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A taxing reality

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Philip Marcovici, Samantha Morgan and Jefferson VanderWolk discuss the potential implications of a recent OECD move towards a global minimum tax for multinational corporations

There has been much press about the move towards a 15 per cent global minimum tax for large multinational businesses.

However, have wealth and business owners (and their advisors) realised that there is real potential for this initiative to affect private capital? The reality is that this new regime may be relevant for not only large multinationals but also for all wealth and business owners.

Although there is guidance in the works on how the new regime will be implemented, based on what has been published to date, wealth and business owners would be well advised to pay attention to expected developments and to prepare themselves accordingly. There are many reasons why it should be expected that upcoming guidance will clarify that typical trust and similar family holdings will be excluded, but wealth and business owners and their advisors need to be ready to navigate what will be a very complex regime.

Trusts, foundations, family partnerships and holding companies can all, it appears, fall into scope. Although the global minimum tax is focused on groups with annual revenues of over EUR750 million, there is little assurance that in the years to come this revenue threshold will not decline.

Families based in many parts of the world, including Asia, the Middle East and elsewhere, have been used to low single-digit levels of taxation given, among other things, the low rates of tax in their home countries and/or the lack of taxation by the countries in which they have activities abroad. The global minimum tax may have significant and surprising impact.

What this is all about

On 20 December 2021, the OECD issued Pillar Two model rules (the Model Rules) for a 15 per cent global minimum tax on large multinational businesses. Two days later, the European Commission released a draft EU directive incorporating the same rules.[1]

In October 2021, 137 countries in the OECD/G20 Inclusive Framework on base erosion and profit shifting (BEPS) agreed on the so-called Pillar One and Pillar Two proposals to change the taxation of large multinational enterprises. The new rules are meant to be implemented by the beginning of 2023.

The first set of new rules to be unveiled were the Model Rules, regarding Pillar Two's global minimum effective tax rate of 15 per cent on the so-called 'excess profits' of multinationals with annual revenue of at least EUR750 million for two out of the four fiscal years immediately preceding the fiscal year in question. The Model Rules consist of 70 pages of highly technical provisions, including ten full pages of definitions, all drafted with the intention of being ready for enactment into the domestic tax laws of the 137 countries that have agreed to follow this so-called 'common approach' to global minimum taxation.

The foreword to the Model Rules states that 'the implementation of these new rules is envisaged by 2023'. That effectively gives countries a single year, 2022, to introduce and enact conforming legislation.

The Model Rules provide for top-up taxation with respect to the income of any group member taxed at an effective rate of less than 15 per cent under globally harmonised income tax rules. The primary method for achieving this top-up taxation is the so-called income inclusion rule (IIR), which requires the ultimate parent entity of the multinational group to pay all of the deficiency for the entire global group. If a parent company is located in a country that has not enacted a qualifying IIR, the undertaxed payment rule (UTPR) comes into play. The UTPR requires a country to deny deductions or otherwise adjust the tax liability of locally taxable group members to the extent necessary to increase their local tax liability to the amount of the total group top-up tax allocated to the country. A country's allocation of global top-up tax is based on the country's share of the group's total employees and tangible assets located in countries that have enacted the UTPR provisions.

The top-up tax computation for each country includes a substance-based exclusion that allows a certain amount of income to be taxed at less than the minimum 15 per cent effective rate. The excluded income is initially 10 per cent of local payroll costs and 8 per cent of the value of tangible assets used locally, reducing steadily over ten years to 5 per cent of each of those bases.

The Model Rules use financial statement income, with certain adjustments, as the globally harmonised base for computing group members' effective tax rates. The Model Rules also provide for the possibility that a country will enact a domestic minimum top-tax using the 15 per cent rate and the same computation method with respect to income from operations in that country, in which case no top-up tax attributable to low-taxed income from that country would be allocated to other countries.

The Model Rules give rise to a host of interpretive issues, and the OECD has already promised to deliver a commentary on the Model Rules during the first quarter of 2022.

There are many uncertainties, including whether the United States Congress will agree to amend US law to conform to the Model Rules. The US has its own global minimum tax regime relating to global intangible low-taxed income (GILTI), but it is inconsistent with the IIR provisions of the Model Rules in a number of respects.

The OECD and the EU have indicated that they will discuss the conditions in which the US rules would be considered compliant with the Model Rules going forward. As a result, there continues to be uncertainty as to how US-based multinationals will be treated if the Model Rules are adopted by other countries but not by the US.

Private capital and the global minimum tax

From what has been published by the OECD to date, clarification is needed as to whether the Model Rules will apply to private investment structures that yield at least EUR750 million of annual investment income; e.g., a 5 per cent return on EUR15 billion of invested assets.

The Model Rules contain carve-outs for non-profits, government entities, pension funds, and regulated investment funds and real estate investment vehicles that are owned by a number of unrelated investors, but there does not appear to be a carve-out for other types of private investment structures, particularly those of a single family. So what happens in the case of typical family ownership or stewardship structures such as a trust or foundation for the benefit of a family that holds its investments in special-purpose entities?

This issue was to a certain extent addressed under the country-by-country reporting (CbCR) rules under BEPS, which requires multinational enterprises to report key information on their taxes and income annually for each jurisdiction in which they do business. In the case of the CbCR, such structures may not be considered multinational enterprise (MNE) groups with EUR750 million of income in countries where the applicable accounting rules do not require consolidation of the income of investment entities.

The Model Rules, by contrast, arguably require a deemed consolidation of the income of all group members (other than those explicitly carved out) in the case of an ultimate parent entity (UPE) that does not prepare consolidated group financial statements. This is the key, as discussed below, to why family business and wealth ownership can unexpectedly fall into the scope of the Model Rules. It would appear that this deemed consolidation is meant to only apply in situations of 'corporate' avoidance strategies being implemented, but this is not yet something that the Model Rules set out with any clarity.

Choices that jurisdictions will be making

Very important for private wealth and business owners, and others, will be how countries participating in the global minimum tax will actually implement the Model Rules. Also relevant will be the accounting rules that impact relevant financial statements. There also appears to be flexibility for countries to elect to increase tax rates to at least 15 per cent for all taxpayers or for only those in scope. More importantly, low-tax jurisdictions can choose to not increase their tax rates and leave it to the jurisdiction of the parent company to collect a top-up tax. Further, given that the rules do not apply if all of a group's activities take place in only one country, one must query whether there will be jurisdictions that seek to position themselves to attract investment and activity by not imposing the minimum rate despite agreeing to be part of the OECD initiative.

It is not only wealth and business owners who will be reviewing their strategies in reaction to the global minimum tax; financial centres have much to gain or lose from how they go about developing legislation that is meant to be put in place in the course of 2022.

Specifics and the reasons for concern

Under the Model Rules, a private investment structure could arguably be within scope despite the apparent intention of the drafters to limit the scope of the rules to 'large multinational enterprise (MNE) groups.'[2] The rules are designed to ensure that the income of such groups is taxed at an effective rate of at least 15 per cent, through mechanisms that impose top-up tax on income taxed at a lower rate.

Consider that a trust or foundation was established with capital contributed by a wealth-owning individual and it now owns controlling interests, directly or indirectly, in various investment holding companies and other investment vehicles, such as partnerships. Consider further that the total annual investment income of the controlled group, under applicable accounting rules, is at least EUR750 million (e.g., a 5 per cent annual return on EUR15 billion).

Relevant provisions of the Model Rules[3] are as follows:

'1.1.1 [These rules] apply to Constituent Entities that are members of an MNE Group that has annual revenue of EUR750 million or more in the Consolidated Financial Statements of the Ultimate Parent Entity (UPE) in at least two of the four Fiscal Years immediately preceding the tested Fiscal Year.

'1.2.1 An MNE Group means any Group that includes at least one Entity or Permanent Establishment that is not located in the jurisdiction of the Ultimate Parent Entity.'

'1.2.2 A Group means a collection of Entities that are related through ownership or control such that the assets, liabilities, income, expenses and cash flows of those Entities […] are included in the Consolidated Financial Statements of the Ultimate Parent Entity […]'

The definition of 'entity' in the Model Rules includes, in addition to legal entities such as corporations, any 'arrangement that prepares separate financial accounts, such as a partnership or trust.'[4]

'Constituent entity' is defined as any entity that is in a group, except for 'excluded entities', which are defined to include an investment fund that is a UPE and that meets a number of criteria: one of which is that there are 'a number of investors (some of which are not connected)'.[5] Therefore, a trust or foundation created by a single individual or family would not be an excluded entity based on this test.

A UPE is defined as an entity that owns a controlling interest in another entity and is not itself controlled by another entity. Thus, the trust or foundation in our example would be the UPE of the group of entities that it controls, provided that the group fits within the definition of 'group' in the Model Rules. That definition requires 'ownership or control such that the assets, liabilities, income, expenses and cash flows of [the Constituent] Entities […] are included in the Consolidated Financial Statements of the Ultimate Parent Entity […]'

The Model Rules' definition of 'consolidated financial statements' provides, in pertinent part:

' (a) the financial statements prepared by an Entity in accordance with an Acceptable Financial Accounting Standard, in which the assets, liabilities, income, expenses and cash flows of that Entity and the Entities in which it has a Controlling Interest are presented as those of a single economic unit; [….] and

(d) where the Ultimate Parent Entity does not prepare financial statements described in the paragraphs above, the Consolidated Financial Statements of the Ultimate Parent Entity are *those that would have been prepared if such Entity were required to prepare such statements* in accordance with an Authorised Financial Accounting Standard [...]'

This definition is difficult to apply with certainty in a case such as our example, because accounting standards (such as the International Financial Reporting Standards (IFRS) 10 and 12) provide that an investment entity, as defined in the accounting standard, should not consolidate its subsidiaries but should rather report the fair value of the stock or other equity interests in the subsidiaries. The definition of 'investment entity' in IFRS 10 appears to require that the entity have multiple investors, so it seems quite possible that a family trust or foundation would not qualify for the exception from consolidation.[6]

Even if the exception were applicable, however, it is not clear how the definition of consolidated financial statements in the Model Rules would work in the case of a family trust or foundation that prepared financial statements that merely reported the fair value of its investments. In such a case, para.(d) of the Model Rules' definition appears to hypothesise that consolidated accounts reflecting the income, expenses and cash flows of all controlled entities are required.

Differences between the Model Rules and the CbCR rules

The UK government's consultation document on implementation of the Model Rules states:

'4.5 There are also rules to address situations where the group does not prepare consolidated financial statements. Broadly, these rules work by identifying the ultimate parent entity and then hypothesising what the group's consolidated revenues would be if that entity prepared consolidated financial statements.

4.6 These rules are similar to the rules in Country-by-Country Reporting (CbCR) and in practice will mean MNEs are only within scope of the Globe when they are in the CbCR population.'[7]

As noted above, the CbCR rules require the reporting of consolidated group numbers if the group is actually required to prepare them under applicable accounting rules, or would be so required if equity interests of any group member or members were publicly traded on a securities exchange.[8] This lets a private investment group off the hook if, in the event that a member of the group was listed on a securities exchange, the accounting rules would provide for fair value accounting of investments in subsidiaries. Thus, the CbCR rules look at what would actually be required if a member of the group were listed rather than creating a hypothetical requirement to consolidate the income and expenses of all group members as the GloBE Rules seem to do. The OECD's guidance on the CbCR rules supports this reading:

'1.1 How should the CbC reporting rules be applied to investment funds? As stated in paragraph 55 of the Action 13 Report, there is no general exemption for investment funds. Therefore the governing principle to determine an MNE Group is to follow the accounting consolidation rules. For example, if the accounting rules instruct investment entities to not consolidate with investee companies (e.g. because the consolidated accounts for the investment entity should instead report fair value of the investment through profit and loss), then the investee

companies should not form part of a Group or MNE Group (as defined in the model legislation) or be considered as Constituent Entities of an MNE Group. This principle applies even where the investment entity has a controlling interest in the investee company. On the other hand, if the accounting rules require an investment entity to consolidate with a subsidiary, such as where that subsidiary provides services that relate to the investment entity's investment activities, then the subsidiary should be part of a Group and should be considered as a Constituent Entity of the MNE Group (if one exists).'[9]

As noted, the Model Rules differ from the CbCR rules. If the drafters of the Model Rules intended that a private investment group should be out of scope if the accounting rules would call for fair value accounting with respect to the group's subsidiaries, as under the CbCR rules, they chose a very unclear way of saying so.

There is an obligation under the Model rules to file an information return (the Return) that enables tax authorities to assess the tax due under the Model Rules. It appears that the Return is required to be filed even if no tax is actually payable, if the Model Rules apply to the group in question.

The Return will include certain information about the MNE group, including information about its constituent entities and a description of the overall structure of the group. The Return can be shared by the tax authorities where it is filed with the tax authorities of other jurisdictions applicable to any constituent entities.

There are still many uncertainties as to how these rules will apply to passive investment structures. In particular, where revenue arises principally from dividends and capital gains, consideration will need to be given as to whether, in calculating the EUR750 million target, it is necessary to mark-to-market investments and take into account unrealised gains. A further question is what is meant by 'cross-border'. It is not uncommon in private asset structures to form entities in one jurisdiction while they are effectively managed from another jurisdiction. If a group has entities established in more than one jurisdiction but they are all effectively managed from a single jurisdiction (where they are treated as tax resident) will they be treated as cross-border? The authors note in this regard that the UK consultation paper on the implementation of OECD Pillar Two states:[10]

'These rules are set out in Chapter 10 of the Model Rules. Broadly, 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.'

Things to consider

Given the uncertainty regarding the scope of the Model Rules, family offices managing large trusts or foundations should consult their advisors and consider the possible implications of being subjected to the new minimum tax rules and the filing and disclosure requirements thereby imposed.

It is also relevant that all wealth and business owners, and their advisors, consider whether it makes sense, in view of the global minimum tax, to consider carefully the many advantages associated with diversification of ownership. Political risk minimisation, creditor protection and many other objectives can be addressed, at least in part, through ownership diversification. Separating the ownership of a family business from ownership of family investments would be a simple example – perhaps the family business itself has revenues of over EUR750

million and is ‘in scope’ – having a single family trust that also holds interests in investment assets could well subject the entire structure to the global minimum tax. Having the ownership in two trust vehicles might well avoid the investment assets being in scope if the revenues involved are below the EUR750 million threshold.

There is also much more to consider and much in the way of uncertainty that it is hoped further guidance will address. Are there risks of mark-to-market treatment being required in relation to investment assets, as opposed to just looking at actual revenues such as dividends and realised capital gains? Are anti-avoidance rules oriented to the restructuring of business groups meant to cover approaches families can consider, given the lack of consolidation required at the level of individuals? Is it clear that several trusts with a common trustee, even if such trustee is a ‘private trust company,’ would not be treated as a single entity?

Finally, the direction of travel is clear. In a world where wealth and income inequality is a growing reality, tax regimes are changing and tax competition is increasingly viewed as a form of competition that is to be controlled, if not eliminated. All wealth and business owners, at whatever level of value or revenue, need to be prepared.[11]

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[1] https://ec.europa.eu/commission/presscorner/detail/en/IP_21_7028

[2] OECD (2021), *Tax Challenges Arising from the Digitalisation of the Economy—Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD, Paris, p.7.

[3] OECD, above note 1, p.57.

[4] OECD, p.56.

[5] OECD, p.59.

[6] See, for example, Deloitte, *IFRS in Focus: Fair value rules—new requirements for investment entities*, November 2012, available online at www.iasplus.com

[7] HM Treasury, HM Revenue & Customs, *OECD Pillar 2: Consultation on implementation*, January 2022, p.14.

[8] See the OECD’s deemed listing provision in the definition of the term ‘Group’ in art. 1.1 of the *Model Legislation Related to Country-by-Country Reporting* and the *Guidance on the Implementation of Country-by-Country Reporting: BEPS Action 13*, Updated December 2019, p.20

[9] OECD, *Guidance on the Implementation of Country-by-Country Reporting: BEPS Action 13*, Updated December 2019, p.15

[10] OECD, above note 8, para. 5.8 on p.19

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