

Pillar 2 part 2 – Safe Harbour Provisions (Lecture B1425 – 22.09 minutes)

Introduction

The safe harbour elections allow the filing member to treat the top up amount in a territory as zero, if the relevant conditions are met.

For the Income Inclusion Rule (IRR), the provisions are temporary (broadly only applying to the first 3 accounting periods of the regime), but it is hoped that permanent safe harbours will be introduced in due course.

For the Qualified Domestic Minimum Top-up Tax (QDMTT), the safe harbour is permanent.

UTPR – safe harbour

This is proposed to broadly apply where a jurisdiction's headline tax rate is at least 20%. In this case it would be assumed that there are no under-taxed profits on which a top-up tax is necessary.

IIR - transitional safe-harbours (Schedule 16, Part 2)

The filing member of a Multi-National Group (MNG) can elect that all of the standard members of the group located in a territory specified in the election do not have top-up amounts or additional top-up amounts for an accounting period.

The conditions to make the election are that:

1. The period commences on or before 31 December 2026 and ends on or before 30 June 2028 (broadly, the first 3 years for which the group is subject to multinational top-up tax);
2. A qualifying CbCR report had been prepared for the territory;
3. The election had been made for the territory for each previous accounting period that commenced on or after 31 December 2023 in which the IIR rules applied to members of the group in the territory;
4. No deemed distribution tax election (s.189) has been made in respect of the territory for the accounting period;
5. At least one of the 'threshold test', the 'simplified effective tax rate test' or the 'routine profits' test is met (see below).

If the ultimate parent company is a flow-through entity, an election cannot be made in respect of its territory unless either

1. Its adjusted profits would be nil, or
2. All of its adjusted profits would be attributable to at least one PE where no income nor expense would be attributed to the ultimate parent by virtue of s.160 (attribution of losses between a PE and the main entity).

Qualifying CbCR report

This is a CbCR

1. Prepared in accordance with the OECD guidance,
2. Filed in accordance with the law, and
3. In which information relating to the territory is prepared on the basis of qualified financial statements of the multinational group.

Where there is no requirement to file a CbCR report in a territory, the filing member can include a report containing the same information as a full CbCR in the information return in which the safe harbour election is made.

Qualified financial statements (Sch 16, para 4)

These are the accounts used to prepare the consolidated financial statements or financial statements of group members prepared in accordance with acceptable accounting standards or an authorised accounting standard.

Acceptable accounting standards are: UK GAAP, IFRS and the GAAP of Australia, Brazil, Canada, An EEA state, Hong Kong, Japan, Mexico, New Zealand, China, India, Korea, Singapore, Switzerland and the United States of America.

Authorised accounting standards are accounting standards permitted by the body responsible for prescribing, establishing or accepting accounting standards for financial reporting purposes in the territory the entity is located in.

Where a group member is not included in the consolidation on a line-by-line basis on materiality grounds, that member's financial statements used for the group's CbCR are taken to form part of the group qualified financial statements.

Information from the qualified financial statements (revenue, profit (loss) before tax, 'qualifying income tax expense' (income tax expense adjusted for amounts not representing covered taxes and amounts relating to uncertain tax positions) and 'qualified substance-based income exclusion amount' is used to establish if the safe harbour tests are met.

The amounts to be used must be derived from whichever of 1. or 2. above was used to prepare the qualifying CbCR for the territory.

Where that information in respect of a territory is not available in qualified financial statements of an MNG, no safe harbour election can be made for that territory.

Qualified substance-based income exclusion amount

This consists of two elements and is designed to reduce the profits which are subject to a top-up tax where the entity in a jurisdiction has substance (e.g. employs people and/or acquires tangible assets for use in its business).

The payroll carve-out is a percentage of eligible payroll costs (9.8% in 2024 falling gradually to 5% by 2033). If the worker spends the majority of their time working in the territory, all their costs are included, otherwise an apportionment is made.

The tangible asset carve-out is a percentage of the average carrying value of tangible assets in the accounting period (7.8% in 2024 falling gradually to 5% by 2023)

Adjustments

Where the ultimate parent is subject to a deductible dividend regime, the profit before tax is reduced (but not below nil) for the amount deductible.

Where the standard members of a multi-national group in a territory have a net unrealised fair value loss from relevant ownership interests (at least an entitlement to 10% of an entity's profits, capital, reserves and voting power) exceeding €50 million, the loss is excluded from the aggregate profit (loss) of those members.

Profits and qualifying tax expense allocated to a member of a multinational group (MNG) from an investment entity as a result of an election under s.213 (investment entity tax transparency election) and s.214 (taxable distribution method election) must be included (to the extent they are not already) in the member's profit (loss) before income tax and qualifying tax expense.

Threshold test (Sch 16, para 7)

Revenue of the standard members in that territory for the period is less than €10 million and the aggregate profit (loss) before income tax of those members for that period is less than €1 million.

Revenue of members 'held for sale' (IFRS 5) not otherwise included in the consolidated revenue must be included for this purpose.

Simplified effective rate test (Sch 16, para 8)

Aggregate qualifying income tax expense of those members for that period, divided by the aggregate profit (loss) before income tax of those members for that period. The test is met if the simplified effective tax rate of the standard members of the group in that territory is:

1. In an AP beginning before 1 January 2025, at least 15%,
2. In an AP beginning in 2025, at least 16%, or
3. In an AP beginning on or after 1 January 2026, at least 17%

Routine profits test (Sch 16, para 9)

The 'qualified substance based income exclusion amount' for that territory for the period is equal to or more than the aggregate profit (loss) before income tax for that period of the standard members of the group located in that territory, or the aggregate profit (loss) before income tax of those members for that period is nil or reflects an overall loss.

Common errors in safe harbour calculations

- Using CbCR figures not qualified financial statement figures
- Using entity figures, not totals for a territory
- Using incorrect consolidations for the tests, i.e. bottom up, rather than top-down

OECD guidance on safe harbour issues

The OECD has issued clarifying guidance on various issues arising out of the safe harbour legislation.

These are around the topics of:

- Purchase price accounting adjustments;
- Group member and JV groups in the same territory (each JV group is tested separately to the ordinary members of the group);
- Use of different sources of qualified financial statements for the same entity or PE (not permitted);
- Fields in the CbCR not used in the safe harbour calculations can come from any permitted source;
- And others.

See <https://www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosion-rules-pillar-two-december-2023.pdf> for more detail.

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