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Reducing Complexity and Compliance Costs: A Simplification Safe Harbour for the Global Minimum Tax

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Reducing Complexity and Compliance Costs: A Simplification Safe Harbour for the Global Minimum Tax

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1. Introduction

In mid-2021, around 135 countries agreed on the introduction of a global minimum tax for multinational corporations (MNEs).[1] The agreement was reached under the guidance of the OECD/G20 Inclusive Framework on BEPS.[2] It continues to leave each state full freedom to design its own tax law, while at the same time ensuring that MNEs' constituent entities reach an effective tax rate (ETR) of at least 15%, regardless of where they are based. Thus, the new rules ensure a levelling of the playing field.[3] In a nutshell, the global minimum tax works as follows: If one country taxes a constituent entity at less than 15%, another country – typically where the ultimate parent entity is based – is allowed to close the resulting taxation gap by levying a top-up tax, until a total of 15% is reached in each country. This applies to MNEs with a worldwide turnover of more than 750 million euros.

The rules for this global minimum tax, also known as Global Anti-Base Erosion rules ('GloBE rules' or 'Pillar Two'), were published in a blueprint in October 2020.[4] As many questions remained open, the OECD further published model rules[5] in December 2021 and a 228 pages commentary[6] in March 2022. This large number of extensive documents is necessary as the underlying methodology is highly

[1] OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy, OECD/G20 Base Erosion and Profit Shifting Project (2021), https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf. Estonia, Hungary and Ireland joined the agreement later. Kenya, Nigeria, Pakistan and Sri Lanka are members of the Inclusive Framework, but have not (yet) joined the agreement, see https://www.oecd.org/tax/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm.

[2] By June 2022, 141 members have joined the Inclusive Framework, https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf.

[3] For a discussion of the impact of the global minimum tax on global competition, see Devereux, Michael P., John Vella, and Heydon Wardell-Burrus (2002), Pillar 2: Rule Order, Incentives, and Tax Competition. Oxford University Centre for Business Taxation Policy Brief 2022, http://dx.doi.org/10.2139/ssrn.4009002.

[4] OECD, Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint, OECD/G20 Base Erosion and Profit Shifting Project, Inclusive Framework on BEPS (2020), https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint-abb4c3d1-en.htm, hereafter: OECD (2020), Blueprint.

[5] OECD, Tax Challenges Arising from the Digitalisation of the Economy. Global Anti-Base Erosion Model Rules (Pillar Two), OECD/G20 Base Erosion and Profit Shifting Project, Inclusive Framework on BEPS (2021), https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf, hereafter: OECD (2021), Model Rules.

[6] OECD, Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), OECD/G20 Base Erosion and Profit Shifting Project, Inclusive Framework on BEPS (2022), https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf.

complex. Complexity exists in the general design of the global minimum tax, and especially in the design of the tax base. To address this complexity, the Inclusive Framework discusses various safe harbours and simplifications[7] and intents to publish them by the end of 2022 as part of the 'Implementation Framework'. Probably the most far-reaching simplification proposal is the 'simplification safe harbour' based on 'tax administrative guidance'[8], developed by Cedric Döllefeld, Joachim Englisch, Simon Harst, Felix Siegel and I in close consultation with the OECD Secretariat.[9]

The simplification safe harbour consists of a two-level test to determine if a full GloBE ETR calculation is required from an MNE or if a simplified ETR calculation or no calculation at all is sufficient. The test consists of a country-level test and – only if necessary – an MNE-level test. The country-level test assesses a country's tax system. It seeks to determine whether the national tax system has (too) low nominal tax rates or significant deviations between a country's tax base and the GloBE income exist. The second level, the MNE-level test, is only carried out if the country-level test has identified potential 'red flags'. Even if this second test is required, the simplification safe harbour offers a significant reduction in compliance costs. This reduction is achieved by relying on national tax data, which is readily available in firms, instead of highly adjusted accounting data.

The remainder is organised as follows. The second section discusses why computing the GloBE income is so complex and deduces why simplification measures are required. In section 3, I will discuss the simplification safe harbour. The fourth section concludes.

2. Why Determining the GloBE Income is so Complex

Although the OECD, finance ministries and multinational enterprises (MNEs) have been working on the global minimum tax reform for years, numerous implementation challenges and the incredible complexity are only now becoming apparent. As long as there was no agreement on the rules, MNEs had not started to implement them either. This changed after the OECD published the model rules and the commentary to explain the methodology of the global minimum tax. The definitions of the terms used are often new and completely unknown in the tax law of the countries involved, both in terms of wording and calculation. MNEs and consultancies are now trying to implement the new tax rules. The effort involved shows that many of the data required to calculate the minimum tax is not available in MNEs. Nor can they be easily derived from existing calculations, tax accounting or financial accounting. Often, further information need to be collected on a transactional basis. De facto,

[7] Other safe harbour options include those based on country-by-country reporting (CbCR) data and de minimis rules, see OECD (2020), Blueprint, Art. 5.1.
[8] See OECD (2020), Blueprint, Art. 5.5.
[9] See Cedric Döllefeld, Joachim Englisch, Simon Harst, Deborah Schanz and Felix Siegel (2022), Tax Administrative Guidance: A Proposal for Simplifying Pillar Two, 50 Intertax, 231–246, hereafter: Döllefeld et al. (2022) Intertax; Cedric Döllefeld, Joachim Englisch, Simon Harst, Deborah Schanz and Felix Siegel (2022), A Simplification Safe Harbour for Pillar Two, 106 Tax Notes International, 1513–1523, hereafter: Döllefeld et al. (2022) TNI.

the minimum tax demands the implementation of a third accounting system: In addition to tax accounting and financial accounting, a third accounting layer for calculating the global minimum tax must be added. All this does not only have to be prepared on the MNE side, but it also must be audited by tax administrations worldwide.

Why does the calculation of the global minimum tax have to be so complex? As there is no uniform tax system, the calculation of the tax bases differs from country to country. Knowing this, the negotiating countries agreed not to use national tax bases when determining the global minimum tax. A way out of relying on different tax bases was found by choosing international financial accounting standards for calculating the GloBE income. These standards are primarily the International Financial Reporting Standards (IFRS), governed by the International Accounting Standards Board[10], which are adopted in many countries worldwide.[11] But as the reconciliation of data from one accounting standard to another requires a very high effort by MNEs, more and more other accounting standards have been accepted by the Inclusive Framework member states. By now, the generally accepted accounting principles of Australia, Brazil, Canada, all 27 Member States of the European Union, Member States of the European Economic Area, Hong Kong, Japan, Mexico, New Zealand, the People's Republic of China, the Republic of India, the Republic of Korea, Russia, Singapore, Switzerland, the United Kingdom, and the United States are considered as additional acceptable financial accounting standards.[12]

At first glance, the use of accounting standards seems to be very promising: Generally, one single accounting standard is used by each MNE, and the data exists broken down to entity-level or country-level. Both are prerequisites for calculating the global minimum tax. On this basis, the test of whether a top-up tax is due can be carried out in an internationally comparable manner by dividing the covered taxes per country by the profit determined according to financial accounting standards in that country. If the resulting ETR is at least 15%, no top-up tax is due. If it is below 15% in one country, then another country where the MNE is based is entitled additionally to tax these profits.

But the accounting standards' purpose is to provide information to investors, not to build a basis for taxation.[13] This difference leads to a major disadvantage: Compared to tax systems, there are massive deviations in the base definition. In order to calculate meaningful GloBE ETRs, adjustments need to be made for many of those deviations.

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[10] See www.ifrs.org.
[11] For the per country adoption see IFRS Foundation, https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction.
[12] See OECD (2021), Model Rules, Art. 10.1.1.
[13] For an early discussion see Fülbier, Rolf Uwe (2006), Konzernbesteuerung nach IFRS, IFRS-Konsolidierungsregeln als Ausgangspunkt einer konsolidierten steuerlichen Gewinnermittlung in der EU?, Frankfurt am Main.

The adjustments are manifold[14]. To name some examples, adjustments are made for dividends, policy disallowed expenses, accrued pension expenses and – perhaps the most complex step – deferred taxes. Dividends are a supposedly simple example. Dividends are in most countries tax-free within groups, as the underlying corporate profits have already been taxed at the level of the subsidiary and, for a second time, later when they are distributed to the shareholders. However, the tax exemption that typically exists when dividends are passed through other group entities is not replicated in financial accounting standards, where dividends are a component of the profit. Receipt of a dividend would then result in a tax base and therefore a tax payment of 0 in a country, but a positive profit according to accounting standards. Without adjustments, this would result in an ETR of 0%, which would lead to a top-up tax of 15%. However, this result is not desired by anyone, so that the GloBE rules prescribe that dividends within corporate groups be excluded.

In more detail, the GloBE rules state that dividends be excluded if at least 10% of the shares are owned for a minimum of 12 months.[15] However, MNEs do not have this information readily available: The total dividends received are known, but which shares and which holding periods are behind them cannot be seen in the aggregated dividend figure. Each individual dividend must therefore be classified as an item to be adjusted or not.

Another complexity results from the fact that there are many constituent entities for which no reports based on their parents' accounting standards are prepared at all. One example are permanent establishments which pay taxes locally, but their profits are attributed to the country of domicile of the legal (parent) entity according to financial accounting standards. In the foreign country where such a permanent establishment exists, there is accordingly no separate accounting, so that no data exists for determining the global minimum tax. Moreover, MNEs often have a huge number of small constituent entities which are not consolidated in their global reports. This is the case if subsidiaries are big enough to exceed the OECD threshold[16], but are otherwise regarded as small and thus, in agreement with the auditors, classified as 'not material'. The consequence: For such entities, no data is available according to the parent's accounting standard as a basis for calculating the global minimum tax. Massive efforts are required for permanent establishments and unconsolidated entities to document their business transactions according to the MNE's accounting standards from scratch.

[14] See OECD (2021), Model Rules, Art. 3.2.

[15] See OECD (2021), Model Rules, Art. 10.1.1. 'Excluded Dividends'.

[16] OECD (2021), Model Rules, Art. 3.1.3 describe conditions under which a country's constituent entities may deviate from their parent's accounting standard. Among those is the requirement that permanent differences arising between the entity's and the parent's items of income would not exceed 1 million euros and that the local accounting standard is also accepted under the GloBE rules.

If these discussed complex adjustments and additional reports are necessary to implement a globally desired tax reform, the high compliance effort should be accepted. But one detail is striking: MNEs and tax administrations alike often expect that the ETRs will exceed 15% in most countries anyway. Initially, this even led MNEs to conclude that the minimum tax would hardly burden them, since according to their initial estimates they would have to pay top-up tax in only a few countries. This seems to hold true even after applying the detailed GloBE rules, but it turns out that the 'no result' comes at a high cost: It is not the minimum tax that leads to an additional burden for MNEs, but the high compliance costs. A burden that benefits no one, however, as it does not generate tax revenue for any state, but only generates further costs through the audits of the ETR calculations by the tax authorities.

3. The Simplification Safe Harbour

This disparity between compliance costs and – in many cases – no tax revenue has also been recognised by the Inclusive Framework and the OECD. They have been taking on the task of analysing the practicability of the new minimum tax with impressive energy and are working on simplifications, such as this simplification safe harbour based on tax administrative guidance. I will explain the two steps of the simplification safe harbour – the country-level and the MNE-level test – below.

3.1. Country-Level Test

The country-level test comprises of two stages to determine a country's tax risk profile. The test is carried out only once, most likely by a review board, and there is no involvement required of MNEs, as the test analyses the national tax system and does not assess data of any specific MNE.

3.1.1. The Two Stages of the Country-Level Test

In stage one, the country-level test examines whether the nominal tax rate in the country is generally below the GloBE minimum tax rate of 15% or if any covered taxes are levied at all. If the country's nominal tax rate is below 15% or the country does not levy any taxes covered under GloBE[17] at all, a full GloBE declaration is required from all MNEs for their constituent entities in that country.

If the country's nominal tax rate exceeds 15%, stage two of the country-level test examines whether there are any red flags. A red flag is defined as a deviation between the GloBE income and the country's tax base. However, a deviation is only marked with a red flag if it is neither addressed by the adjustments provided by the GloBE rules nor considered as immaterial or unproblematic. A red flag is also identified if the local tax rate in a country is partially below the GloBE minimum tax rate of 15%. For example, such a reduced tax rate might exist for specific sectors, regions, or income types.

[17] OECD (2021), Model Rules, Art. 4.2., defines the covered taxes.

Only if one or more red flags exist in a country, further MNE-level tests are required in that country. If there is no red flag present in the country, the country is generally classified as low-risk and no further global minimum tax declarations or tax payments are due.

3.1.2. 'Red Flag' Base Deviations

The identification of the red flag base deviations is the core of the country-level test. In the following, I will discuss criteria which serve as a basis for this red flag identification.[18] First of all, deviations between financial accounting and the national tax law must be identified. In countries which apply IFRS, they will be chosen for that comparison, but the other accepted accounting standards would have to be accepted alike.[19] Based on this list of potential deviations, immaterial and unproblematic deviations will be excluded to reach a list with significant deviations only.

In a first step, all deviations that the GloBE rules already address are filtered out. These comprise dividends, excluded equity gains or losses, included revaluation method gains or losses, asymmetric foreign currency gains or losses, policy disallowed expenses, and accrued pension expenses[20]. The exclusion from the list of deviations is because the GloBE rules also make these adjustments to financial accounting. As such, these items cannot be regarded as a difference between GloBE rules and national tax law.

In a second step, further deviations are eliminated from the remaining red flag list based on four different types of criteria. The simplification safe harbour divides these criteria into four boxes:[21]

Box 1-criteria filter out the deviations that lead to a broader tax base compared to the GloBE income. These deviations do not raise concern from the global minimum tax perspective. The reason is that these deviations can only exist if a national tax law is stricter than the GloBE rules. Falling below the 15% minimum tax is technically not possible based on these rules. Box 2-criteria mainly filter out remaining deviations that are temporary and do most likely reverse within five years. Box 3-criteria filter out small amount deviations between the GloBE income and national law. These deviations can be either relatively or absolutely small. The relative threshold eliminates deviations resulting from valuation differences that do not differ by more than a certain percentage of any asset or liability. As an example, the financial accounting standard could allow for the capitalisation of certain parts of an asset whereas national tax law does not. The absolute threshold filters out absolute small amount deviations. This is the case when a valuation difference of an asset or liability does not exceed a specific value of a single item or the total balance sheet position, such as due to full expensing rules for

[18] See Döllefeld et al. (2022) Intertax, p. 235.
[19] See section 2 for other accepted accounting standards.
[20] See OECD (2021), Model Rules, Art. 3.2.
[21] See Döllefeld et al. (2022) Intertax, pp. 236–237, for a detailed description of the criteria.

assets with minor value. For the box 3-criteria, the concrete relative and absolute small amount thresholds have not been defined yet but need to be agreed upon by the Inclusive Framework in the ongoing political process. Finally, box 4-criteria filter out deviations between the GloBE income and national tax law that do not raise concerns under the GloBE policy objectives. These are, for example, deviations that are linked to real investments, such as tangibles.[22]

3.2. MNE-Level Test

If an MNE's constituent entity is based in a country considered low-risk according to the country-level test, there is no MNE-level test or GloBE ETR calculation necessary. If it is in a country that is classified as high-risk (i.e. a low-tax country), there is also no MNE-level test due, as the full GloBE ETR calculation is required anyway. Only if a country is classified with a case-specific risk of under-taxation, (i.e. at least one red flag is present), the MNE-level test comes into play and a simplified ETR needs to be calculated by the MNE. This simplified ETR then determines whether a full GloBE declaration needs to be submitted or not.

The MNE-level test in a country consists of two stages. In a first stage, the MNE analyses if it has benefited from a below 15% nominal tax rate. If a low rate applies at least to a part of the tax base, a simplified ETR has to be calculated as taxes divided by the tax base[23]. If the result is below 15%, a full GloBE declaration is required.

If preferential nominal tax rates below 15% (red flag rate deviations) either do not exist, have not been applied to any of the MNE's tax base, or the simplified ETR is higher than 15%, the assessment proceeds to a second stage to test whether the MNE has benefitted from any tax base deviations (red flag base deviations). If this is not the case, no GloBE declaration needs to be made and no top-up tax is due. If the MNE has profited from rules which are identified as red flag deviations, a new simplified ETR is calculated based on an adjusted tax base: The taxes are now divided by the sum of the tax base and the red flag base deviations.

The beauty of this approach is that is relies to a large extent on tax and not financial accounting data. MNEs need only the following input data in each country in which they perform the MNE-level test: the local tax base[24], taxes paid, and red flag deviations. Apart from the red flags, the data is readily available in all countries, also for constituent entities which are not consolidated for financial accounting purposes.

[22] See their preferential treatment in OECD (2021), Model Rules, Art. 4.4.5. and Art. 5.3.
[23] The treatment of losses is discussed in Döllefeld et al. 2022 TNI, p. 1518.
[24] In a loss situation, also the losses must be considered. The loss data is also available for tax purposes without any further modifications. The following loss data is required for calculating the simplified ETR: before loss carry-forward and loss carry-back, used loss carry-forward, newly accumulated loss carry-forward. See Döllefeld et al. (2022) TNI, p. 1519.

As an extension of this approach, one could go a step further and consider substance-based income exclusions (SBIE)[25] in the MNE-level test. To keep the general approach simple, the substance-based income exclusions would only be deducted from the simplified 'tax base plus red flags' base for countries with an initial simplified ETR below 15%. These deductions would be, in line with the OECD rules, certain payroll costs and tangibles. Especially for countries with high payroll costs and tangibles but a low tax rate, the deductions would better mirror the full GloBE ETR calculation and help identify those MNE's entities as ones which pay already more than 15% taxes. Thus, unnecessary further full GloBE ETR calculations could be avoided.

4. Conclusion

More than 135 countries agreed on the introduction of a global minimum tax. A blueprint, model rules and an extensive commentary have been published, but there are still open questions. A major concern that is shared internationally is the complexity in implementing the rules. To tackle the high complexity of the GloBE rules and the related high compliance and audit costs for both MNEs and tax administrations, the GloBE blueprint addresses several safe harbours. Among those is the 'simplification safe harbour' based on 'tax administrative guidance'.[26]

The main application for the simplification safe harbour lies in the identification of low-risk countries that can be excluded from any GloBE declarations. A country's tax system is classified as low-risk if technically constituent entities in those countries cannot fall below the 15% global minimum tax. Moreover, the simplification safe harbour is a tool for calculating a simplified ETR whenever there are some country risks ('red flags'). Based on the simplified ETR, the MNE can quickly show when a full GloBE ETR calculation is not necessary.

On top of that original purpose, the idea of greatly simplified profit calculation could be used not only for the 15% test. Further simplifications are possible. The Inclusive Framework countries have agreed on a de minimis exclusion, that being to levy the minimum tax only from a profit of 1 million euros.[27] However, to prove that the profit is below the limit, it must be determined according to the GloBE rules. The compliance effort would therefore be just as high as if the minimum tax were levied. The simplified profit calculation could be used for that prove instead. Likewise, it would be useful with regard to developing countries, whose tax administrations might not have the capacity to comprehend financial accounting standards and the elaborate minimum tax calculations. Moreover,

[25] See OECD, Model Rules, Art. 5.3.
[26] See Döllefeld et al. (2022) Intertax; Döllefeld et al. (2022) TNI.
[27] According, to Art. 5.5.1. of the OECD (2021) Model Rules, an MNE will not have to pay top-up tax in a country if the average GloBE turnover is less than 10 million euros and the average GloBE income or loss is less than 1 million euros.

countries such as Ireland, Great Britain, Canada, and Switzerland are currently announcing their intention to introduce the complex GloBE rules in their own countries by implementing a 'Qualified Domestic Minimum Top-up Tax'. This domestic tax ensures that a local 15% tax burden is always met and that no other country can impose further top-up taxes on the profits. Here, too, much unnecessary work could be saved if these reforms were based on simplified profit determination.

To summarise, the idea for a practicable, implementable minimum tax is there. Now it is important that it is sufficiently heard in the political process and implemented in a binding manner; not only at the level of the OECD but also in the European Union, which is currently trying to overtake the international community of states with its proposed directive. Through the simplification safe harbour, the political goal of ensuring a 15% minimum tax can be reached, whilst unnecessary compliance and audit costs would be avoided for MNEs and tax administrations alike.