Irish Association of Corporate Treasurers

Pillar 2 and the Impact on Corporate Treasury in Ireland

Since early October 2021, when the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting ("**BEPS**") initially proposed their implementation plan around Pillar 1 and Pillar 2, the EU Member States have been through a rollercoaster journey in an attempt to reach unanimous agreement.

Finally, in December 2022, the EU Council announced progress on the implementation of Pillar 2 with Zbyněk Stanjura, (the Czech presidency of the EU Council) stating that;

> *"I am very pleased to announce that we agreed to adopt the directive on the Pillar 2 proposal today. Our message is clear: The largest groups of corporations, multinational or domestic, will need to pay a corporate tax that cannot be lower than 15%, globally."*

The end result was the adoption of a final EU Council Directive on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the European Union, which must be transposed into local country legislation no later than 31 December 2023. This is otherwise known as the EU Directive on Pillar 2, which undoubtedly will have a major impact on treasury centres in Ireland.

Broadly, the EU Directive provides a common framework for Member States to implement the Model Rules on the Pillar 2 Global Minimum Tax ("**GloBE**", or Global Anti-Base Erosion Rules) as agreed by the OECD/ G20 Inclusive Framework on BEPS ("**OECD Model Rules**").

What is Pillar 2?

Pillar 2 contains rules aimed at ensuring that the largest multinational and domestic groups of companies (see below) pay a minimum rate of corporate tax of 15% on an amount of profit computed based on a standard set of rules (basically, the accounting profit before tax, subject to some adjustments). Specifically, it will apply to entities forming part of a consolidated group with a combined annual turnover of at least €750 million in two of the last 4 years preceding the year that the new rules apply.

Pillar 2 involves the introduction of two interlocking domestic rules:

- an Income Inclusion Rule ("**IIR**"), which imposes top-up tax on a parent entity in respect of the low taxed income of a "constituent entity" (which is an entity of an in-scope multinational enterprise group). Broadly, the IIR applies on a top-down basis such that in most cases any tax due is calculated and paid by the ultimate parent company to the tax authority in its country. The tax due is the "top-up" amount needed to bring the overall tax on the profits in each country where the group operates up to the minimum effective tax rate of 15%.

  and

- an Undertaxed Profits Rule ("**UTPR**") (sometimes referenced as the undertaxed payments rule), which denies deductions or requires an equivalent adjustment to the extent the low tax income of a constituent entity is not subject to tax under an IIR. Broadly, the UTPR will apply as a secondary (backstop) rule in cases where the effective tax rate in a country is below the minimum rate of 15%, but the IIR has not been fully applied in that country. The top-up tax is allocated to countries which have adopted the undertaxed profits rule based on a formula and is to be implemented by countries either by denial of a deduction for payments or by making an equivalent adjustment.

The OECD Model Rules and the Directive also allow for countries to introduce a qualified domestic minimum top-up tax ("**QDMTT**") aligned with Pillar Two. Top-up taxes in respect of any low-taxed profits of a group's entities in that country would then be paid to the local tax authority, rather than to other countries under the income inclusion or undertaxed profits rules.

From a hierarchical perspective, a QDMTT will be applied first following the principle that the country in which the profits arise should have first opportunity to ensure that the Minimum Effective Tax Rate is applied. Thereafter, the IIR is applied, followed by the UTPR to collect any tax which is outstanding.

In other words, if Ireland introduces the QDMTT, then any differences between the Irish corporation tax payable and the 15% minimum rate would be payable to the Irish Revenue, not a foreign jurisdiction. As noted in the Irish Government's consultation paper on Pillar 2 from May 2022, it is very likely that Ireland will introduce a QDMTT as part of the implementation of Pillar 2.

When will the Directive take effect?

The agreement reached in December 2022 now means that EU Member States will have to transpose the Directive into Member States' national law by 31 December 2023. Accordingly, once countries transpose the directive into their domestic law, the IIR comes into effect for tax periods commencing from 31 December 2023 with the UTPR becoming effective one year later for tax periods commencing from 31 December 2024.

What guidance is available?

In February 2023, the OECD/G20 Inclusive Framework on BEPS released a package of technical and administrative guidance ("**Administrative Guidance**") related to Pillar 2 or GloBE. The guidance was agreed by consensus of all 142 countries and jurisdictions in the OECD/G20 inclusive framework.

The publication of the Administrative Guidance follows the release of the Pillar 2 Model Rules in December 2021 and updated the commentary released in March 2022, as well as rules for safe harbours and penalty relief released in December 2022.

The Administrative Guidance consists of five chapters, is over 100 pages and covers over two dozen topics, addressing those issues that members of the inclusive framework identified as most pressing. The guidance includes topics relating to the scope of companies that will be subject to the GloBE rules, the method for allocating global intangible low-taxed income ("**GILTI**") among the subsidiaries of a US MNE for purposes of determining their effective rates under the GloBE rules, transition rules that will apply in the years before the global minimum tax applies, and guidance on QDMTTs that countries may choose to adopt.

This Administrative Guidance will be incorporated into a revised version of the commentary that is expected to be released later in 2023.

What does Pillar 2 mean for treasury companies in Ireland?

From an Irish tax perspective, Irish tax resident entities forming part of consolidated groups with turnover below the €750 million threshold should still be able to avail of the existing 12.5% rate of corporation tax on trading profits (as computed under Irish tax rules) in Ireland, as before.

In addition, certain companies may fall within the transitional and short-term safe harbour rules which may exclude companies from the Pillar 2 top up tax calculations for years beginning on or before 31 December 2026 (i.e. three years for most groups).

The transitional safe harbour rules use information taken from an MNE Group's country-by-country ("**CbC**") report and/or financial statements to determine whether its operations in a country meet any of three tests:

- **De minimis test**: The MNE Group reports total revenues of less than EUR 10 million and profit before income tax of less than EUR 1 million on its CbC report for a country.

- **Effective tax rate test**: The MNE Group has a "simplified ETR" for a country that is equal to or greater than the "transition rate" for the year. The transition rate is 15% for years beginning in 2023 and 2024, increasing to 16% and then 17% for years beginning in 2025 and 2026 respectively.
- **Routine profits test**: The MNE Group's profit before income tax in a country is equal to or less than the "substance-based income exclusion amount" (as calculated under the OECD Model Rules).

Where the transitional safe harbour applies, the top-up tax for that country will be zero. Longer term, it remains to be seen if the OECD inclusive framework can agree further simplifications that will be meaningful for a wide range of groups.

However, for those in scope, the Pillar 2 rules are very much becoming a reality. For impacted treasury centres in Ireland there are a number of considerations that emerge with respect to Pillar 2 and the application of the rules to such companies and their group particularly in relation to the computation of GloBE income or loss (tax base). These include, but are not limited to, the following examples:

- Due care and consideration should be given where losses are present in an Irish trading entity as a possibility exists to convert such Irish tax losses to a 15% deferred tax asset (instead of a 12.5% deferred tax asset) where it can be demonstrated that such losses would have existed under the Model Rules.

- A substance-based income exclusion (also known as the substance based carve-out) will apply to reduce the amount of profit that is subject to the additional top-up tax and is intended to provide relief where real substance exists in a jurisdiction. This carve-out has two components:

    - A payroll component equal to 5% (but see below) of payroll costs (including salaries, health insurance, pension contributions, employment taxes, and employer social security contributions) of eligible employees (including independent contractors) performing activities in the country; and

    - A tangible asset component equal to 5% (but see below) of the carrying value of tangible assets located in the country including property, plant and equipment and natural resources.

  A transition period applies during the first ten years of the rules, during which 8% of the carrying value of tangible assets and 10% of payroll is initially excluded from the Pillar 2 profit, declining gradually over the period to 5% in 2033. This carve-out can be of particular relevance where an

Irish treasury entity is part of a consolidated group that consists of other Irish tax resident constituent entities that have substantive payroll and tangible asset components in Ireland. This is because the Pillar 2 rules are applied on a jurisdictional basis. If regard is further had to the safe harbour rules mentioned above and in particular the "Routine profits test", it follows that where a consolidated group has sufficient tangible assets and payroll costs in Ireland it may escape the Pillar 2 rules altogether, resulting in the 12.5% tax rate continuing to apply to treasury profits. For other treasury centres unable to avail of any relief measures, the amount of taxation in Ireland may increase up to the 15% Minimum Effective Tax rate level.

- At the election of the relevant entity, gains and losses in respect of assets and liabilities that are subject to fair value accounting may be determined and included in the Pillar 2 qualifying income or loss on a realisation basis instead. Such an election would have consequences for all other Irish tax resident entities within the consolidated group and should be carefully considered.

- In some cases, debt issued can be treated as debt in the issuer/debtor company and as equity in the creditor company. In the issuer company, interest on such debt may not be deductible under the Pillar 2 rules as the rules seek to prevent asymmetrical treatment in these circumstances.

- Pillar 2 contains specific rules that apply to financing arrangements between entities within the same consolidated group, as well as a requirement to adjust payments between such entities to be in line with the arm's length standard.

- Specific rules apply with respect to the taxation of debt releases which would mean in certain circumstances, the credit to the income statement would not be taxed under the GloBE rules.

- While the Directive only applies to EU countries, it should be noted that other non–EU countries may incorporate the Model Rules or equivalent rules into their domestic legislation and EU entities will need to consider non-EU rules when determining where any top up tax will be paid. Accordingly, businesses should also continue to monitor developments in other countries that are relevant to their footprint.

  Non-EU Countries that have implemented the Model Rules or indicated their intention to implement such rules include the UK, Japan, South Korea, Singapore, Hong Kong and Switzerland. One exception is the US, which already has its own version of the minimum tax rules (which are not the same as the Model Rules). A proposed modification of the US rules to accommodate the Model Rules failed to reach agreement late last year.

- The administrative and data aspects of Pillar 2 should not be underestimated. As an approximate guide, the data list currently includes four pages of "group" data, 10 pages of data that will be required by country, six pages of data that is required by entity, and two pages of calculation of top-up tax by country.

What is the accounting impact?

The computation of GloBE income (used as the tax base for the ETR calculation) will be primarily based on the financial accounting net income included in the parent entity's consolidated accounts (using the parent entity's generally accepted accounting principles, or GAAP). As a result, Pillar Two is built upon

accounting foundations, and understanding the interaction with the accounting standards applied by the group and its legal entities is critical to determining how the measures will operate.
Some of the challenges to be considered include (but are not limited to) the following:

- For multinational groups, in instances where different accounting standards have been adopted throughout the group, understanding the key differences between these standards, along with the specific accounting policy choices taken at the consolidation level will be essential;
- Pushing down consolidation adjustments – the rules are based on the application of the GAAP used for the group's global consolidation but broken down to individual entity level. As a result, understanding the financial reporting ledger system within the group and establishing what adjustments that need to be made will be crucial, for example:
    - Is local ledger reporting based on the local GAAP or the Parent's GAAP?
    - Is the Parent company's GAAP ledger information available by each Legal Entity within the consolidation?
    - What accounting entries are maintained in consolidation ledgers and/or top side ledgers?
    - Are the intercompany transactions of the legal entity easily identifiable and how are they eliminated within the consolidation process?
- Potential lack of comparability with competitors depending on the choice of GAAP for the parent consolidation – Groups using different GAAP's for consolidation may have different Pillar 2 consequences
- Deferred tax implications – see additional considerations outlined below.

Deferred tax implications and potential IFRS reliefs
Most GAAP's (including IFRS) require deferred tax positions to be recognised for anticipated temporary differences in the timing of when items are included in taxable profit and accounting profit. The Pillar 2 rules, and any related potential future top-up tax thereon, has the potential to create significant complexity for entities when assessing the need to recognise and remeasure any deferred tax assets and liabilities. Given some GAAP's (such as IFRS) require any deferred tax positions to reflect tax rates (and tax laws) that have been enacted or substantially enacted by the end of the reporting period, and some jurisdictions (including Ireland) are expected to enact tax law to implement Pillar Two in 2023, the concern around this uncertainty has understandably led to urgent calls for clarity.

Recognising this uncertainty, the International Accounting Standards Board (IASB), who are responsible for developing IFRS, have released in January 2023 an exposure draft that would propose to provide temporary relief from accounting for deferred taxes arising from the implementation of the Pillar 2 rules. While clearly beneficial to entities who prepare IFRS financial statements in the immediate term, it should be noted that the relief is intended to be temporary (currently the end date is not specified, due to the uncertainty around the timeline required for an entity to reliably measure such an impact) and there are additional disclosures required to be provided, namely:

- The fact that the entity has applied the exception;
- its current tax expense (if any) related to the Pillar 2 top-up tax; and
- during the period between the legislation being enacted and the legislation becoming effective, entities might be required to provide other targeted disclosures (mainly to give an indication of what the tax expense might be after legislation becomes effective).

At the time of writing, it is hoped that the reliefs will be finalised and can be applied for entities in the scope of Pillar 2 in 2023 onwards.
It should be noted that the above proposed reliefs relate only to entities preparing financial statements under IFRS – different implications conclusions may arise for entities preparing financial information under other GAAP's.

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What are the next steps?

As mentioned above, Ireland has to enact the Pillar 2 Directive by latest 31 December 2023. Over the course of the year we can expect to see further consultation documents from the Department of Finance, including feedback statements. It may however only be late in the summer of 2023 that taxpayers would have a clearer sense of any further details and particulars regarding the Irish provisions, prior to publication in the Finance Bill likely in October 2023.

As set out above, the impact on treasury centres in Ireland will differ depending on the specific circumstances of the Irish tax resident entity and the level of substance the relevant MNE Group has in Ireland as a whole. Whereas a close eye should be kept on the Irish developments and consultation documents during 2023, the Irish rules will closely mirror the agreed EU Directive. Therefore, affected MNE Groups with treasury entities in Ireland would be well advised to assess the potential impact of the Pillar 2 rules on their Irish tax rate (including the tax accounting impact) and compliance obligations as soon as possible based on the agreed Directive.

With respect to other MNE Groups with a presence in Ireland but that do not have treasury activities in Ireland yet, there can be no doubt that a closer look will be given to potentially establishing and / or centralising treasury functions in Ireland now that the Pillar 2 rules and the minimum tax rate have been agreed. For MNE Groups within scope (i.e. that breach the €750 million turnover threshold) the number of acceptable international tax planning options following the BEPS process have become more and more limited. Ireland's corporation tax rate of 12.5% is very close to the 15% minimum rate and as set out above, where MNE Groups have substantial payroll and tangible assets located in Ireland the 12.5% rate may be maintained on treasury profits as a result of the substance-based carve out or possibly the safe harbour rules. Ireland has a long history as a centre of excellence for the centralisation of treasury functions with a number of compelling commercial reasons in support, including but not limited to being an English speaking, EU and Eurozone common law country with a well understood creditor-friendly legal environment, supported by a deep pool of experienced corporate treasurers, lawyers, accountants and other skilled professionals. Ireland therefore continues to provide an attractive sustainable environment for the establishment and / or relocation of a treasury centre, squarely aligned with the objectives and international consensus on international tax reform.

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