in the GloBE rules to reflect the risk that the CbCR ETR is different because of differences in how the GloBE income and adjusted covered taxes are calculated.

9.7 There is an important policy design question whether that risk should be addressed solely through increasing this rate premium over 15% or whether there should also be adjustments to the CbCR figures to bring the ETR calculation closer into line with how the GloBE ETR is calculated.

9.8 There is a trade-off between accuracy and simplicity here. Increasing the number of adjustments reduces the risk that a MNE inappropriately qualifies for the safe harbour. Equally, it reduces the risk a MNE is inappropriately excluded from the safe harbour.

9.9 However, it also increases the complexity of the calculation, and therefore reduces some of the simplification benefits the safe harbour is intended to provide.

9.10 The adjustments that could be made broadly fall into two categories.

9.11 The first would mirror some of the adjustments made to GloBE income in Chapter 3 of the Model Rules. So, for example, the CbCR profit could be adjusted where this includes gains and losses from the sale of >10% shareholdings, so the figure more accurately represents the profit in the GloBE base (and in most cases also the taxable profit in the local tax jurisdiction).

9.12 These adjustments wouldn't necessarily need to reflect all of the adjustments in the GloBE rules but could identify those which are most significant or are most likely to lead to the ETR being inappropriately inflated (those which might lead to it being deflated could be optional).

9.13 The second category would be intended to reflect timing differences and bring the CbCR ETR closer into line with the outcomes achieved by the timing differences rules in Chapter 4 of the Model Rules.

9.14 Without these adjustments, a taxpayer could have a low ETR in the CbCR even though this low ETR is simply a consequence of the taxpayer having used losses from earlier years to offset its profits.

9.15 The design could also seek to reduce some of the complexities in the jurisdictional blending rules. For example, there may be limited risk a branch is low-taxed when it is taxed in the head office jurisdiction at a high rate.

9.16 There may be scope to consider whether the safe harbour could be designed to take account of this and reduce the allocations between jurisdictions required under the main rules.

Questions for submitters

- Do you have any comments on a CbCR based safe harbour and how it could be designed?
- What adjustments do you think should be made to give an appropriate approximation of the full ETR calculation?
- How could timing differences be addressed within a CbCR safe harbour design? Do they need to be?

Other safe harbours

9.17 A key feature of the Model Rules is that ETRs and top-up tax are calculated on a jurisdictional basis – in other words, covered tax and GloBE income from different jurisdictions cannot be blended. During OECD discussions it has been clear that safe harbours will only be available on a jurisdictional basis to support the jurisdictional design of the rules.

9.18 Officials welcome ideas on other safe harbours that could be developed for application on a jurisdictional basis.

Question for submitters

- Do you have any suggestions about alternative safe harbours that could be developed for application on a jurisdictional basis?

PART III: Explaining New Zealand-specific Pillar Two issues

CHAPTER 10

Mode of Implementation in New Zealand

Overview

10.1 This chapter considers what form enactment of the GloBE rules in New Zealand should take.

Aligning NZ law with OECD Model Rules

10.2 One of the most important aspects of Pillar Two is the status of the rules. The Inclusive Framework has agreed that the GloBE rules are a common approach. This means that jurisdictions that choose to implement the GloBE rules must implement them in line with the Pillar Two agreement.

10.3 There are good reasons for this. The Pillar Two agreement was reached after extensive negotiations and consultation with businesses and other stakeholders and represents a compromise agreed between over 130 jurisdictions. Consequently, it is important that jurisdictions respect it. The effectiveness of the GloBE rules also depends on a high degree of consistency in the implementation in different jurisdictions.

10.4 For example, there would be a high risk of double taxation or double non-taxation if implementing jurisdictions adopted different rules to measure the level of taxation and top-ups required in each jurisdiction. Similarly, there could be significant double taxation and disputes between jurisdictions and taxpayers if some countries do not respect the agreed rule order.

10.5 Therefore if the Government decides to adopt GloBE rules, it will implement them in New Zealand as closely to the OECD Model Rules as possible. There may be limited areas where the rules need to be adapted, for example to reflect concepts in New Zealand law, but the general approach will be to follow the agreed OECD Model Rules where possible. If changes are required, these will respect the intended outcomes agreed in the OECD.

How to best implement the Model Rules

10.6 Adopting the Model Rules will require government to pass a Bill incorporating the rules into New Zealand law. The method used for this incorporation is a decision for New Zealand. Previous OECD tax reforms have been legislated in New Zealand using one of the following methods:

- Repetition: OECD rules are rewritten into New Zealand legislation in full, with adaptations in limited areas, for example to reflect concepts in New Zealand law. This was generally the approach taken to the anti-hybrid rules in subpart FH of the Act, though reference was made to the OECD's Hybrids Report in a number of places.
- Incorporation by reference: New Zealand legislation provides the legal scaffolding necessary to support the OECD rules but gives effect to them by reference to the rules themselves, rather than re-writing them in the legislation. Even in this case, it is likely that some amendment to particular OECD rules might be desirable, to ensure that they are interpreted consistently with their intention and the Commentary.

10.7 Each method has its pros and cons. Repetition is better at allowing legislation to be adapted to reflect New Zealand circumstances when that is appropriate. However, it creates a far greater administrative burden in terms of initial drafting and for updating any changes than direct incorporation. It also creates risk that some aspects of the rules may be translated inaccurately and not reflect the intent of Pillar Two. And the use of local translations increases the risk that administrators or courts in different countries will come to different views on the application of the rules. Pillar Two like many OECD initiatives is likely to be subject to a peer review process whereby its implementation by countries is reviewed to ensure correct translation has taken place.

10.8 If New Zealand decides to incorporate the Model Rules directly, there is also a decision on how adaptable we want our legislation to be to changes made at the OECD level, either explicitly or through changes to interpretation. Again, there are broadly two options:

- Fully ambulatory: any changes made to the Model Rules at the OECD will automatically be adopted into New Zealand law.
- Partially ambulatory: changes made to the Model Rules at the OECD may be adopted into New Zealand law pending action by the New Zealand government, for example, passing an Order in Council to enact the changes.

10.9 New Zealand has used a partially ambulatory, direct incorporation approach to enact recent OECD tax reforms like the Automatic Exchange of Information (AEOI) multilateral agreement and Transfer Pricing guidelines. This approach has been generally well received and has functioned well in retaining New Zealand's legislative sovereignty while reducing the administrative burden of enacting and updating laws. For these reasons it is officials' preferred approach if New Zealand were to adopt Pillar Two.

Updating mechanism

10.10 If New Zealand chooses to adopt a partially ambulatory approach, there is also a decision to be made on mechanically how any OECD changes could come into force in New Zealand.

10.11 AEOI and the Transfer Pricing guidelines use different approaches. For AEOI, changes flow through to New Zealand law automatically, but this can be prevented by the passing of an Order in Council. New Zealand's Transfer Pricing legislation on the other hand refers to a specific version of the OECD Transfer Pricing guidelines, and so requires legislation to be passed to incorporate any updates to the guidelines into New Zealand law.

10.12 There are pros and cons to each of these approaches. A 'negative-update' approach as for AEOI keeps New Zealand law aligned as closely as possible with international norms and best practice and reduces administrative burden if changes are usually likely to be ones New Zealand agrees with. However, this administrative burden is flipped if changes are more likely to be ones New Zealand does not agree with. A 'positive-update' approach grants greater legislative sovereignty to New Zealand and allows interested parties the ability to submit on any potential changes that may be made in future to Pillar Two through the New Zealand legislative process.

10.13 In the interest of maintaining international best practice and based on the experience of the AEOI regime, officials' view is that a 'negative-update' approach may be the best option for New Zealand to adopt. This would mean that any changes to Model Rules were automatically incorporated into New

Zealand law unless action to prevent that is taken. This would not preclude other (positive) amendments being made to the application of the rules in New Zealand, where that was necessary to improve international consistency of the rules. For example, it may be that where there are gaps in the Model Rules, or further developments make aspects of those rules seem undesirable, it may be that at an Inclusive Framework level, the matter is easier to resolve through changes to the Commentary rather than the Model Rules themselves. Changes of this sort could be expressly incorporated into New Zealand law.

Whether to exist in the Income Tax Act (ITA)

10.14 The GloBE rules tax income, but they do so in a very different way from New Zealand's existing income tax. Other taxes which also are income tax related but differ in some way (for example, Fringe Benefit Tax, Employer Superannuation Contribution Tax) are imposed by provisions in the Income Tax Act 2007 but their different status is recognised by their being listed in subpart BF of the Income Tax Act. Officials propose a similar approach is taken for the IIR and UTPR under Pillar Two. They would be included in the Income Tax Act, but would be imposed under separate provisions from income tax.

Questions for submitters

If New Zealand were to adopt the Pillar Two Model Rules:

- Should New Zealand use repetition, incorporation by reference, or some other method to implement Pillar Two into our domestic legislation?
- If incorporation by reference is used, is a fully or partially ambulatory approach the best approach?
- If a partially ambulatory approach is used, what type of updating mechanism should be used?
- Is there a reason for not imposing them using the Income Tax Act 2007?

CHAPTER 11

Undertaxed Profits Rule implementation in New Zealand

Overview

11.1 As explained in Chapter 6, the UTPR primarily functions as a backstop to the IIR and aims to ensure that top-up tax for an LTCE is paid even if its parent entities are located in jurisdictions without a qualified IIR.

11.2 The UTPR also ensures that any LTCEs in the UPE's jurisdiction are subject to top-up taxation, to prevent distortions and level playing field concerns that could arise if those entities were outside the GloBE rules.

11.3 This chapter discusses how top-up tax allocated to New Zealand under the UTPR should be brought to charge.

How top-up tax allocated to New Zealand under the UTPR should be brought to charge

11.4 The Model Rules do not prescribe how tax allocated to a jurisdiction by the UTPR should be brought to charge. This is left to individual jurisdictions. The outcome must be to produce an additional cash tax impost in that jurisdiction equal to the top-up tax allocated to it. The amount of this impost in a particular year is subject to the limit that it should not exceed the tax benefit of tax deductions otherwise available to constituent entities in that country in that year.

11.5 While the top-up tax allocated to a jurisdiction will be charged to the MNE's constituent entities in that jurisdiction, an MNE may have multiple constituent entities and countries are free to determine how that liability is allocated and charged between them.

11.6 The tax administration aspects of Pillar Two are discussed in more detail in Chapter 12, however, one key issue is what approach to take to charging the top-up tax under the UTPR. Officials are interested in submitters' views on the preferred approach.

Option 1: Denying a deduction

11.7 The first approach which is set out in the Model Rules would be to deny an income tax deduction on otherwise deductible expenses of the MNE group.

11.8 The top-up tax allocated to New Zealand would be converted to denied deductions by dividing the top-up tax allocated to New Zealand by the company tax rate. For example, a top-up tax liability of $1,000 would be converted into denial of a deduction for $3,571 of otherwise deductible expenditure, in the year the top-up tax relates to. This would cap the top-up tax based on the total deductions of the entity. If deductions in that year were less than $3,571, the shortfall would be carried forward and used to reduce deductions in the next year.

11.9 As the top-up is allocated for the jurisdiction as a whole, there would need to be rules to specify how the MNE should apply the adjustment when there are multiple entities within New Zealand.

11.10 This could be achieved by specifying that the deductions should be denied first in the constituent entity in the group with the highest taxable income (ignoring any deduction denial) and then continue on to the constituent entity with the next highest taxable income if that is still insufficient to collect the tax and so on.

Example 20: Ordering of denied deductions under UTPR

An MNE has its UPE in a jurisdiction that does not have an IIR. Top-up tax of $100 has been allocated to New Zealand under the UTPR for the MNE's 2030 Fiscal Year.

At a 28% company tax rate, the $100 of top-up tax converts to $357 of denied deductions ($100 / 0.28).

The MNE has 3 New Zealand subsidiaries. Before denying any deductions under the UTPR, the subs have the following gross income, deductions and taxable income:

- Sub A has gross income of $300, deductions of $250 and taxable income of $50
- Sub B has gross income of $140, deductions of $100 and taxable income of $40
- Sub C has gross income of $200, deductions of $170 and taxable income of $30

If New Zealand chose to collect tax under the UTPR by denying deductions, first in the constituent entity with the highest taxable income (and so on), Sub A would be denied deductions of $250, Sub B would be denied deductions of $100 and Sub C would be denied deductions of $7.

11.11 There are a number of disadvantages to this approach in the New Zealand context:

- Denying deductions to taxpayers would have flow on effects to provisional tax liabilities of the company.
- Denying a deduction will not result in an additional cash tax expense when the relevant New Zealand entity is in a loss position. While the additional cash tax expense may materialise at a future point if the entity becomes profitable, this may not occur for a long time. This is inconsistent with the OECD's intention that the UTPR should give rise to an additional cash tax expenses as early as possible.
- Denying a deduction would result in a company paying more income tax, which would result in more credits to its imputation credit account. For the reasons set out in Chapter 13, this seems particularly inappropriate in relation to tax imposed under the UTPR.
- New Zealand allows a relatively long period for taxpayers to file tax returns compared to other jurisdictions. However, the filing dates for these income tax returns is still before the filing date for the GloBE information returns. This could result in a taxpayer having to limit deductions in an income tax return that is due for filing prior to the taxpayer calculating that denial of expenditure in their subsequent GloBE information return. For example, a taxpayer with a 31 March 2024 balance date would generally have to file its tax return for that income year by 31 March 2025 but the GloBE information return would be due on 30 June 2025. This could result in taxpayer having to request reassessments

which will also have flow on impacts for use of money interest charges (UOMI) and compliance costs for taxpayers.

Option 2: Separate tax liability

11.12 The second approach would be to treat the GloBE calculation and any resulting tax liability as a separate tax liability independent of income tax. This would apply to the UTPR as well as the IIR.

11.13 The tax would be a joint and several liability of all New Zealand constituent entities.

11.14 In relation to the UTPR, this charge would still be capped by reference to deductions in order to meet the "equivalent adjustment" requirements in the Model Rules. But it will be capped by the *total* deductions claimed by all New Zealand constituent entities.

11.15 Officials see this approach as avoiding the disadvantages of using the income tax system to account for the UTPR as this will not impact provisional tax and being a stand-alone tax will not have flow on effects to other taxes. Officials consider that the UTPR's type of calculation and payment is better dealt with as a separate tax type.

11.16 It will also eliminate some of the complexity of using the income tax system such as having to identify entities with the most capacity to absorb any top-up and creating ordering rules where deductions are subject to some sort of limitation under other tax rules or where the group or a member of it has losses. Therefore officials currently prefer Option 2.

11.17 Other tax administration aspects of GloBE reporting are covered in Chapter 12.

Questions for submitters

- Do you prefer Option 1 (denying a deduction) or Option 2 (separate tax liability) for implementing the UTPR in New Zealand? Why?
- If you prefer Option 1, do you have suggestions to resolve the issues outlined in this chapter?

CHAPTER 12

Tax administration impacts

12.1 Chapter 8 of the Model Rules provides a coordinated and standardised approach to reporting which is designed to reduce the compliance burden for businesses and facilitate the effective administration of the GloBE.

12.2 The model rules place an obligation on each constituent entity to file a GloBE information return with the local tax administration. However, a constituent entity is discharged from this obligation when the UPE or a designated filing entity files the GloBE information return with the tax administration of the jurisdiction where it is located and the Competent Authority of that jurisdiction has an agreement in effect to automatically exchange the GloBE information return with the Competent Authority of the jurisdiction of the constituent entity.

12.3 Under this approach a New Zealand resident UPE of an MNE Group (or other New Zealand resident designated filing entity) will be required to submit a GloBE information return providing detailed information to support their GloBE calculation, including information about the calculation of their ETR, any top-up tax liabilities and how they are allocated between different jurisdictions.

12.4 In addition, a New Zealand GloBE *tax* return will be filed with the calculation and assessment of any top-up tax liabilities by the New Zealand UPE of an MNE group (or other New Zealand resident designated filing entity) and any constituent entities in New Zealand with a UTPR liability.

12.5 The GloBE information return will need to be provided in a global standardised return which is to be developed as part of the Implementation Framework for Pillar Two. A standardised return will enable the smooth transfer of information between various tax authorities ensuring that the same information is provided to every tax authority which will reduce the scope for error and help to reduce compliance costs across jurisdictions.

12.6 The Model Rules allow for GloBE information returns to be exchanged between tax authorities using a similar approach to the framework developed for CbC reporting.

12.7 GloBE information returns must be filed within 15 months of the end of the fiscal year although for the initial reporting year this has been extended to 18 months. If New Zealand enacted GloBE rules at the end of September 2023, effective for income years beginning after enactment, the first full year GloBE information return would be due in March 2026 (for taxpayers balancing at 30 September 2024). This initial extended date would allow affected taxpayers more time to establish reporting systems and processes for the new returns.

12.8 The due date for the New Zealand GloBE tax returns required is proposed to be one month (two months in the initial year) after the GloBE information return due date to allow foreign groups to arrange filing of the New Zealand GloBE tax return. If New Zealand enacted GloBE rules at the end of September 2023, effective for income years beginning after enactment, the first New Zealand GloBE tax return would be due in May 2026 (for taxpayers balancing at 30 September 2024).

12.9 This proposed timeframe reflects the fact that completing the New Zealand GloBE tax return should be relatively straightforward and is likely to be little more than transposing facts or figures from the GloBE information return.

12.10 If New Zealand does not enact the GloBE rules effective from 2024, New Zealand headquartered MNE groups may still have to file GloBE information returns by no later than 18 months after their balance date for that year, under GloBE rules enacted by other countries.

Filing the returns

12.11 Taxpayers subject to the GloBE will have the associated tax type set up as a new IRD number or separate tax type within its existing IRD number depending on the final system design.

Registration

12.12 Taxpayers will be required to notify Inland Revenue that they are within the scope of the GloBE through a new annual registration process. It is proposed that taxpayers would be given 6 to 9 months from the end of their income year to complete this annual registration. This process would apply to both New Zealand headquartered MNEs and foreign MNEs with constituent entities located in New Zealand.

12.13 Part of this registration will be informing Inland Revenue of the identity and location of the UPE or the designated filing entity that will be filing the GloBE information return. This will provide Inland Revenue with notice of where it will receive the GloBE information return from (that is, directly or through information exchange channels.

12.14 As most of the taxpayers subject to the GloBE requirements will already be subject to CbC reporting Inland Revenue can work with those taxpayers to assist in the registration process

The GloBE information return

12.15 The current reporting model for CbC used within New Zealand is not suitable for GloBE information reporting as the CbC model involves the collection of a wider range of financial information to facilitate the risk assessment of particular taxpayers by tax administrations. It is not designed specifically to contribute to a tax assessment for a liability whereas the GloBE information reporting could result in the assessment of a tax liability in the New Zealand GloBE tax return and therefore a more tailored process is appropriate.

12.16 Because of the proposed internationally standardised nature of the GloBE information return, to enable the sharing of these between tax authorities, it is also proposed that the GloBE information return is filed electronically with Inland Revenue in the Extensible Markup Language (XML) format which is the standard used to exchange CbC reporting between tax authorities.

The New Zealand GloBE tax return

12.17 The New Zealand GloBE tax return will contain the calculation of any top-up tax required and will be filed as a separate tax return.

12.18 Given the preference to treat the GloBE as a separate tax type an assessment will result from the New Zealand GloBE tax return filed by taxpayers as with any other tax type.

Returning and paying tax under the UTPR

12.19 As noted in Chapter 11 there are two approaches being considered to bring the UTPR top-up tax to account. The first is the denial of expenses of liable entities which would result in increased income tax paid by the entity equating to the minimum tax (subject to the limit imposed by the amount of otherwise-deductible expenses).

12.20 The second option is a stand-alone tax liability dealt with independently from any other income tax liability of the New Zealand constituent entities, but again limited by reference to their deductions in the relevant year. As outlined in Chapter 11 officials' preference is for this second option which avoids many of the complexities of denying deductions.

12.21 In the New Zealand context there are several additional complications that make this second option more workable:

- Denying deductions to taxpayers would have flow on effects to provisional tax liabilities of the company. By isolating any top-up as a separate tax liability this impact is eliminated.
- New Zealand allows a relatively long period for taxpayers to file tax returns compared to other jurisdictions. However, when considering the filing dates for the GloBE information returns compared to the filing dates for New Zealand income tax returns this could result in a taxpayer having to limit deductions in an income tax return that is due for filing prior to the taxpayer calculating that denial of expenditure in their GloBE information return.
- Denying deductions would prima facie mean the additional tax would give rise to imputation credits. As set out in Chapter 13, officials do not think this would be appropriate.

12.22 Given these issues, this chapter proceeds on the basis that GloBE information return and any resulting tax liability in the New Zealand GloBE tax return, both under the IIR and the UTPR, will be treated as a separate tax type and charged independently from income tax.

Proposal for change to CbC Reporting process

12.23 As part of the introduction of GloBE information reporting for Pillar Two Inland Revenue also consider that the CbC reporting process should be modernised by moving to electronic filing using the XML format. This will reduce compliance costs for taxpayers and administration costs for Inland Revenue and bring New Zealand into line with other jurisdictions such as Australia and the United Kingdom who also require CbC reporting electronically in XML format.

12.24 The current process for CbC reporting can be cumbersome and result in queries to taxpayers and rework by Inland Revenue. Streamlining the process into a single XML electronic filing process will reduce these costs for both taxpayers and Inland Revenue.

12.25 Officials also see benefits in aligning these two processes as the simplification measures discussed in Chapter 9 may allow CbC information to be used as the basis for the ETR calculations required for GloBE reporting.

Penalties for late filing

The GloBE information return and CbC reporting

12.26 The due date for the GloBE information return will be 15 months after the end of the income year of the taxpayer (18 months in the initial reporting year).

12.27 For the exchange of information with other tax authorities it is important that Inland Revenue receives the GloBE information return on time and in the correct format to give time for the information to be checked before it is provided to other jurisdictions.

12.28 In comparison with international standards, New Zealand has relatively low penalties for the late filing of information. For example, a significant global entity in Australia who does not file a tax return (including CbC reports) by the due date could be liable for a late filing penalty of between $111,000 to $555,000 depending on how overdue the return is.

12.29 Because the taxpayers subject to GloBE information reporting are MNEs it is considered that the current penalties for late filing are not appropriate for GloBE information returns or CbC reporting.

12.30 Officials are considering an appropriate level for a late filing penalty and seek submitters' views on this. To be effective such a penalty should be sufficient to deter MNEs from not filing on time.

12.31 Section 139AB of the *Tax Administration Act 1994* contains a penalty for large multinational groups failing to provide information required under section 17 of $100,000. This provides a useful point of comparison, and may also be appropriate for GloBE information and CbC reporting.

12.32 The current rules around the imposition of late filing penalties would apply in that Inland Revenue would have to advise the taxpayer that a penalty may be imposed if a return is not filed prior to the penalty being applied.

12.33 A return not filed electronically in the XML format would not be treated as filed for this purpose.

The New Zealand GloBE tax return

12.34 To give foreign headquartered groups time to arrange filing of any required New Zealand GloBE tax return, officials propose that this return would be due for filing on the last day of the month following the due date for GloBE information return for that MNE Group.

12.35 There is a natural incentive for taxpayers to file their New Zealand GloBE tax return on time because as the consequence of not doing this the Commissioner could make a "default" assessment in the absence of a return.

12.36 Given this the current penalties in the *Tax Administration Act 1994* for late filing returns would seem appropriate for the GloBE New Zealand tax return.

Paying the tax

12.37 As the GloBE liability would be a separate tax type, payment of the tax would be due separately from any income tax liability of the company and have its own payment date.

12.38 It is envisaged that any payment would be due on the same date as the New Zealand GloBE tax return is due with Inland Revenue (that is, the last day of the month following the date the GloBE information return is due). This should give sufficient time for foreign headquartered groups to arrange filing of a New Zealand GloBE tax return. Payments under GloBE would not be subject to provisional tax.

12.39 The standard rules in Parts 7 and 9 (Interest and Penalties) within the *Tax Administration Act 1994* would apply to GloBE payments that are paid after the due date.

> **Example 21: Reporting dates**
>
> World is my Oyster Limited (WOL) is the New Zealand resident UPE of a MNE that produces specialist Oyster fishing equipment. It has operations in 15 countries and meets the requirements to be subject to the GloBE.
>
> WOL has a June balance date and the first fiscal year it will be required to report under GloBE will be for the year ended 30 June 2025. WOL has a New Zealand tax agent and an extension of time to file its New Zealand income tax return.
>
> WOL's reporting dates for the initial 30 June 2025 year will be as follows:
>
> - New Zealand Income Tax return – due 31 March 2026.
> - GloBE information return – due 31 December 2026 (18 months after balance date – normally this will be due 15 months after balance date on the 30 September).
>
> New Zealand GloBE tax return – due 28 February 2027 (20 months after balance date – normally this will be due on 31 October).

Joint and several liability

12.40 Officials propose that all New Zealand resident entities of the MNE group will be jointly and severally liable for any top-up payments that are charged to any one New Zealand resident entity of the MNE group under GloBE reporting. This approach is also proposed in the United Kingdom.

12.41 Officials consider this is appropriate given these liabilities result from undertaxed profits of the MNE group measured on a jurisdictional basis.

12.42 As all groups with liabilities in New Zealand will have a New Zealand tax presence it would not be necessary to extend this joint and several liability to non-resident members of the MNE group.

Other provisions of the Tax Administration Act 1994

12.43 As a preliminary position, officials envisage that other provisions within the *Tax Administration Act 1994* (as applicable) will apply to the New Zealand GloBE tax return and any tax liability as with any other tax liability (for example, disputes and recovery processes). However, there may be matters where closer examination suggests this is not appropriate. The OECD work on an Implementation Framework may also require a particular approach to be adopted to these matters.

12.44 Officials are interested in submitters' views as to whether there are any areas of the Tax Administration Act 1994 that would need modification to deal with the specialised nature of GloBE taxation.

Questions for submitters

- Is treating GloBE as a separate tax type appropriate?
- Do submitters see any issues with filing GloBE information returns and CbC reports in an electronic XML format?
- Do submitters think that payment of any top-up should be aligned with the due date for the New Zealand GloBE tax return?
- Is the end of the month following the due date for the GloBE information return a suitable due date for filing the New Zealand GloBE tax return?
- What level of monetary penalty do submitters consider appropriate for late or non-electronic filing of GloBE information returns?
- Do submitters consider any of the other provisions in the TAA may require modification to deal with the new GloBE reporting and associated local tax returns?
- Are there any other practical tax administration issues submitters see with the proposals for GloBE reporting outlined in the chapter?

CHAPTER 13

Interaction with imputation

13.1 Generally New Zealand income tax paid by a New Zealand company gives rise to an imputation credit, which can be passed on to the company's shareholders when the company pays a dividend (including a taxable bonus issue). This includes tax paid on income recognised under the controlled foreign company rules.

13.2 However, the payment of foreign income tax does not give rise to imputation credits. The issue considered in this chapter is whether tax paid under the GloBE rules should give rise to an imputation credit or not.

Purpose of imputation

13.3 The broad purpose of the imputation credit regime is to ensure that income earned through a company is taxed at the shareholder's marginal rate. The exclusion of foreign income tax from the regime reflects a policy choice not to give shareholders in New Zealand companies a credit for foreign income tax paid, even though a foreign tax credit generally is available on income earned by the shareholders directly. This can be justified on the following basis:

- The payment of foreign taxes does not benefit New Zealand, as those foreign taxes are not available for the Government to spend on services here. Accordingly, providing a deduction rather than a credit for foreign taxes maximises national welfare and encourages companies to pay taxes in New Zealand rather than offshore.
- Foreign tax credits are also not available for New Zealand shareholders in foreign companies with respect to underlying foreign tax, that is, tax paid by the company.
- When a foreign company earns income and pays tax in New Zealand, no foreign country gives a credit to the foreign company's shareholders for the New Zealand tax paid. There is an argument that a country should only give residents tax credits for another country's taxes if the other country reciprocates (though New Zealand gives a unilateral foreign tax credit on directly earned income).

13.4 Tax imposed in New Zealand under the IIR is clearly New Zealand tax, which does benefit the New Zealand economy, and therefore presents a prima facie case for an imputation credit. However, there are also a number of arguments against giving a credit.

Reasons Pillar Two tax should not give rise to imputation credits

13.5 First, the reason for the imposition of the IIR is that insufficient tax has been paid in a country outside New Zealand. The purpose of the GloBE rules is to correct that insufficiency. If the IIR gives rise to an imputation credit, this policy is significantly undermined. Although sufficient tax is paid at a corporate level, the entire top-up amount is available as a dollar for dollar tax reduction to the shareholder. This means the imposition of the IIR would be unwound on distribution.

13.6 This is conceptually different from the imposition of tax under the CFC regime. Our CFC regime generally only taxes mobile, passive income, which could as easily have been derived in New Zealand as overseas. So the kind of income on which CFC tax is imposed does not have a sufficiently strong connection with the foreign country where it prima facie is taxable to justify exempting it from New Zealand tax. The amount of foreign tax paid on the income is generally not relevant to making this determination (though it will affect the amount of New Zealand tax). Since the income is treated effectively as income directly earned by the New Zealand shareholder, it is logical to provide an imputation credit in that case. The same analysis does not apply to IIR tax.

13.7 Consistent with this line of reasoning, the GloBE rules seem explicit that if the payment of tax under New Zealand's IIR gives rise to an imputation credit, it will not be a Qualified IIR. This means that other countries' UTPRs would still apply to New Zealand headquartered MNEs (in addition to our IIR). This is an unacceptable result, meaning we are effectively required by the Model Rules not to allow an imputation credit.[12]

13.8 Third, allowing an imputation credit for tax paid under the IIR would be complex due to the rate at which such tax is imposed. Generally, the maximum rate at which imputation credits can be attached to a dividend reflects the rate of corporate tax. When that rate changes, the maximum rate also changes. The rate of tax imposed under the IIR depends on the rate of tax imposed in the relevant country. For example, if there is $100 of excess income in a foreign country, and $10 of tax, the IIR liability will be $5, representing a tax rate of 5.2%. Any credit that did arise from the payment of this tax should only be creditable at a rate of $0.052 of credit for each $0.948 of cash distributed. Setting up a system to achieve this, or a reasonable approximation of it, would be complex.

13.9 Fourth, allowing an imputation credit for tax paid under the UTPR seems particularly anomalous. Tax paid under the UTPR will often be paid by a MNE member other than the shareholder of the low tax member. So there will be no cash earnings included in the paying company's assets (either directly owned or through participation in lower tier companies) corresponding to the tax paid.

13.10 Accordingly, officials do not propose that tax paid in New Zealand under the GloBE rules gives rise to an imputation credit.

Question for submitters

- Do you agree that tax paid in New Zealand under the GloBE rules should not give rise to an imputation credit? If not, please explain.

[12] The definition of a Qualified IIR excludes an IIR where the country provides benefits relating to the IIR. The Commentary says that if a jurisdiction provides a tax credit equivalent to a portion of the tax paid under an IIR to be used against other taxes, that will not be a Qualified IIR. This is explained on the basis that the intention of the rules is to provide a level playing field among all jurisdictions to avoid inversions incentivised by differences in the implementation and application of the GloBE rules. Clearly if the payment of IIR tax by a New Zealand company generates an imputation credit for a New Zealand shareholder, whereas the payment of IIR tax by a non-New Zealand company does not, that will provide some incentive for an inversion, that is, corporate migration to New Zealand (for companies with a substantial New Zealand shareholder base). While other factors might make that unlikely in the context of New Zealand, it might be much more likely for other countries if they were to give a shareholder level credit. Obviously it is not possible for one rule to apply to New Zealand while another applies to a country which is a more likely destination for inversions.

CHAPTER 14

Domestic minimum tax

14.1 The GloBE rules contemplate that countries may introduce a domestic minimum top-up tax (DMT), which would use the same tax base as the GloBE rules but take priority over them. For New Zealand, this tax would be closely based on the GloBE rules but would apply to undertaxed profits in New Zealand. It would mean that New Zealand would collect all of the top-up tax on such profits, rather than sharing it with other countries with Pillar Two rules. So there would be no additional tax cost for MNEs subject to the tax, just a change in what country they pay the tax to.

14.2 A DMT could be imposed solely on New Zealand headquartered in-scope MNEs. For these MNEs, top-up tax on undertaxed New Zealand profits would ordinarily be collected under the UTPR. The UTPR allocation mechanism (based on tangible assets and number of employees in each UTPR country) means that in many cases much of this tax would be allocated to New Zealand, but this would depend on the level of overseas assets and employees. A DMT would avoid them having to pay any part of the Pillar Two tax on undertaxed New Zealand income in other countries under the UTPR. This would benefit New Zealand, by allowing us to retain all of the tax that our MNEs would otherwise need to pay offshore under the UTPR.

14.3 A DMT could be expanded to apply also to foreign headquartered in-scope MNEs operating in New Zealand. In this case it would allow New Zealand to collect a tax equivalent to the Pillar Two tax on any low-tax New Zealand income that would otherwise arise under either another country's IIR (in most cases) or other countries' UTPRs.

14.4 Given New Zealand's small Pillar Two population, relatively high tax corporate income tax rate and general lack of tax preferences (other than for capital gains) it may be that there is insufficient benefit from a DMT to make it worthwhile implementing. In considering the size of any benefit, it also needs to be remembered that the DMT would be determined after taking into account not just New Zealand tax, but also foreign taxes (primarily CFC taxes and taxes imposed by worldwide taxing regimes) imposed on New Zealand income, since these are included in the ETR numerator.

14.5 In favour of adopting a DMT, it:

- Would mean that any tax on undertaxed profits is paid in New Zealand rather than offshore.
- Would largely rely on rules already developed to impose tax on non-New Zealand income.
- Would not impose any additional tax or compliance burden on MNEs.
- Might in fact simplify compliance for New Zealand headquartered groups at least, where it allows tax to be paid in New Zealand under the IIR rather than to multiple other countries under their UTPRs.

14.6 Another issue to consider is that the introduction of a DMT would mean capital gains made by in-scope groups would be taxed to the extent they resulted in an ETR below 15% for the New Zealand group.[13] As set out above, the nature of the GloBE rules means that this tax will apply whether New Zealand enacts it or not. However, submitters may feel that there is a point of principle regarding capital gains taxes which would be contravened if New Zealand were to enact a DMT.

Domestic minimum tax and initial phase relief

14.7 There is a question as to whether a DMT should apply to a group which is entitled to initial phase relief. Officials propose that if the group is headquartered in New Zealand, a DMT would not apply to it during the initial phase. That is because any undertaxed New Zealand profits would not be subject to any other country's UTPR or IIR during the period. If the group is not headquartered in New Zealand, another country's IIR could apply, so the rationale for a DMT (to allow New Zealand priority in collecting top-up tax on low tax New Zealand profits) would potentially still apply.

Domestic minimum tax and imputation

14.8 The interaction between imputation and GloBE taxation considered in chapter 13 takes on a different aspect when the GloBE taxation is applying to New Zealand income. The Model Rules do not treat the existence of a shareholder level credit as inconsistent with the recognition of the corporate level tax as a covered tax for GloBE purposes if the tax is imposed pursuant to a Qualified Imputation Tax such as New Zealand's. This suggests that the credit also should not prevent a domestic minimum tax being a Qualified Domestic Minimum Top-up Tax (QDMTT), and thus as reducing any GloBE tax liability on a dollar for dollar basis.

14.9 However, there are some issues.

- Paragraph (c) of the definition of a QDMTT excludes a tax where the jurisdiction provides any benefits that are related to the rules. Providing a shareholder-level credit could be such a benefit. This would likely need to be discussed at an Inclusive Framework level.
- As discussed in chapter 13, the maximum rate at which such credits should be able to be attached to dividends is not clear. Possibly a 15% rate would make sense. This would require treating the DMT tax credit as different from ordinary imputation credits, which would require redesign of the relevant forms and other administrative and legislative measures.

Given the relatively low amount of DMT likely to be imposed, it may not be worth bringing the tax into the imputation regime. Officials welcome submissions on this issue.

Questions for submitters

- What are your views on whether or not New Zealand should adopt a DMT?
- If so, should it be limited to New Zealand headquartered MNEs?
- Should a DMT give rise to a credit under the imputation system.

[13] There are also timing rules, which spread the capital gain over the preceding five years, and allow any tax paid over the 15% minimum in those earlier years to be counted. In addition, capital gains from the sale of <10% shareholding interests are excluded. So we expect that capital gains will not be taxed in most cases.

CHAPTER 15

Treatment of foreign GloBE taxes in determining New Zealand income tax liability

15.1 Whether or not New Zealand adopts GloBE rules, if other countries do so, the status of GloBE tax for purposes of calculating New Zealand tax on foreign earnings will need to be dealt with. Should GloBE tax be creditable, deductible, or neither when determining New Zealand income tax liability?

15.2 The design of the GloBE rules makes it clear that GloBE taxes should not be either creditable or deductible for non-GloBE income tax purposes. The rules impose a top-up tax on a per-country basis. The top-up tax is determined after taking into account income tax imposed on the income attributable to the country, whether that tax is imposed by the country itself or a third country. Tax may be imposed by a third country:

- By way of withholding tax imposed on a cross border payment.
- Under a worldwide taxation regime, or a CFC regime.

15.3 Given that the GloBE top-up tax is calculated after taking into account tax imposed under a worldwide or CFC tax regime, it would clearly not be appropriate for the GloBE top-up tax to be creditable when calculating those taxes.

Example 22: New Zealand tax treatment of foreign GloBE taxes

Suppose New Zealand does not adopt GloBE rules, and that a New Zealand company has a subsidiary X Co tax resident in Country X which has adopted GloBE rules. X Co in turn owns 100% of Y Co, which has an ETR below 15%. Country X imposes GloBE tax on X Co with respect to that undertaxed income of Y Co. Suppose also that the income of both companies is in part subject to New Zealand's CFC rules, so that New Zealand tax is also paid on that income.

The New Zealand CFC rules should give a credit against the CFC tax for income tax paid by X Co and Y Co in their respective countries of incorporation. The GloBE ETR calculation for Country X and Country Y will include the New Zealand CFC tax in the numerator, subject to the limit in Article 4.3.3. The IIR liability of X Co in Country X with respect to the undertaxed income of Y Co will therefore take into account the New Zealand CFC tax with respect to Y Co. It would clearly not be appropriate then for that IIR liability to give rise to a credit in determining the New Zealand CFC liability in relation to either X Co or Y Co. Nor would it be appropriate for that tax to be deductible in determining the income subject to the New Zealand CFC rules in either country.

If New Zealand does adopt GloBE rules, this issue can still arise. Referring to the example in the above paragraphs, suppose X Co were 25% owned by another shareholder. Under the partially owned parent entity rule, this means X Co would be responsible for paying the top up tax with respect to Y Co, despite New Zealand having an IIR.

Question for submitters

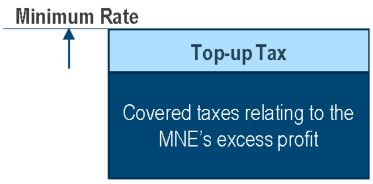
- Do you agree that GloBE tax imposed by other countries should not give rise to a tax credit or tax deduction in New Zealand? If not, please explain.

APPENDIX 1

Overview of the key operating provisions of the GloBE rules[14]

Overview of the Key Operating Provisions of the GloBE Rules

Figure 1. Simplified Top-up tax mechanism



Top-up tax mechanism

The GloBE rules apply a system of top-up taxes that brings the total amount of taxes paid on an MNE's excess profit in a jurisdiction up to the minimum rate of 15%.

Summary

The tax imposed under the GloBE Rules is a "top-up tax" calculated and applied at a jurisdictional level. The GloBE rules use a standardized base and definition of covered taxes to identify those jurisdictions where an MNE is subject to an effective tax rate below 15%. It then imposes a coordinated tax charge that brings the MNE's effective tax rate on that income up to the minimum rate (after taking into account a substance-based carve-out). The design of the GloBE Rules as a top-up tax facilitates the coordinated application of the GloBE Rules.

Steps in determining top-up tax liability for an MNE

This figure illustrates the steps that an MNE might undertake in order to apply the GloBE rules.

- In **Step 1** an MNE Group determines whether it is within the scope of the GloBE rules and identifies the constituent entities within the Group and their location.
- **Step 2** and **Step 3** determine the effective tax rate of each constituent entity.
- In the event an MNE is subject to an effective tax rate below 15% in any jurisdiction, **Step 4** sets out the mechanism for calculating the top-up tax in respect of that low tax jurisdiction.
- This top-up tax is then imposed on a group entity under an IIR or UTPR under **Step 5**.

Each of these Steps is described in further detail in the following information sheets.

Step 1 – Constituent Entities within scope

- Identify Groups within Scope and the location of each Constituent Entity within the Group

Step 2 – GloBE Income

- Determine Income of each Constituent Entity

Step 3 – Covered taxes

- Determine taxes attributable to Income of a Constituent Entity

Step 4 – Effective Tax Rate and Top-up Tax

- Calculate the Effective Tax Rate of all Constituent Entities located in the same jurisdiction and determine resulting Top-up Tax

Step 5 – IIR and UTPR

- Impose Top-up Tax under IIR or UTPR in accordance with agreed rule order

OECD

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[14] OECD. *Overview of the key operating provisions of the GloBE rules.* https://www.oecd.org/tax/beps/pillar-two-GloBE-rules-fact-sheets.pdf

Step 1 – Constituent Entities within scope

Summary

MNE Groups are in scope of the GloBE rules if their consolidated revenue exceeds EUR 750m.

The Constituent Entities of an MNE Group include all the entities within the Group with any permanent establishment of a group entity being treated as a separate Constituent Entity. Excluded entities are, however, not within scope and excluded from the operation of the GloBE rules.

The location of each Constituent Entity is determined based on its local tax treatment.

- Step 1 • Identify MNE Groups within scope
- Step 2 • Identify Constituent Entities
- Step 3 • Remove any Excluded Entities
- Step 4 • Identify location of each Constituent Entity

Step 1 • Identify MNE Groups within scope of the GloBE Rules

EUR 750m consolidated revenue test. MNE Groups are in scope if the revenue in their Consolidated Financial Statements exceeds EUR 750m. The test is based on the two of the four Fiscal Years immediately preceding the tested Fiscal Year (Article 1.1.1) Special rules address the effect of mergers or demergers with respect to the consolidated revenue test (Article 6.1).

Step 2 • Identify Constituent Entities

Constituent Entities. Constituent Entities are those Group Entities that are subject to the operative provisions of the GloBE Rules. The term comprises all entities included in a group and permanent establishments (PEs) (Article 1.3.1).
Permanent Establishments. Any PE that is a Constituent Entity is treated as a separate Constituent Entity from the Main Entity and any other PE of the Main Entity (Article 1.3.2).

Step 3 • Remove any Excluded Entities

Excluded Entities. Excluded Entities are not subject to the operative provisions of the GloBE Rules however their revenue is still taken into account for purposes of the consolidated revenue test.

- Excluded Entities are Governmental Entities, International Organisations, Non-profit Organisations, and Pension Funds as well as any Investment Fund or Real Estate Investment Vehicle that is the UPE of the MNE Group (Article 1.5.1).
- The definition of Excluded Entities is also extended to cover some entities owned by excluded entities and that hold assets or invest funds and only carry out ancillary activities, or that mostly derive income that is excluded from the GloBE tax base. (Article 1.5.2).

The exclusion from the operative provisions of the GloBE rules does not extend to an Excluded Entity's ownership interest in other Constituent Entities.

Step 4 • Identify location of each Constituent Entity

Entity located where it is tax resident. If an entity is tax resident in a jurisdiction based on its place of management, place of creation or similar criteria, it is located in that jurisdiction. In all other cases, it is located in the jurisdiction where it was created (Article 10.3.1). Flow-through entities are subject to special treatment under the rules (Article 10.3.2).
PE located where it is situated. A PE is located in the source jurisdiction where it is treated as a PE and subject to tax (Article 10.3.3). Special rules apply for PEs that are exempt from tax.

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Step 2 - GloBE Income or Loss

Summary

Under Chapter 3, the amount of GloBE Income or Loss of a Constituent Entity is determined by taking the Financial Accounting Net Income or Loss for the Constituent Entity for the Fiscal Year under Article 3.1 and then adjusting the amount under Articles 3.2 through 3.5 to arrive at that Entity's GloBE Income or Loss.

GloBE Income or Loss is then allocated between a Permanent Establishment and Main Entity or to owners of a Flow-through Entity in accordance with local tax treatment

Step 1
- Determination of Financial Accounting Net Income

Step 2
- Adjust Financial Accounting Net Income or Loss to GloBE Base

Step 3
- Allocate GloBE Income or Loss to Permanent Establishments or Flow-through Entities, if necessary.

Step 1
- Determination of Financial Accounting Net Income

Financial Accounting Net Income or Loss The starting point for determining a Constituent Entity's GloBE income is the net income or loss that is used for preparing Consolidated Financial Statements of the Ultimate Parent Entity prior to the elimination of intra-group items. (Article 3.1).

Step 2
- Adjust Financial Accounting Net Income or Loss to GloBE Base

- The net income or loss determined under Step 1 is adjusted to eliminate a number of common book to tax differences where that adjustment is justified on policy grounds (Article 3.2). These adjustments include:
  - *Excluded Dividends; Excluded Equity Gain or Loss* – Avoids double counting of previously taxed income and aligns with participation exemptions and similar relief common to many IF jurisdictions
  - *Policy Disallowed Expenses* – Disallows deduction for illegal payments
  - *Stock-based compensation* – Prevents top-up tax arising in respect of book-to-tax differences associated with stock-based compensation plans.
  - *Asymmetric Foreign Currency Gains and Losses* – Adjustments are made to avoid distortions from arising where the functional currencies used for accounting and tax are different.
- Exclude International Shipping Income (Article 3.3)

Step 3
- GloBE Income or Loss allocated to Permanent Establishments or through Flow-through Entities where necessary)

- GloBE Income or Loss is allocated between a Permanent Establishment and Main Entity (Article 3.4) or to owners of a Flow-through Entity (Article 3.5) in accordance with local tax treatment. These allocation rules ensures an appropriate allocation of financial net income or loss between these Entities and their owners in line with the applicable local tax rules

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Step 3 - Adjusted Covered Taxes

Summary

The amount of a Constituent Entity's Covered Taxes is determined by taking the Constituent Entity's current taxes for the Fiscal Year, adjusted to reflect certain timing differences. Covered Taxes are allocated from one Constituent Entity to another in certain cases. To the extent there are changes in tax liability after filing, additions or reductions to taxes are identified and allocated to a particular jurisdiction and time period.

Step 1
- Identification of Covered Taxes

Step 2
- Adjust Covered Taxes for temporary differences and prior year losses

Step 3
- Allocate Covered Taxes as necessary

Step 4
- Take post-filing adjustments into account

Step 1
- Identification of Covered Taxes

Identify Covered Taxes (Articles 4.1 and 4.2)**:** The starting point for the computation of Covered Taxes is the current tax expense accrued for Financial Accounting Net Income or Loss. Adjustments to the current tax expense amount are made under Articles 4.1.2 through 4.1.5 for GloBE purposes. Tax credits that are refundable after four or more years are treated as a reduction in covered taxes in the year such credits are granted. On the other hand, qualified refundable tax credits, which must be paid within four years, are added to covered taxes when such credits are used to reduce current tax expense.

Step 2
- Adjust Covered Taxes for temporary differences and losses

- An adjustment is made to Covered Taxes by way of the Total Deferred Tax Adjustment amount to take temporary differences and prior year losses into account for GloBE purposes (Article 4.4).
- Article 4.4 includes a number of safeguards designed to protect the integrity of the ETR calculation under the GloBE rules. These safeguards include limiting the recognition of the deferred tax assets and liabilities to the minimum rate and a recapture rule to ensure that amounts claimed as Covered Taxes are actually paid within a set period of time.
- A simplified loss carry-forward equivalent may be elected under Article 4.5 in lieu of applying the deferred tax accounting rules set out in Article 4.4.which provides appropriate recognition of losses arising in no or low-tax jurisdictions.

Step 3
- Allocate Covered Taxes to other Constituent Entities as necessary

- Covered Taxes are allocated to other Constituent Entities when necessary (Article 4.3) Such taxes that may require allocation include CFC taxes, distribution taxes (withholding tax), and tax in respect of a Permanent Establishment, Tax Transparent Entity, or a Hybrid Entity.

Step 4
- Take post-filing adjustments into account

- Special rules apply when there is an adjustment to a tax liability for a prior year (e.g., as the result of an audit or the filing of an amended return to correct an error).
- These special rules require the ETR to be recalculated for a prior year where there is a material reduction in tax liability for that year. To the extent additional Top-up Tax liability results from the adjustment, such amount of Top-up Tax is paid in the current fiscal year (i.e., no amended return is required for the prior year). Increases in tax amounts for prior years are added to Covered Taxes in the current fiscal year. (Article 4.6)

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Step 4 - Effective Tax Rate and Top-up Tax

Summary

Under Chapter 5 the Top-up Tax of each Low-Taxed Constituent Entity is computed by:

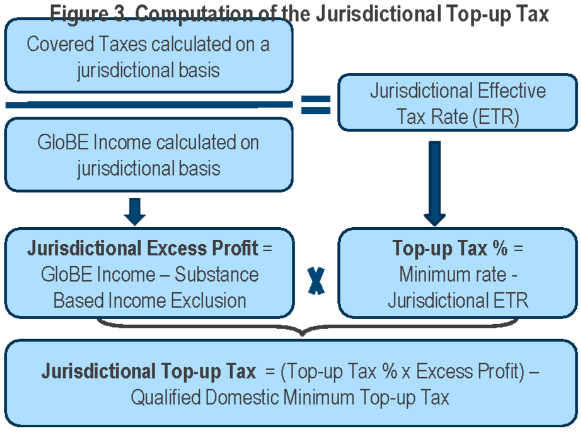
(i) calculating the Top-up Tax Percentage for each Low-tax Jurisdiction;

(ii) applying the Top-up Tax Percentage to the Excess Profits of the Jurisdiction;

(iii) deducting the amount of top-up tax imposed under a qualified domestic minimum tax; and

(iv) allocating the Jurisdictional Top-up Tax to the Constituent Entities in the Jurisdiction in proportion to their GloBE Income.

Figure 3. Computation of the Jurisdictional Top-up Tax



Step 1 • Computation of jurisdictional Top-up Tax for low-taxed jurisdictions

1. The amount of Covered Taxes with respect to a jurisdiction are divided by the GloBE Income in such jurisdiction to determine the Effective Tax Rate (ETR) for such jurisdiction. (Article 5.1)

2. When the ETR is below the Minimum Rate, the Top-up Tax percentage for the jurisdiction must be calculated. This is computed by subtracting the ETR from the Minimum Rate (e.g., if the ETR is 10%, the Top-up Tax percentage is equal to 15% - 10% = 5%). (Article 5.2.1)

3. The Top-up Tax percentage is then multiplied by the Excess Profit (Article 5.2.2) in the jurisdiction to determine the amount of Top-up Tax. The Excess Profit for the jurisdiction is equal to the GloBE Income less the Substance Based Income Exclusion (i.e., an excluded routine return on tangible assets and payroll) (Article 5.3).

4. Finally, the Top-up Tax for the jurisdiction is reduced by any applicable Qualified Domestic Minimum Top-up Tax. (Article 5.2.3)

Step 2 • Allocation of the Top-up Tax between Low Taxed Constituent Entities

- **Identification of Constituent Entities with GloBE Income.** The Jurisdictional Top-up Tax is allocated to Constituent Entities in the Low Tax Jurisdiction that have GloBE Income for the Fiscal Year (and in proportion to such income) in order to determine which entities trigger a charge to Top-up Tax under Step 5 (Article 5.2.4).

Exceptions • GloBE rules provide for de mininimis exclusion and allow for development of safe-harbours

De Minimis Exclusion (Article 5.5)

- For jurisdictions where the MNE has (i) an Average GloBE Revenue that is less than €10m and (ii) an Average GloBE Income or Loss that is either a loss or less than €1m, computed on a three-year average basis.

GloBE Safe Harbours (Article 8.2)

- Any safe-harbours to be developed as part of the GloBE Implementation Framework will limit compliance and administration burden for those aspects of an MNE's operations that are likely to be taxable at or above 15% on a jurisdictional basis.
- The final design of any safe harbours will be developed further in consultation with business and stakeholders, and reflected in the Implementation Framework to be released in 2022.

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Step 5 – IIR and UTPR

Summary.

The Top-up Tax is first imposed under the IIR on a parent entity with an ownership interest in the low-taxed constituent entity.

If there is any residual amount of Top-up Tax that remains unallocated after the IIR applies, the UTPR allocation mechanism results in a liability to Top-up Tax in the jurisdictions that introduced the UTPR.

Step 1
- Identification of the Parent Entity liable for the Top-up Tax under the IIR

Step 2
- Determination of amount of Top-up Tax paid by the Parent Entity under the IIR

Step 3
- Identification of the remaining amount, if any, that is allocable under the UTPR

Step 4
- Liability for residual Top-up Tax in the UTPR Jurisdictions through a UTPR adjustment

Step 1
- Identification of the Parent Entity liable for the Top-up Tax under the IIR

- **Ultimate Parent Entity.** The Ultimate Parent Entity (UPE) of the MNE Group is primarily liable for the Top-up Tax of all Low-Tax Constituent Entities (Article 2.1.1).
- **Top-down approach**. If the UPE is not required to apply an IIR, the Top-up Tax is imposed on the next Intermediate Parent Entity in the ownership chain that is subject to the IIR (Articles 2.1.2 and 2.1.3).
- **Partially-owned parent entities**. A Partially-Owned Parent Entity is a Constituent Entity that has more than 20% of the Ownership Interests held by non-group members. In this case Top-up Tax is imposed on the Partially-Owned Parent Entities that are subject to the IIR in priority to the top-down approach (Articles 2.1.4 and 2.1.5).

Step 2
- Determination of amount of Top-up Tax paid by the Parent Entity under the IIR

- **The Top-up Tax is attributed to Parent Entities in proportion to their Allocable share.** The Allocable Share of Top-up Tax is determined on the basis of a Parent Entity's Inclusion Ratio, i.e. the share of the profits of the Low-Taxed Entity attributable to that Parent Entity on the basis of accounting standards (Article 2.2).
- **Offsetting mechanism**. If several parent entities are liable for the Top-up Tax under the IIR in respect of the same low-taxed constituent entity, the parent entity that is higher in the ownership chain shall reduce its top-up tax by the amount being paid by a lower-tier intermediate parent entity or partially-owned parent entity (Article 2.3).

Step 3
- Identification of the remaining amount, if any, that is allocable under the UTPR

- **Backstop mechanism**. If there is low taxed income beneficially owned by a UPE that is *not* brought into charge under an IIR then the low-taxed income is subject to the back-up mechanism of the UTPR (Article 2.5).
- **UPE jurisdiction.** The UTPR can also apply in respect of the Top-up Tax that arises in relation to the low tax outcomes in the UPE Jurisdiction.
- **UTPR limitation.** There is a limitation of the application of the UTPR when an MNE is in its initial phase of expanding abroad (Article 9.3)

Step 4
- Liability for residual Top-up Tax in the UTPR Jurisdictions through a UTPR adjustment

- **Allocation key.** The UTPR Top-up Tax amount identified in Step 3 is allocated among the UTPR jurisdictions by applying a two-factor allocation key based on (i) the net book value of tangible assets held and (ii) the number of employees employed by all the Constituent Entities that are located in such UTPR Jurisdictions. (Article 2.6)
- **UTPR Adjustment.** The UTPR Top-up Tax amount allocated to a jurisdiction is collected through a denial of a deduction for any deductible expense (or an equivalent adjustment under domestic law). (Article 2.4)

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