taxnotes® international

Volume 114, Number 4 ■ April 22, 2024

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Reprinted from *Tax Notes International*, April 22, 2024, p. 529

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In this article, Pouga Tinhaga examines pillar 2 elections for corporate taxpayers, summarizing the mechanics behind each election and its effects, and provides a preliminary generalized assessment of each election from the taxpayer's perspective.

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Introduction

In a bid to combat base erosion and profit shifting caused by the digitalization of the economy,[1] the OECD embarked on and continues to work toward a two-pillar solution to reallocate taxing rights and ensure a minimum level of effective taxation.[2] Pillar 1, which would allow market jurisdictions a tax claim on a greater share of a multinational's profits, has moved at a slower pace to date and remains subject to fundamental debate at the OECD.[3] Pillar 2 endeavors to provide a minimum level of effective taxation in each jurisdiction and continues to move very fast toward implementation with the major building blocks now agreed upon.[4] As of now, pillar 2 has been pushed forward through several documents, including blueprints, model rules, multiple iterations of guidance, and various countries' domestic legislation.[5] One of the notable features of pillar 2, likely in an effort to drive consensus among jurisdictions and reconcile their differing approaches to tax and accounting rules, is the

[1] OECD, "Action Plan on Base Erosion and Profit Shifting" (2013).

[2] OECD, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy" (Oct. 8, 2021).

[3] OECD, "Tax Challenges Arising From Digitalisation — Report on Pillar One Blueprint: Inclusive Framework on BEPS," OECD/G20 Base Erosion and Profit Shifting Project (2020).

[4] OECD (2021), "Tax Challenges Arising From the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two)" (2021) (pillar 2 GLOBE rules).

[5] Pillar 2 GLOBE rules; OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), First Edition" (2022) (pillar 2 commentary); OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)" (Feb. 2023) (February administrative guidance); OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)" (July 2023) (July administrative guidance); OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)" (Dec. 2023) (December administrative guidance); OECD, "Tax Challenges Arising From the Digitalisation of the Economy — GLOBE Information Return (Pillar Two)" (2023); OECD, "Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two)" (2022) (safe harbor rules); OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two) Examples" (2022).

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multitude of elections and elective regimes it provides.

To assist companies in navigating the myriad of elections, this article summarizes the mechanics behind each election and its effects. It also provides a preliminary generalized assessment of each election from the taxpayer's perspective.[6]

Not-Excluded Entity Election (1.5.3)

Pillar 2 sets out various conditions for its application; specifically, the regime is tailored so as to only apply to constituent entities that are members of a multinational enterprise group that satisfies the annual revenue test.[7] Importantly, the pillar 2 regime provides a clear list of entities that are excluded from its application; those excluded entities are defined as government entities, international organizations, nonprofit organizations, pension funds, and investment funds or real estate investment vehicles that are themselves an ultimate parent entity (UPE).[8] Further, article 1.5.2 broadens the list to include entities that (1) are owned 95 percent by an excluded entity and operate primarily to hold assets or invest on behalf of the excluded entity or entities, or (2) only engage in activities that are ancillary or supportive of those carried out by the excluded entity or entities. Similarly, an entity becomes an excluded entity when 85 percent of its value is owned by an excluded entity (other than a pension services entity) if substantially all its income constitutes excluded gain or loss that is not factored into the computation of global anti-base-erosion (GLOBE) income or loss.[9]

Article 1.5.3 allows certain taxpayers to elect into the pillar 2 regime even though they otherwise satisfy the requirements of an excluded entity as previously defined. The not-excluded entity election allows a taxpayer, for five years, to ignore the ownership provisions in those definitions and voluntarily apply the pillar 2 rules.

A practical implication of this election, which may prove beneficial for some taxpayers, is that the taxpayer may find it better to submit itself to the pillar 2 income inclusion rule than the pillar 2 UTPR (formerly known as the undertaxed payments rule). As an example, the pillar 2 commentary describes a scenario involving an MNE group with an investment fund UPE that consolidates with its subsidiaries under the accounting method used to prepare consolidated financial statements. In this situation, the election would allow an income inclusion rule to apply to all of the UPE's low-tax constituent entities and prevent a UTPR from applying to all of the UPE's low-tax constituent entities.[10] As the OECD's February 2023 administrative guidance effectively expanded the scope of activities an excluded entity may conduct, this election has become even more relevant.[11]

Stock-Based Compensation Election (3.2.2)

Under the pillar 2 regime, a constituent entity's financial accounting net income or loss is adjusted for certain items of income and expense to arrive at the entity's GLOBE income or loss.[12] Generally, taxpayers arrive at GLOBE income or loss by adjusting the entity's book values; financial accounting net income or loss, as reported in the financial statements, is the starting point for making several book value adjustments.

The stock-based compensation election, under article 3.2.2, allows taxpayers to elect to substitute the book-value-based deduction taken in the financial accounts with a tax deduction for stock-based compensation allowed in the local jurisdiction.[13] Instead of using amounts recorded as stock compensation expense for book purposes, taxpayers can use the deduction allowed for tax purposes in computing the entity's GLOBE income or loss. Taxpayers can make the

[6] Given the rapidly developing nature of pillar 2 developments, it is possible that elections will be added, deleted, or amended in the future and are therefore fluid. This article summarizes the elections available at the time of publishing.

[7] Pillar 2 GLOBE rules, art. 1.1.1 ("The GLOBE Rules apply to Constituent Entities that are members of an MNE Group that has annual revenue of EUR 750 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.").

[8] *Id.* at art. 1.5.1.

[9] *Id.* at art. 1.5.2(b).

[10] Pillar 2 commentary, art. 1.5.3, para. 57.

[11] February administrative guidance, ch. 1.5.

[12] *See generally* pillar 2 GLOBE rules, art. 3.2.1.

[13] *Id.* at art. 3.2.2.

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election in any fiscal year, and it applies for five years.[14] The election must be applied consistently to the stock-based compensation of all constituent entities located in the same jurisdiction for the year in which the election is made and all subsequent years.[15]

As an example, assume company Xco awards its employee 100 stock options with a vesting period of five years and an exercise price of $10. We assume the current present value of the option is $5. The total value of the stock options granted therefore is $500 (i.e., $5 times 100 options). From a book and financial accounting perspective, Xco will have a total expense of $500 for stock-based compensation and will book and record $100 of stock-based compensation expense each year ($500 of total value, divided by five years of vesting period). From a tax perspective however, the local jurisdiction may allow Xco to deduct, for tax purposes, the fair market value of the stock on the exercise date.

In our example, let's further assume the FMV of the stock on the exercise date has increased to $30. The employee exercises all 100 of his options, with the exercise price of $10 per share. Even though Xco will still book $100 of stock-based compensation expense for book purposes, it will have a $2,000 tax deduction representing the full value of the options exercised minus the price paid for the stock [(100 times $30) - (100 times $10)]. If Xco makes the stock-based compensation election in the year of exercise, it can adjust its financial accounting net income or loss downward by $1,600. This amount represents the difference between $2,000 (the amount allowed for tax purposes) and $400 (the amount allowed as a deduction for book purposes in previous years that is in excess of the amount that would have been allowed had the election been in place in those years).[16]

The election can be powerful for certain taxpayers situated in a jurisdiction that allows them to deduct the full value of the stock for tax purposes; in many situations, the value of the stock on the date of exercise would be much higher than its value on the date of grant, making the downward adjustment to the denominator of the GLOBE effective tax rate calculation much more consequential. Further, the election has the merit of aligning the computation of GLOBE income or loss with local tax reporting rules, which can be a welcome area of simplification for many taxpayers.

Realization Principle Election (3.2.5)

As indicated previously, the starting point for computing a constituent entity's GLOBE income or loss is the financial accounting net income or loss as reported in the UPE's financial statements. When the UPE's relevant financial accounting standard requires adjustments to assets and liabilities based on their FMV, these amounts get added into financial accounting net income or loss.

The realization principle election intends to alleviate the problems created by the need to constantly include fair value adjustments in financial accounting net income or loss. This five-year election applies to all constituent entities within the jurisdiction in which the election is active. By default, the election is effective for all assets and liabilities, but it can be limited to only tangible assets of the constituent entities or only to constituent entities that qualify as investment entities.[17]

Accordingly, the election excludes all gains or losses of constituent entities in the electing jurisdiction from fair value or impairment accounting for either (1) all assets and liabilities; (2) tangible assets; or (3) assets and liabilities of investment entities. The carrying value of such assets or liabilities is recorded at the later of the first day of the election year or the date that the asset acquisition or liability is incurred.

The stated policy of this election is to "reduce volatility by allowing the taxpayer to crystallise the gain for GloBE purposes as of the actual date of disposition rather than from one period to the next in line with the accounting treatment."[18] This is likely to be particularly helpful for banks and

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[14] Pillar 2 commentary, art. 3.2.2, para. 92.

[15] *Id.*

[16] *Id.* at art. 3.2.2, para. 93. The recapture of $400 is based on the assumption that the entire tax deduction of $2,000 is allowed in the year of exercise and no tax deduction is allowed before the year of exercise.

[17] *Id.* at art. 3.2.5, para. 115.

[18] *Id.* at art. 3.2.5, para. 117.

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financial institutions with significant assets that are not taxed under a mark-to-market regime. Absent this election, fluctuations in the value of these assets and liabilities would be added to GLOBE income or loss without any offsetting covered tax, thereby potentially understating the ETR. Similarly, the pillar 2 commentary discusses this election's relevance to a constituent entity holding convertible debt in a poorly performing start-up company that is sold to an unrelated purchaser at cost after yielding several years of losses.[19] On the date of sale, gain may be reported because of ongoing local accounting for the years of losses. However, any "gain" reported upon sale is not really an economic gain but could be subject to a top-up tax if no related covered taxes are paid on the gain in that year. The realization principle election prevents that outcome by allowing the constituent entity to determine gain or loss based on the original cost (and not the subsequent intermediary accounting adjustments) of the assets.

Aggregate Asset Gain Election (3.2.6)

Article 3.2.6 allows a filing constituent entity[20] to elect annually to adjust GLOBE income and loss with respect to aggregate asset gains or to spread remaining asset gains over the lookback period (which is defined in article 10.1 as the election year and the four prior fiscal years). Aggregate asset gains are net gains earned in the election year from the disposition of local tangible assets by all constituent entities in a particular jurisdiction.[21]

Once determined, aggregate adjusted gains are applied to net asset losses[22] that arose during the lookback period, starting with the earliest fiscal year in the lookback period in which net asset losses exceed net asset gains (loss year).[23] The aggregate asset gain may be applied to the net asset losses of any constituent entity located in that particular jurisdiction (adjusted asset gain).[24] If any adjusted asset gain remains after being applied to net asset loss in the first loss year of the lookback period, the remainder is carried forward to the following loss year and applied to the net asset loss of any constituent entity in that jurisdiction (allocated asset gain).[25] The adjusted asset gain carryforward may apply indefinitely to loss years within the lookback period until the aggregate asset gain is fully absorbed or no loss years remain in the lookback period.[26]

If adjusted asset gains are not fully absorbed after being applied ratably to the loss years during the lookback period, any remaining allocated asset gain may be included in the computation of GLOBE income or loss for a constituent entity in that year based on the following formula[27]:

$$\frac{\textit{The Specified Constituent Entity's Net Asset Gain in the Election Year}}{\textit{The Net Asset Gain of all Specified Constituent Entities in the Election Year}}$$

Overall, this election provides an MNE group with the ability to better match the timing of its gains and losses on a jurisdictional basis and mitigates the effect of recognizing those gains in a single year.[28]

[19] *Id.* ("For example, if a Constituent Entity holds convertible debt in a start-up company and the company performs poorly in its first few years, the Constituent Entity may be required, under the applicable accounting standard, to recognise a fair value loss on the investment. If the start-up is eventually acquired by an unrelated purchaser and the Constituent Entity disposes of the convertible debt for its original acquisition cost, the 'gain' reported upon sale is not really an economic gain but could be subject to a top-up tax if there are no related Covered Taxes paid in respect of the gain in that year. An election under Article 3.2.5 prevents this result by permitting the Constituent Entity to determine the gain upon sale based on the original cost of the asset.").

[20] *See* pillar 2 GLOBE rules, art. 10.1. A filing constituent entity is defined as an entity filing the GLOBE information return in accordance with article 8.1.

[21] *Id.* at art. 10.1.

[22] *Id.* A net asset loss is defined as the net loss from the disposition of local tangible assets by that constituent entity in that year, excluding gain or loss on the transfer of assets to another MNE group member.

[23] Pillar 2 commentary, art. 3.2.6, para. 122.

[24] Pillar 2 GLOBE rules, art. 3.2.6(b); the pillar 2 GLOBE rules define "Adjusted Asset Gain" as an amount equal to the aggregate asset gain in the election year, reduced by any gain that has been applied against the net asset loss in a prior loss year under article 3.2.6(b) or (c).

[25] *Id.* at art. 3.2.6(c).

[26] Pillar 2 commentary, art. 3.2.6, para. 122.

[27] Pillar 2 GLOBE rules, art. 3.2.6(d).

[28] *See generally* pillar 2 commentary, art. 3.2.6, para. 119.

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Jurisdictional Consolidated Transaction Election (3.2.8)

Under article 3.2.8, the UPE may elect to apply consolidated accounting treatment to constituent entities[29] located in the same jurisdiction. As a result, the income, expenses, gains, and losses resulting from transactions between these entities are netted and eliminated under the same consolidation adjustment rules employed by the UPE in preparing its consolidated financial statements.

The five-year election, however, limits the benefits of consolidated accounting treatment to transactions between constituent entities located in the same jurisdiction. It is not uncommon for local tax laws to net transactions between related parties in the same jurisdiction under its own consolidated group regime, thereby negating the need for calculating transfer prices. In the absence of an election, additional efforts under these circumstances may become necessary to accurately compute GLOBE income or loss.

Commentators seem to agree that this election may become common for taxpayers, allowing them to eliminate intercompany transactions within the same jurisdiction and likely align with the local tax treatment and requirements. With its potential complexities, however, this election may produce unexpected results.

Unclaimed Accrual Election (4.4.7)

Article 4.4 was established to provide a mechanism to address mismatches in income reporting as a result of temporary differences between financial accounting and tax reporting.[30] Constituent entities with a temporary difference for local tax and financial accounting or GLOBE purposes must determine a total deferred tax adjustment amount, which is an adjustment that is ultimately added to the calculation of covered taxes in order to take certain deferred tax items into account.[31] The total deferred tax adjustment amount is added to a constituent entity's adjusted covered taxes for a given fiscal year.[32] A total deferred tax adjustment amount is defined in the pillar 2 GLOBE rules as "the deferred tax expense accrued in [a constituent entity's] financial accounts if the applicable tax rate is below the Minimum Rate or, in any other case, such deferred tax expense [is] recast at the Minimum Rate, with respect to Covered Taxes for the Fiscal Year[,] subject to adjustments set forth in Articles 4.4.2 and 4.4.3."[33] Therefore, deferred tax expense is treated as the net movement of deferred tax assets and liabilities for a given fiscal year and is incorporated in the total deferred tax adjustment amount that is applied to adjusted covered taxes. Under article 4.4.4, deferred tax liability amounts that are not paid within five subsequent fiscal years from the fiscal year that the deferred tax liability is incurred will be subject to recapture with certain exceptions.[34] The recaptured deferred tax liability is treated as a reduction to covered taxes in the fifth preceding fiscal year, and the ETR and top-up tax are to be recalculated under article 5.4.1. Deferred tax liabilities that do not reverse within five years and must be automatically recaptured therefore become recaptured deferred tax liabilities as defined in article 4.4.4.[35]

However, taxpayers may elect under article 4.4.7 to exclude any deferred tax liability that is not expected to be paid within the election year and the five subsequent fiscal years.[36] This election was created to aid in compliance simplification

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[29] The election also does not apply to investment entities, minority-owned constituent entities, and joint ventures treated as constituent entities under article 6.4. *See* pillar 2 commentary, art. 3.2.8, para. 135.

[30] *See generally* pillar 2 GLOBE rules, art. 4.4; pillar 2 commentary, art. 4.4, para. 67.

[31] Pillar 2 GLOBE rules, art. 4.4.7.

[32] *See id.* at art. 4.1.1:

> The Adjusted Covered Taxes of a Constituent Entity [are described as being] equal to the current tax expense accrued in its Financial Accounting Net Income or Loss with respect to Covered Taxes for the Fiscal Year adjusted by:
>
> (a) the net amount of its additions to Covered Taxes for the Fiscal Year (as determined under Article 4.1.2) and Reductions to Covered Taxes for the Fiscal Year (as determined under Article 4.1.3);
>
> (b) the Total Deferred Tax Adjustment Amount (as determined under Article 4.4); and
>
> (c) any increase or decrease in Covered Taxes recorded in equity or Other Comprehensive Income relating to amounts included in the computation of GLOBE Income or Loss that will be subject to tax under local tax rules.

[33] *Id.* at art. 4.4.1.

[34] *See id.* at art. 4.4.4. Unpaid deferred tax liability amounts (within the five subsequent fiscal years) are expected to be recaptured except for amounts that qualify as a recapture exception accrual, as defined in article 4.4.5.

[35] *Id.* at art. 4.4.4; pillar 2 commentary, art. 4.4.4, para. 89.

[36] Pillar 2 commentary, art. 4.4.7, para. 112.

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for taxpayers, because it allows the elector to automatically exclude deferred tax liabilities that are not expected to be paid within the subsequent five fiscal years, and thus will absolutely require recapture, from the total deferred tax adjustment amount.[37]

GLOBE Loss Election (4.5)

Among their other idiosyncrasies, the pillar 2 rules lack a comprehensive loss carryforward mechanism allowing a loss to create a deferred tax asset, a benefit in the financial accounts.

For example, a taxpayer with a net GLOBE loss of 100x incurred in a jurisdiction with no corporate income tax may end up with an artificially reduced GLOBE ETR in subsequent tax years in which it turns a profit, notwithstanding its actual economic loss from a previous year. Under these circumstances, the taxpayer would be faced with both the economic realities of the corporation's net loss for the tax year and no corresponding tax attribute for GLOBE purposes. If a profit were earned in the following tax year, no adjustment would apply to account for the preceding year's loss, which could cause a GLOBE top-up tax to apply. The OECD intended to alleviate this disparate treatment through the GLOBE loss election, which allows for a deferred tax asset to be created to offset the potential GLOBE top-up tax.[38]

Continuing with the preceding example in which no corporate income tax is levied in the jurisdiction where the loss is incurred and further assuming a GLOBE loss election is made, a deferred tax asset is created in the loss year equal to the top-up tax that would have been payable had there been GLOBE income.[39] Therefore, the 100x loss would be effectively converted into a 15x carryover of taxes paid, which may be used to reduce top-up tax when GLOBE income results.[40]

The GLOBE loss election is made on a jurisdictional basis. Although the rules allow deferred tax assets under a GLOBE loss election to be carried forward indefinitely, the commentary states this may be limited by local law.[41] The GLOBE loss election needs to be filed with the first GLOBE information return of the MNE group;[42] revocation of the GLOBE loss election reduces the remaining deferred loss tax assets to zero on the first day of the fiscal year in which the election is no longer active.[43]

Immaterial Decrease in Covered Taxes Election (4.6.1)

An MNE group must make a current-year adjustment for an increase in liabilities for covered taxes related to previous fiscal years under article 4.6.1. Conversely, an MNE group that books an adjustment for a decrease in covered taxes would be required to recompute the ETR and top-up tax for the fiscal year to which the tax adjustment relates under the requirements in article 5.4.1; as such, the adjustment for a decrease in covered taxes is not treated as a current-year adjustment.[44] However, article 4.6.1 allows a filing constituent entity to make an annual election to treat an "immaterial decrease" in covered taxes as a current-year adjustment. In other words, the taxpayer may elect to include an adjustment for an "immaterial decrease" in covered taxes in the current fiscal year.

The pillar 2 GLOBE rules and commentary determine "immaterial" adjustments to covered taxes by referencing the aggregate increase and

[37] *Id.*

[38] *See id.* at art. 4.5.1-4.5.3, para. 114 ("For example, if a Constituent Entity is located in a country that does not impose a [corporate income tax], an election under Article 4.5 would provide a GloBE Loss attribute at the Minimum Rate for economic losses incurred that otherwise would not have a corresponding deferred tax asset due to the lack of a domestic [corporate income tax].").

[39] *See* pillar 2 GLOBE rules, art. 4.5.2 ("The balance of the GloBE Loss Deferred Tax Asset is carried forward to subsequent Fiscal Years, reduced by the amount of GloBE Loss Deferred Tax Asset used in a Fiscal Year.").

[40] This is calculated by multiplying the 15 percent minimum rate by the 100x GLOBE loss, resulting in 15x of deferred tax liability that may be carried to subsequent tax years; *see also* pillar 2 GLOBE rules, art. 4.5.3 (requiring the deferred tax asset be used in a tax year with GLOBE income).

[41] Pillar 2 commentary, art. 4.5.1-4.5.3, para. 114 ("While Article 4.5 provides for an indefinite carry-forward, domestic law in certain circumstances may limit the practical application of the GloBE Loss [deferred tax asset] after a certain period of time. For example, a jurisdiction may prevent a taxpayer from claiming the benefit of a carry-forward loss unless they can meet certain record keeping and evidential requirements."). In addition, the election is not available for jurisdictions with an eligible distribution tax system as defined in article 7.3.

[42] Pillar 2 GLOBE rules, art. 4.5.5.

[43] *Id.* at art. 4.5.4.

[44] *Id.* at art. 4.6.1.

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decrease in covered taxes for each fiscal year.[45] Further, an immaterial decrease is defined as "an aggregate decrease of less than EUR 1 million in the Adjusted Covered Taxes determined for the jurisdiction for a Fiscal Year."[46] The pillar 2 commentary offers, as a potential rationale for this election providing disparate treatment, that material decreases in covered taxes and their adjustments must be made in previous fiscal years to which they relate because adjusting covered taxes in the current year (as a solution to an actual material decrease in a previous fiscal year) may distort and not effectively recapture an accurate top-up tax amount.[47]

Therefore, an MNE group correcting a liability determination discrepancy must determine if the discrepancy in the tax computation resulted from the computation of taxable income. If a corresponding discrepancy exists in the computation of the relevant constituent entity's financial accounting net income or loss under articles 3.2.1(h) and 4.6.1, the group must redetermine ETR and top-up tax for the prior year based on newly calculated taxes and GLOBE income or loss.[48] Any additional top-up tax ought to be included in the jurisdictional top-up tax computation under article 5.2 in the fiscal year of the redetermination.[49]

Substance-Based Income Inclusion Election (5.3)

The substance-based income exclusion is expected to provide the most relief to capital-intensive industries with significant fixed, tangible assets and labor costs. The basic mechanics of the exclusion function as a 5 percent carveout for a constituent entity's payroll costs and tangible assets in a given jurisdiction.[50] These carveouts are the inputs to the substance-based income exclusion formula, which reduces a jurisdiction's excess profit (calculated for purposes of computing top-up tax) and net GLOBE income.[51]

Naturally, the substance-based income inclusion election serves as a waiver of these benefits, which is made by the filing constituent entity annually on a jurisdiction-by-jurisdiction basis on the GLOBE information return.[52]

As the pillar 2 commentary makes clear, allowing taxpayers to choose not to lower excess income by these carveouts may be appropriate in order to avoid the administrative burden of calculating these amounts in the first place, particularly in smaller jurisdictions where the exclusion's benefits are outweighed by associated compliance costs.[53] Nonetheless, the practicalities involved in determining whether the benefits of the exclusion are worth waiving may themselves prove to be just as onerous as the calculation itself.

De Minimis Exclusion Election (5.5)

Constituent entities may annually elect under article 5.5 to adjust top-up tax to zero for a given fiscal year (de minimis election) when the following two conditions are met[54]: (1) a particular jurisdiction's average GLOBE revenue is less than €10 million; and (2) the jurisdiction's average GLOBE income or loss is a net GLOBE loss of any amount or is net GLOBE income of less than €1 million.[55] Although the de minimis exclusion election is made annually, the elector must measure the average of GLOBE revenue (or GLOBE income or loss) of the applicable jurisdiction for the current and two preceding fiscal years in order to determine eligibility.[56]

For the first condition, article 5.5 defines a jurisdiction's GLOBE revenue as the sum of the revenue of all constituent entities in the jurisdiction for a fiscal year, taking into account

[45] Pillar 2 commentary, art. 4.6.1, para. 121.

[46] Pillar 2 GLOBE rules, art. 4.6.1.

[47] Pillar 2 commentary, art. 4.6.1, para. 122.

[48] *Id.* at art. 4.6.1, para. 123.

[49] *Id.*

[50] *See generally* pillar 2 GLOBE rules, art. 5.3.3 and art. 5.3.4.

[51] *Id.* at art. 5.3.1 and art. 5.3.2. The payroll and tangible asset carveout is not excluded for investment entities.

[52] *See* pillar 2 commentary, art. 5.3.1, para. 29.

[53] *See id.* at art. 5.3.1, para. 28 ("The election not to apply the exclusion is provided because some MNE Groups may consider that the burden of computing the amount of the exclusion for a particular jurisdiction outweighs the potential benefits of the exclusion in that jurisdiction.").

[54] Pillar 2 GLOBE rules, art. 5.5.1.

[55] *Id.*

[56] *See id.* at art. 5.5.2, which defines the average GLOBE revenue as "the average of the GloBE Revenue (or GloBE Income or Loss) of the jurisdiction for the current and two preceding Fiscal Years."

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adjustments to GLOBE income or loss under article 3.[57] For the second condition, article 5.5 defines GLOBE income or loss as the net GLOBE income or loss of any particular jurisdiction.[58] The average of these amounts (hereinafter referred to as average GLOBE revenue and average GLOBE income or loss) is taken by measuring the average of GLOBE revenue or the average GLOBE income or loss over the course of three fiscal years, the current and prior two fiscal years.[59] The pillar 2 commentary specifies that this computation is meant to be applied on an aggregate and cumulative basis; the average GLOBE revenues and average GLOBE income and losses of constituent entities located in a particular jurisdiction are to be aggregated for the purposes of applying the de minimis election.[60] Notably, this election may be made notwithstanding additional requirements in article 5; specifically, an MNE group may make this election without computing the average GLOBE revenue and average GLOBE income or loss of the members of a minority-owned subgroup[61] on an entity basis. Therefore, the GLOBE revenue and the GLOBE income or loss of those entities are only taken into account for purposes of determining the average GLOBE revenue and the average GLOBE income or loss on a jurisdictional basis.[62] If no constituent entities have GLOBE revenue or GLOBE losses in the jurisdiction for the prior two fiscal years, these years are excluded from the calculation of average GLOBE revenue and the average GLOBE income or loss for the relevant jurisdiction.[63]

The de minimis election does not apply to stateless constituent entities or investment entities.[64] As a policy rationale, the pillar 2 commentary notes that the exclusion of these entities does not significantly reduce taxpayers' compliance burden.[65] Overall, the de minimis election was implemented to reduce the complexities of determining the adjusted covered taxes for the ETR and top-up tax calculations for constituent entities with minimal income and revenues. In those cases, any potential top-up tax calculated for these entities is not likely to justify the associated compliance and administrative burden in computing these amounts.[66]

Fair Value Basis Adjustment Election (6.3.4)

Functionally, article 6.3 attempts to harmonize the pillar 2 GLOBE rules with dispositions and acquisitions of constituent entity assets and liabilities. Under a hierarchy of rules, the default tax treatment of these dispositions and acquisitions requires the inclusion of gain or loss on the disposition (to GLOBE income or loss). The acquirer then succeeds to the historic carrying values of the purchased assets or liabilities under the UPE's accounting standard.[67] This treatment is then modified for the disposing constituent entity for which the transaction is part of a GLOBE reorganization and adjusted further for a GLOBE reorganization resulting in nonqualifying gain or loss.[68] For the acquirer, however, the result is unchanged. The constituent entity simply inherits the carrying values of the disposing entity and only adjusts these values to account for nonqualifying gain or loss, which may be limited by local tax rules.[69]

Against this backdrop, the fair value basis adjustment allows a filing constituent entity in a jurisdiction requiring a fair value adjustment for tax purposes to incorporate this amount into its GLOBE income or loss computation. The includable amount is simply the difference between the carrying value before the transaction

[57] *Id.* at art. 5.5.3(a).

[58] *Id.* at art. 5.5.3(b). Net GLOBE income or loss is otherwise defined in the rules in article 5.1.2 as the difference between the total GLOBE income of all constituent entities minus the total GLOBE loss of all constituent entities.

[59] *Id.* at art. 5.5.2.

[60] Pillar 2 commentary, art. 5.5.1, para. 81.

[61] Pillar 2 GLOBE rules, art. 10.1. Minority-owned subgroup is defined as a minority-owned parent entity and its minority-owned subsidiaries.

[62] Pillar 2 commentary, art. 5.5.1, para. 82.

[63] Pillar 2 GLOBE rules, art. 5.5.2.

[64] Stateless constituent entities are described in the pillar 2 GLOBE rules, articles 10.3.2(b) and 10.3.3(d). Investment entities are outlined in the pillar 2 GLOBE rules, art. 10.1.

[65] Pillar 2 commentary, art. 5.5.4, para. 95.

[66] *Id.*

[67] *See generally* pillar 2 GLOBE rules, art. 6.3.1.

[68] Defined as the lesser of the gain or loss of the disposing constituent entity arising in connection with a GLOBE reorganization that is subject to tax in the disposing constituent entity's location and the financial accounting gain or loss arising in connection with the GLOBE reorganization. *Id.* at art. 10.1.1.

[69] *Id.* at art. 6.3.2 and art. 6.3.3.

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and the fair value immediately after the date of the event triggering the adjustment, decreased or increased by nonqualifying gain or loss arising from the event.[70] The availability of this election depends on the constituent entity using fair value to compute GLOBE income or loss after the triggering event and must be consistent with the fair value determined under the financial accounting standard used to prepare the consolidated financial statements.[71] Though this election will likely be seen positively by taxpayers keen on aligning the pillar 2 regime with the carrying values represented on their books, it remains to be seen how these rules will coordinate with section 338 and other similar provisions under U.S. law that allow taxpayers to elect into asset step-ups.

Deemed Distribution Tax Election (7.3.1)

Article 7.3.1 allows a filing constituent entity, subject to an eligible distribution tax system, to elect to include deemed distribution tax in its adjusted covered tax.[72] For the purposes of the pillar 2 GLOBE rules, an eligible distribution tax system refers to a corporate tax system that generally imposes income tax upon the distribution of a corporation's profits to shareholders.[73] This election is made on a jurisdictional basis, because it applies to all constituent entities in that particular jurisdiction.[74]

Article 7.3.2 defines deemed distribution tax as tax that is the lesser of: (1) the amount of adjusted covered taxes necessary to increase the ETR[75] for the jurisdiction for the fiscal year to the minimum rate; or (2) the tax that would have been due upon the distribution of income by constituent entities that are subject to the eligible distribution tax regime during the distribution year.[76] This limitation acts as a safeguard against paying excess taxes upon distribution by restricting the deemed distribution tax to the distributed earnings, particularly when GLOBE income exceeds total earnings for the fiscal year.[77] Further, the pillar 2 commentary states that this limitation ensures "that under ordinary circumstances[,] the Deemed Distribution Tax does not exceed the amount of tax that could possibly arise . . . if all earnings were distributed in the year earned."[78]

The deemed distribution tax is subject to a recapture system, whereby an annual distribution tax recapture account, recording the amount of deemed distribution tax, must be established for each fiscal year in which the election in article 7.3.1 applies (distribution tax recapture account).[79] The deemed distribution tax recapture accounts are maintained on a jurisdictional basis and established over a four-year period, facilitating the blending of income on a jurisdictional basis.[80] The recapture account is reduced by deemed distribution taxes, which are charged against the account in chronological order, starting with the account recording the earliest fiscal year.[81] Further, the distribution tax recapture account cannot be reduced below zero. A constituent entity may also have a loss carryforward on its recapture account when the net GLOBE loss of a jurisdiction multiplied by the minimum tax rate of 15 percent exceeds the outstanding balance of the deemed distribution tax recapture accounts.[82] The loss carryforward equals that excess and is taken into account in subsequent fiscal years as a reduction applied to the deemed distribution tax recapture accounts for the applicable fiscal years.[83] Once the loss carryforward is applied to the recapture accounts, the loss carryforward is reduced by the amount utilized. The loss carryforward may be carried forward indefinitely,

[70] *Id.* at art. 6.3.4(a).

[71] Pillar 2 commentary, art. 6.3.4, para. 81.

[72] Pillar 2 GLOBE rules, art. 7.3.1.

[73] *Id.* at art. 10.1. An eligible distribution system also requires taxes paid on a distribution to be imposed at a rate that equals or exceeds the minimum rate of 15 percent; and to be subject to tax systems that were in force on or before July 1, 2021.

[74] *Id.* at art. 7.3.1.

[75] ETR as computed under pillar 2 GLOBE rules art. 5.2.1.

[76] Pillar 2 GLOBE rules, art. 7.3.2.

[77] Pillar 2 commentary, art. 7.3.2, para. 55.

[78] *Id.* at art. 7.3.2, para. 56.

[79] Pillar 2 GLOBE rules, art. 7.3.3.

[80] *Id.*; *see also* pillar 2 commentary, art. 7.3.2, para. 57.

[81] Pillar 2 GLOBE rules, art. 7.3.3.

[82] *Id.* at art. 7.3.4.

[83] *Id.*

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with constituent entities having the burden of proof in substantiating loss carryforwards.[84] However, recapture accounts must be reduced when a constituent entity leaves the MNE group or substantially all its assets are transferred outside the MNE group or jurisdiction.[85]

Investment Entity Tax Transparency Election (7.5)

The investment entity tax transparency election permits a filing constituent entity that owns an investment entity or insurance investment entity to treat either as a tax-transparent entity for five years if the constituent entity-owner is subject to a mark-to-market type tax regime in its home jurisdiction.[86] In this way, the election allows the constituent entity-owner to include the share of income at the constituent entity-owner level and provides parity between the pillar 2 GLOBE rules and the local tax regime. The election also permits the constituent entity-owner to apply the substance-based income exclusion to its share of investment entity income,[87] which may be preferred when all the management activities are performed outside the entity itself. Revocation of the election requires gain or loss to be determined based on the fair value of the assets or liabilities on the first day of the revocation year.[88]

Importantly, the fair value treatment applies to gain or loss from the underlying assets and liabilities being held (including indirect ownership),[89] not the constituent entity-owner's interest in the investment entity or insurance investment entity. This remains true even if the owner does not hold a controlling interest in the entity, because its gain or loss is still calculated under the accounting standard used to determine the constituent entity's income in preparing consolidated financial statements.[90] There are several specifics that would require careful assessment for any taxpayers contemplating this election.

Taxable Distribution Method Election (7.6)

Non-investment entity constituent entity-owners may elect under article 7.6.1 to apply a taxable distribution method to their ownership interest in a constituent entity if the owner expects to be taxed at a rate equal to or greater than the minimum tax rate (that is, 15 percent) on distributions from an investment entity.[91] The taxable distribution method, once elected, has four key features:

First, distributions and deemed distributions of the investment entity's GLOBE income must be included in the GLOBE income of the constituent entity-owner.[92] Article 7.6.5(c) describes deemed distributions as transfers of ownership interests in an investment entity to an entity outside the MNE group; the transferred interests must equal the proportionate share of undistributed net GLOBE income that is attributable to that ownership, as determined on the date of distribution.[93] The pillar 2 commentary notes that deemed distributions under the taxable distribution method are generally determined by reference to the law applicable to the constituent entity-owner's jurisdiction, representing a departure from the ordinary pillar 2 GLOBE rules, under which distributions from constituent entities are typically excluded from GLOBE income.[94]

Second, under the taxable distribution method, a local creditable tax gross-up is included in the GLOBE income and adjusted covered taxes of the constituent entity-owner that received the distribution.[95] Article 7.6.2(d) describes the local creditable tax gross-up as the amount of creditable covered taxes that are incurred by the investment entity, allowed against the constituent entity-owner's tax liability, and arise in connection with a distribution from the investment entity.[96] This rule attempts to

[84] Pillar 2 commentary, art. 7.3.4, para. 64.

[85] Pillar 2 GLOBE rules, art. 7.3.7.

[86] The mark-to-market regime must tax the interest at a rate that equals or exceeds the minimum rate. *See* pillar 2 commentary, art. 7.5.1, para. 91.

[87] *Id.* at art. 7.5.1, para. 97.

[88] Pillar 2 GLOBE rules, art. 7.5.2.

[89] Pillar 2 commentary, art. 7.5.1, para. 93.

[90] *Id.* at art. 7.5.1, para. 95.

[91] Pillar 2 GLOBE rules, art. 7.6.1.

[92] *Id.* at art. 7.6.2(a).

[93] *Id.* at art. 7.6.2(c); *see also* pillar 2 commentary, art. 7.6.2, para. 102.

[94] Pillar 2 commentary, art. 7.6.2, para. 102.

[95] Pillar 2 GLOBE rules, art. 7.6.2(b).

[96] *Id.* at art. 7.6.2(d).

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harmonize and effectively track covered taxes associated with each constituent entity-owner by including creditable taxes associated with each constituent entity-owner's interest in an investment entity.[97]

Third, under the taxable distribution method, the constituent entity-owner's proportionate share of the investment entity's undistributed net GLOBE income is treated as GLOBE income of the investment entity for the fiscal year.[98] That income is multiplied by the minimum tax rate of 15 percent, and the result is treated as top-up tax of a low-tax constituent entity in the fiscal year for purposes of chapter 2.[99]

Lastly, under the election, the investment entity's GLOBE income or loss for the fiscal year and any associated adjusted covered taxes are excluded from all ETR computations for GLOBE purposes.[100] The pillar 2 commentary notes that this was created to achieve the intended result of attributing income and tax consequences of the investment entity to the constituent entity-owners rather than the investment entity.[101] Overall, commentators seem to agree that this election was created to facilitate accurate reporting regarding the timing and location of income that is earned by an MNE group through its investment entity, therefore enabling the constituent entity-owner to be taxed on that income in the same location where the constituent entity-owner is subject to tax on deemed distributions.[102]

GLOBE Safe Harbor Election (8.2.1)

Though the exact confines of the GLOBE safe harbor rule in article 8.2.1 are still being developed, the OECD's publication of "Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules" (the safe harbor rules) suggests it will consist of transitional and permanent safe harbors, with the latter applying if a transitional safe harbor cannot be met.[103]

Transitional CbC Safe Harbor

The transitional country-by-country safe harbor will apply to fiscal years beginning on or before December 31, 2026, and ending on or before June 30, 2028.[104] In effect, the transitional safe harbor results in no top-up tax in a jurisdiction for the relevant fiscal year, but its availability is limited to only MNE groups that satisfy at least one of the following three tests:

First, the MNE group must report less than €10 million of revenue and less than €1 million of profit or loss before taxes in the jurisdiction on its qualified CbC report[105] for the fiscal year. By design, this "de minimis test" requires few inputs and completely eliminates the need to compute GLOBE ETR for multiple years.[106]

Second, the MNE group must have a simplified ETR[107] that is equal to or greater than the transition rate in the jurisdiction for the fiscal year (the "simplified ETR test"). This necessitates computation of the jurisdiction's ETR, albeit simplified, by dividing simplified covered taxes by the jurisdiction's profit or loss before tax, as presented on the CbC report.[108]

Third, under the "routine profits test," an MNE group's profit or loss before income tax in the jurisdiction cannot exceed the substance-based income exclusion (as calculated under article 5.3) for constituent entities residing in the jurisdiction under the CbC report.[109] This test will be especially relevant for jurisdictions with no profits, because the routine profits test is designed to mirror the results of article 5.1 of the pillar 2 GLOBE rules in which an ETR computation is unnecessary for jurisdictions without net GLOBE income. The test is also expected to benefit MNEs

[97] Pillar 2 commentary, art. 7.6.2, para. 104.

[98] Pillar 2 GLOBE rules, art. 7.6.2(c).

[99] *Id.*

[100] *Id.* at art. 7.6.2(c).

[101] Pillar 2 commentary, art. 7.6.2, para. 105.

[102] *Id.* at art. 7.6.2, para. 104.

[103] *See* safe harbor rules at p. 21.

[104] *Id.* at p. 29.

[105] "Qualified CbC Report" means a country-by-country report prepared and filed using qualified financial statements. *Id.* at p. 8 ("Source of Information").

[106] *Id.* at p. 10.

[107] "Simplified ETR" is calculated by dividing the jurisdiction's simplified covered taxes by its profit (loss before income tax as reported on the MNE group's qualified CbC report). "Simplified Covered Taxes" is a jurisdiction's income tax expense as reported on the MNE group's qualified financial statements, after eliminating any taxes that are not covered taxes and uncertain tax positions reported in the MNE group's qualified financial statements. *See id.* at p. 6 ("Transitional CbCR Safe Harbor").

[108] *Id.* at p. 10.

[109] *Id.* at p. 11.

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operating in jurisdictions with significant tangible capital and labor investments, which by themselves are likely to have enough substance to render full GLOBE calculations unnecessary.[110]

Permanent Safe Harbor

The OECD has yet to adopt detailed rules on the mechanics of the permanent safe harbor but has indicated intentions to incorporate the de minimis test, simplified ETR test, and routine profits test.[111] In line with the general aim of the pillar 2 GLOBE rules, satisfaction of one of these tests in a given jurisdiction is intended to result in no top-up tax for the MNE group. These tests are to be applied using simplified calculations that result in outcomes that do not undermine the integrity of the pillar 2 GLOBE rules, while at the same time providing some flexibility in determining alternative calculations.[112] Further details could be published in subsequent administrative guidance.[113]

Administrative guidance published by the OECD in July 2023 introduced both a qualified domestic minimum top-up tax (QDMTT) safe harbor[114] and a transitional UTPR safe harbor.[115] On the one hand, an MNE qualifies for the former if (1) a QDMTT accounting standard[116] applies; (2) the consistency standard[117] is satisfied; and (3) the administration standard[118] is met. Rather than treating the QDMTT payable as a credit, qualification under these criteria results in a deemed top-up tax of zero. On the other hand, the transitional UTPR safe harbor may apply to fiscal years that are no longer than 12 months in duration and begin on or before December 31, 2025, and end before December 31, 2026; the UPE jurisdiction must, however, have a corporate income tax of at least 20 percent, which results in a deemed UTPR top-up tax of zero. Importantly, the rules permit an MNE group qualifying for more than one safe harbor to choose which safe harbor to apply in each jurisdiction.

Equity Investment Inclusion Election

Administrative guidance published by the OECD in February 2023 introduced an additional equity investment inclusion election to assuage concerns over inequities that could arise under the pillar 2 GLOBE rules' treatment of "Excluded Equity Gain or Loss." These default rules generally ignore equity investments (other than portfolio interests) that create gain, loss, or profit from changes in fair value or from the disposition of investments, as well as profit or loss from equity interests that are accounted for under the equity method of accounting. This is accomplished by both excluding this income or loss from the GLOBE tax base and omitting their corresponding levies from covered taxes. Consequently, under normal circumstances, the excluded equity gain or loss rule has a neutral effect on the overall ETR calculation, because the income or loss is removed from the denominator and associated tax is likewise disregarded in the numerator. However, the neutrality of this rule is called into question when an excluded amount also yields a tax benefit, particularly a deduction. The rule's failure to address the economic realities of such a benefit creates an asymmetry in the ETR fraction, because no rule clearly allows a positive adjustment to covered taxes in the numerator.

The equity investment inclusion election attempts to remedy this asymmetry by permitting taxpayers to make a five-year election on a jurisdiction-by-jurisdiction basis to effectively turn off the excluded equity gain or loss rule for all ownership interests falling into one of three categories:

(1) unrealized fair value gains and losses, as well as impairments, on an ownership

[110] *Id.*

[111] *Id.* at p. 23.

[112] *See, e.g.*, *id.* at p. 24 ("All the Simplified Calculations developed in Agreed Administrative Guidance would need to meet one of the parameters set out in Paragraph 4 of the box above. That is to say the calculations would provide for the same outcomes as those contemplated under the Model Rules and Commentary or be based on alternative calculations that would not otherwise undermine the integrity of the GloBE Rules.").

[113] *Id.* at p. 22.

[114] July administrative guidance, ch. 5.1.

[115] *Id.* ch. 5.2.

[116] Requires the QDMTT to be computed by reference to the UPE's financial accounting or, subject to certain conditions, a local financial accounting standard.

[117] Requires that the QDMTT be computed in the same manner as dictated by the GLOBE rules except when the pillar 2 commentary provides otherwise or the inclusive framework endorses an option departing from the GLOBE rules that nonetheless is deemed to satisfy the standard.

[118] Requires the jurisdiction in which the QDMTT applies to meet certain ongoing monitoring standards reminiscent of those applicable to implementing jurisdictions.

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interest held by an owner that is taxed on a mark-to-market or realization basis and whose income tax expense includes deferred tax expense from the mark-to-market adjustments;

(2) income or loss from a tax-transparent entity accounted for under the equity method; and

(3) dispositions of an ownership interest giving rise to gain or loss that is included in the owner's domestic taxable income (excludes any gain reduced by deductions or other comparable relief, such as a participation exemption directly attributable to the disposition of the ownership interest).

In addition, taxpayers must account for all taxes (including tax benefits) attributable to these three categories in covered taxes.

The utility of this election appears to turn on the taxpayer's ability to foresee the accrual of future tax benefits, a mostly uncertain exercise for the taxpayer.

Excess Negative Tax Carryforward (4.1.5)

In the absence of net GLOBE income in a jurisdiction in a fiscal year, an MNE group generally has no top-up tax liability in that jurisdiction for that fiscal year.[119] Operating as an exception, article 4.1.5 applies when (1) there is no net GLOBE income in a jurisdiction in a fiscal year, and (2) a constituent entity has a deferred tax asset arising as a result of permanent differences between the local taxable income and GLOBE income (for example, super deductions and notional interest deductions).[120] If article 4.1.5 applies, the constituent entities in the jurisdiction will be liable for adjusted current top-up tax on the permanent difference at the minimum rate in the fiscal year.[121] The February 2023 administrative guidance incorporates an annual election to avoid the adjusted current top-up tax by establishing an "Excess Negative Tax Expense Carry-forward" in the same amount.[122] The excess negative tax expense carryforward is a GLOBE tax attribute and is used to reduce the adjusted covered taxes for the jurisdiction in each subsequent fiscal year in which the MNE group has positive GLOBE income.[123]

This election is intended to address circumstances in which the deferred tax asset attributable to the permanent differences results in a relatively smaller reduction (or no reduction) in the top-up taxes of the MNE group in subsequent years.[124] MNE groups may want to undertake modeling exercises to ascertain the potential benefits from using this elective administrative procedure.

Conclusion

The majority of the GLOBE elections seem intended to facilitate efficient reporting and compliance with pillar 2 rules, whether by aligning the computation of GLOBE income and loss with local tax reporting rules, navigating timing mismatches between the recognition of income items and tax reporting, or removing compliance pressures on taxpayers for rather negligible amounts. Although ostensibly designed to make life easier for taxpayers, many of these elections pose challenges, some of which could take companies by surprise.

Because an election involves trade-offs, companies need to assess an election's relevance to their specific facts. Engaging in modeling exercises and scenarios appears critical to this determination. Like an informed voter, companies should model their results before they elect. ■

[119] Pillar 2 commentary, art. 5.1.2, para. 11.

[120] *Id.* at art. 4.1.5, para. 19.

[121] *Id.* at art. 4.1.5, para. 21. This amount is expected to represent the maximum amount by which the permanent difference could reduce the top-up tax in a subsequent year. *Id.* at art. 4.1.5, para. 20; February administrative guidance, ch. 2.7, para. 5.

[122] February administrative guidance, ch. 2.7, para. 14. The excess negative tax expense carryforward attribute is retained until fully utilized, even if the constituent entities in the jurisdiction are disposed (i.e., remains a jurisdictional GLOBE attribute of the transferor group). *Id.*

[123] *Id.*

[124] *Id.* ch. 2.7, para. 5.

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