

OECD releases Pillar Two guidance on Safe Harbours and Penalty Relief

21 December 2022

In brief

On the one-year anniversary of issuing the Pillar Two Model Rules, 20 December 2022, the OECD released four guidance documents related to Pillars One and Two;

1. Pillar Two [Guidance on Safe Harbours and Penalty Relief](#);
2. Pillar Two public consultation document on [Tax Certainty for the GloBE Rules](#) (comments due 3 February) (see [tax policy alert](#));
3. Pillar Two public consultation document on the [GloBE Information Return](#) (comments due 3 February); (see [tax policy alert](#)) and
4. Pillar One public consultation document on the [Draft Multilateral Convention \(MLC\) Provisions on Digital Services Taxes \(DSTs\) and other Relevant Similar Measures](#) (comments due 20 January) (see [tax policy alert](#)).

All of these documents are OECD Secretariat [consultation documents](#) (and, thus, unagreed) except for the guidance on Pillar Two Safe Harbours and Penalty Relief, which was approved by the Inclusive Framework (IF) on 15 December.

This tax policy alert will consider the release on Safe Harbours and Penalty Relief which covers the following:

The terms of a **Transitional Country-by-Country Reporting (CbCR) Safe Harbour**, which effectively excludes from the scope of GloBE an MNE's operations in lower-risk jurisdictions in the initial years, thereby providing relief to MNEs in respect of their GloBE compliance obligations as they implement the rules;

A framework for the development of a permanent **Simplified Calculations Safe Harbour**, which would allow an MNE to either reduce the number of computations and adjustments required under the GloBE rules or perform alternative simplified income, revenue, and tax calculations; and

A **Transitional Penalty Relief Regime**, which recognises that no penalties or sanctions should apply during a transitional period in connection with filing GloBE Information Returns where an MNE has taken reasonable measures to ensure the correct application of the GloBE rules.

The transitional safe harbour generally will be welcomed by taxpayers as mitigating the immediate difficulties associated with compliance with the GloBE rules in the initial years of their implementation. In these early years, they will be able to use data available from an MNE's qualified CbCR and jurisdictional revenue and income information contained in qualified financial statements. However, the relative paucity of detail on the permanent safe harbours (and the possibility that they could still require considerable detail before the safe harbour kicks in) is a concern.

In detail

Safe Harbours

Unlike the other Pillar Two releases on Tax Certainty and the GloBE Information Return, the rules on safe harbours and penalty relief are not subject to a public consultation process. This release takes the form of an Inclusive Framework approved publication.

Stakeholders in earlier public consultations highlighted the need for safe harbours and simplifications which would reduce the complexity of performing detailed calculations and meeting burdensome compliance obligations under the Pillar Two rules, particularly in the early years of implementation and for low-risk jurisdictions. The Inclusive Framework has attempted to respond to this by designing a **transitional CbCR safe harbour**, a regulatory framework for the development of a potential **permanent safe harbour**, as well as a common understanding for a **transitional penalty relief regime**.

Transitional CbCR Safe Harbour

The first of the safe harbours is temporary in nature and would reduce an MNE's top-up tax for a particular jurisdiction to zero where one of three criteria are met. We note that this is an 'or' test, rather than an 'and' test. This transitional safe harbour would exist for fiscal years beginning on or before 31 December 2026, but not including a fiscal year that ends after 30 June 2028.

A 'tested jurisdiction' (as defined by the document) must pass one of the three following tests to qualify for the transitional CbCR safe harbour:

1. **De minimis test:** The jurisdiction has total CbCR revenue of less than €10 million, and the CbCR profit (loss) before income tax is less than €1 million (including a loss).
2. **Simplified ETR test:** The jurisdiction has an ETR that is equal to or greater than the 'transition rate' in the jurisdiction for the fiscal year.
 - a. The 'simplified ETR' is calculated by dividing the simplified covered taxes (income tax expense reported in the MNE's financial statements, minus any taxes that are not covered taxes or taxes relating to uncertain tax positions) by the profit or loss before tax reported in the MNE Group's CbCR.
 - b. The 'transition rate' is:
 - i. 15% for fiscal years beginning in 2023 and 2024;
 - ii. 16% for fiscal years beginning in 2025; and
 - iii. 17% for fiscal years beginning in 2026.

3. **Routine profits test:** The tested jurisdiction's profit or loss before income tax for the jurisdiction is equal to or less than the substance-based income exclusion (SBIE) for constituent entities resident in that jurisdiction under the CbCR, as calculated under the GloBE rules.

Observation: This safe harbour effectively buys an MNE Group three accounting periods in which detailed GloBE calculations may not be required in all jurisdictions, and the MNE Group may be able to reduce a jurisdictional top-up tax to nil based on simplified calculations, depending on the MNE's particular facts. This is likely to be most helpful for MNEs with significant capital investments in tangible assets in some jurisdictions. In these fact patterns, the SBIE is likely to be relatively high compared to the excess profits, and the safe harbour calculation should in many cases be relatively straightforward, at least compared to full application of the GloBE rules.

Observation: Note, however, that the CbCR ETR may be lower than the Pillar Two ETR because, for example, of the double counting of income within a group under CbCR, e.g., if intra-group dividends are not excluded, or because covered taxes that are not recognised in the financial statements do not get factored into the simplified ETR calculation. So this may not be as helpful to every business as it first appears.

Observation: A de minimis rule applies beyond the 'transition period' in the Pillar Two rules which reduces a jurisdictional top-up tax to nil where (i) the average qualifying revenue of all constituent entities located in such jurisdiction is less than €10 million; and (ii) the average qualifying income or loss of all constituent entities in such jurisdiction is a loss or is less than €1 million. Beyond the 'transition period,' MNEs groups may no longer be able to use the CbCR data and may need to apply the more complex GloBE calculation rules to identify these amounts.

Observation: *Qualifying for a safe harbour (be it a temporary or permanent safe harbour) does not exempt an MNE Group from complying with the group-wide GloBE requirements such as the requirements to prepare and file a GloBE Information Return (GIR), which we will address in another alert.*

Special rules shall apply for a number of specific situations:

- This safe harbour rule will apply to joint ventures (JV) and JV subsidiaries as if they were constituent entities of a separate MNE group, except that the GloBE income/loss and total revenues would be the results reported in the qualified financial statements.
- This rule shall not apply in the ultimate parent entity (UPE) jurisdiction where the UPE is a flow-through entity unless all the ownership interests in the UPE are held by qualified persons (refer to Article 7.1.1(a)-(c), and Article 7.2.1 (a) - (c)). Where a UPE is a flow-through entity or subject to a deductible dividend regime, the profit or loss before tax of the UPE shall be reduced to the extent that such amount is attributable to or distributed as a result of an ownership interest held by a qualified person.
- There are further special rules applicable for investment entities, net unrealised fair value losses and certain exclusions from the safe harbour.
- Article 4.1.5 of the Model Rules, which can result in a top-up-tax payable in loss situations (and has been raised by stakeholders as a fundamental design flaw), appears to be neutralised by the routine profits test. Per par. 33 of the Guidance, "no Top-up Taxes arise in or with respect to a Fiscal Year in which a Tested Jurisdiction benefits from the Transitional Safe Harbour, including Additional Current Top-up Taxes (e.g. as a result of applying Art. 4.1.5)."
- Article 9.1.3, which impacts the deferred tax of certain intra-group transfers, is also altered by this safe harbour. The release notes that the transition year referred to in Article 9.1.3 would be the first fiscal year in which the jurisdiction no longer qualifies for or applies the transitional CbCR safe harbour, unless the

jurisdiction where the disposing entity is located comes within the scope of the GloBE rules or the disposal of the assets creates a taxable gain, as determined by agreed administrative guidance.

Observation: the inclusion of this latter special rule for Article 9.1.3 will be of particular note for certain businesses and represents another issue that attracted particular interest in previous public consultations. The policy rationale behind Article 9.1.3 was to prevent acquiring entities from receiving a 'step up' cost base without paying tax under GloBE on the intra-group transfer. We would hope that the inclusion of the 'taxable gain' aspect would ease the strictness currently associated with Article 9.1.3, but additional guidance is necessary for clarity on this point.

Simplified Calculations (Permanent) Safe Harbour

In addition to the transitional safe harbour rules as set out above, the document sets out a framework for the development of a permanent safe harbour. This safe harbour is aimed at allowing MNEs to avoid having to perform some of the more complex GloBE calculations in circumstances where the calculation could be simplified without affecting the outcomes that would otherwise apply to the MNE group (or otherwise undermining the GloBE rules).

Essentially, this safe harbour makes use of simplified income, revenue and tax calculations, which are alternative calculations to the GloBE income or loss, GloBE revenue and adjusted covered taxes calculations under the GloBE rules.

These simplified calculations will be available for a jurisdiction where it satisfies at least one of the following three tests:

1. A **routine profits test**, where the excess profits of a jurisdiction (i.e., a simplified measure of income that exceeds the jurisdiction's SBIE) is nil. Moreover, this test also will be met for a jurisdiction where (applying the simplified income calculation) the jurisdiction has a GloBE loss;
2. A **de minimis test**, which also follows the de minimis exclusion in the GloBE rules (see explanation provided in the observation above). Again, although the GloBE rules must be applied in performing these calculations, simplified income and revenue calculations will make provision for adjustments or simplifications to apply the test; or
3. An **effective tax rate test**, which involves determination of the ETR as per the GloBE rules, the only difference being that the ETR may be computed using simplified income, revenue, and tax calculations. This test will be met where the ETR is at least 15%.

The difference between the above tests and the corresponding tests under the transitional CbCR safe harbour is that the tests are applied using the GloBE rules, with simplified calculations of income, revenue, and tax calculations (as opposed to using CbCR and qualified financial statement data).

The effect of meeting any one of the above tests is that the top-up tax for a jurisdiction will be deemed to be zero for the relevant fiscal year.

Observation: These 'simplified calculations' will be provided as part of the agreed administrative guidance at a later date. The release notes that to access this safe harbour, the MNE group would need to comply with the relevant filing requirements yet to be agreed. Additionally, in many cases the GloBE rules first have to be applied – and only after that can it be determined that the safe harbour applies. That may strike some as not much simplification. So, for example, further simplifications could be provided by allowing an MNE group to avoid having to calculate a GloBE loss under the detailed GloBE rules.

Simplified income and tax calculations also exist for non-material constituent entities (NMCEs). A NMCE is a member of an MNE group (and any permanent establishments of such NMCE) that is not consolidated on a line-by-line basis in the MNE groups consolidated financial statements solely by reason of its size or on materiality grounds. The revenue, income, and adjusted covered taxes of the NMCE are determined by reference to the relevant CbC regulations or OECD CbCR guidance if there are no domestic CbC regulations.

Observation: The simplified adjusted covered taxes for NMCEs is the income tax accrued in accordance with the relevant CbC regulations which excludes deferred tax expenses, other non-current items and provisions for uncertain tax liabilities. Adjustments for such tax attributes to adjusted covered taxes is typically one of the most difficult adjustments for MNE groups to make, so this simplification should be welcome for NMCEs.

Transitional Penalty Relief

Although the document acknowledges the fact that many jurisdictions already provide penalty relief, a common understanding among implementing jurisdictions is that there needs to be specific penalty relief in respect of the filing of GloBE information returns for a transition period (i.e., as is the case with the transition CbCR safe harbour, applicable for any fiscal year beginning on or before 31 December 2026, but not including a fiscal year that ends after 30 June 2028).

Accordingly, where a tax administration considers that an MNE has taken reasonable measures to ensure the correct application of the GloBE rules (and the MNE can demonstrate that it acted in good faith to understand and comply with the GloBE rules), relief from sanctions and penalties should apply.

Observation: Essentially, this penalty relief is intended to provide MNEs with a 'soft landing' during the initial years of the introduction of the GloBE rules. In the initial years during which the GloBE rules come into effect, both MNEs and tax administrations will need to devote considerable time and resources to familiarise themselves fully with the rules and their application, and to develop appropriate and robust compliance and reporting systems. It would be counter-productive (and could hamper the effective implementation of the GloBE rules) if tax administrations were to impose penalties and sanctions for good faith errors that are to be expected in the course of the implementation of such a comprehensive reform as the introduction of the GloBE rules.

Observation: Note that, although the common understanding is aimed at providing relief from penalties and sanctions that may arise from the GloBE Information Return, the requirement that the MNE take reasonable measures (and that these reasonable measures be demonstrable to the relevant tax authority) effectively means that the relief will not apply to situations involving avoidance, fraud or abuse. Additionally, these provisions would not relieve the MNE from any liability to correct any errors and pay any unpaid or underpaid top-up tax in accordance with domestic legislation.

Observation: Subject to the tax certainty provisions discussed in another of the releases, this relief is at the discretion of individual governments, and not subject to any type of multilateral procedure or review. In some countries that may cause concern.

The takeaway

Given that the Pillar Two rules have recently been agreed by the EU Member States and we expect to see the rules adopted in other countries early in 2023, MNE Groups will be turning their attention to the practical application of the rules. This guidance from the OECD may well provide MNE groups some transitional relief from immediate compliance requirements, but there will still be great challenges in collecting data and ensuring consistency of design across systems to comply with the transitional rules. While the guidance endeavours to address many of the issues that stakeholders were most concerned about in previous consultation processes, including managing the

complexity for low-risk jurisdictions and entities, it remains to be seen in practice how helpful the transitional relief really is for a broad range of MNEs.

Additionally, the simplification provided by the framework of the permanent safe harbour is not yet completely clear. As businesses get to grips with the full impact of the GloBE rules in 2023, we encourage continued engagement with the OECD Inclusive Framework to identify and address additional issues that may need simplification.

An open question is whether the transitional CbCR safe harbour will incentivise systematic scrutiny by authorities of the CbCR report of an MNE. Although at various points IF members tried to reassure stakeholders, the CbCR report will receive much more attention going forward, as it will be at the core of calculating whether a top-up tax is due in a jurisdiction.

Let's talk

For a deeper discussion of how the safe harbours might affect your business, please contact:

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