3 Calculating the ETR under the GloBE rules

3.1. Overview

127. This chapter sets out the rules for determining an MNE's effective tax rate (ETR) under the GloBE rules. The Globe ETR is determined by dividing the amount of covered taxes by the amount of income as determined under the GloBE rules. Section 3.2 below sets out the definition of covered taxes and Section 3.3 describes the methodology for calculating an MNE's income for GloBE purposes. As described in further detail in Section 3.3, the GloBE rules start with the financial accounts that are prepared under the same accounting standard that is used by the parent of the MNE to prepare its consolidated financial statements. The rules then require certain adjustments to be made to those financial accounts to eliminate specific items of income from the tax base, such as intra-group dividends, and to incorporate certain expenses, such as tax deductible stock-based compensation. Section 3.3 also describes a number of modifications that can be made to the tax base to address differences in the timing in the recognition of income and taxes. The first modification, described in Section 3.3.5, addresses timing issues that can arise through immediate expensing and accelerated depreciation of assets for local law purposes. The second modification, described in Section 3.3.6, addresses the timing issues raised by distribution-based corporate income tax systems. Finally, Section 3.3.8 describes an exclusion from the GloBE tax base for emergency government assistance.

128. The GloBE ETR is calculated on a jurisdictional basis as described further in Section 3.4. The jurisdictional ETR computation requires assignment of the income and taxes among the jurisdictions in which the MNE operates and to which it pays taxes. Generally, the income of the MNE is assigned to the jurisdiction of the Constituent Entity that earned the income with each permanent establishment being treated as a separate Constituent Entity. The corresponding covered taxes on that income are then assigned to the jurisdiction that has been allocated the income. Special rules address the treatment of entities that are tax transparent and that do not have any tax jurisdiction of residence.

3.2. Covered taxes

Definition of covered taxes

Covered taxes means any tax on an entity's income or profits (including a tax on distributed profits), and includes any taxes imposed in lieu of a generally applicable income tax. Covered taxes also includes taxes on retained earnings and corporate equity.

A tax is a compulsory unrequited payment to general government.

129. The definition of covered taxes aligns the numerator (i.e. the measure of covered taxes) and the denominator (i.e. the measure of net income) in the GloBE's ETR calculation so that the taxes imposed on income included in the GloBE tax base are treated as a covered tax for the purposes of determining the GloBE ETR. The definition of covered taxes is developed solely for the purposes of the GloBE rules and has no direct interaction with Article 2 (Taxes Covered) of the OECD Model Tax Convention (OECD, 2017[1]), which is developed for the distinct purpose of eliminating double taxation. Taxes that do not qualify for the definition of covered taxes under the GloBE, such as excise taxes and payroll taxes, will be treated as deductible in the computation of the GloBE tax base (i.e. as reductions to the denominator in the GloBE's ETR calculation).

130. The definition of covered taxes applies not only to taxes imposed on income at the time such income is derived but also on taxes that are imposed on a subsequent distribution of profits. The definition further applies to any tax that is imposed in lieu of a generally applicable income tax. The definition of covered taxes also includes taxes on retained earnings and corporate equity. In determining whether a tax is a covered tax, the focus is on the underlying character of the tax. The name that is given to a tax or the mechanism used to collect it (such as through a withholding mechanism) is not determinative of its character. Whether a tax charge is levied under a jurisdiction's corporate income tax rules or under a separate regime or statute does not have any bearing on its underlying character. Whether a tax is deductible is not relevant to determining whether it is a covered tax.

131. The definition of tax is based on the OECD's longstanding definition of taxes used for statistical purposes, with the same definition equally used by many international organisations (IMF, World Bank, United Nations, European Union) (OECD, 2018[2]), and which defines taxes as any compulsory unrequited payment to general government. General government is a defined term in the UN-OECD National Accounts that includes the central administration, agencies whose operations are under its effective control, state and local governments and their administrations (OECD, 2018[2]). Taxes are unrequited in the sense that any benefits provided by government to the taxpayer are not in proportion to their payments. Thus, fees and payments for privileges, services, property, or other benefits provided by government do not qualify as taxes. Similarly, taxes do not include fines and penalties nor do they include interest or similar charges with respect to payments of tax liabilities after the applicable due date.

3.2.1. Design principles

132. The agreement on a definition of covered taxes under the GloBE rules has been guided by a number of principles:

- **Align with the GloBE tax base and avoid double taxation.** Because the GloBE tax base covers a wide range of income and gains, it is imperative that the GloBE ETR calculation similarly adopts an expansive definition of covered taxes in order to accommodate the present and future design of tax systems and to avoid the risk of double taxation.
- **Provide for clear and consistent outcomes.** To enhance compliance and administration, and to ensure a level playing field, the GloBE demands a definition of covered taxes that is transparent and clear in its application, and produces consistent and predictable outcomes.
- **Avoid the need for a legalistic analysis of the specific technical design features of taxes in various jurisdictions.** The definition of covered taxes focuses on the underlying character of the tax and avoids the need to engage in a legalistic analysis of the technical nuances of particular taxes imposed by each jurisdiction to determine whether those taxes qualify as a covered tax.
- **Accommodate differences in the timing of the imposition of tax under local law.** The definition of covered taxes is designed to take account of the effects of temporary differences so that the GloBE does not result in incremental taxation in respect of temporary mismatches between the recognition of income and the imposition of tax on that income.

133. The principles set out above underpin the definition of covered taxes that has been developed for the purposes of the GloBE, and which is further elaborated in the commentary below. The commentary explains how this definition is applied to certain common design features of taxes in many Inclusive Framework on BEPS jurisdictions. The commentary does not describe or address every design feature of all the taxes that may fall within the definition. In order to provide certainty to MNEs and ensure the rules are consistently applied, Inclusive Framework on BEPS members have adopted a common definition of covered taxes. Consistency in the application of that definition could be co-ordinated through additional guidance, as necessary, as part of the development of model rules (see Section 10.5.1).

3.2.2. Taxes on income

134. While there is no internationally agreed definition of an income tax, income taxes are generally levies on a flow of money or money's worth that accrue to a taxpayer during a period of time. Income taxes take into account related expenses of producing the flow of money to measure the taxpayer's net increase in wealth for the period. A definition of covered taxes that applies to income calculated on a net (rather than gross) basis is in line with the definition of income tax used for financial accounting purposes and therefore it is expected that a tax recognised as an income tax for financial accounting purposes should generally qualify as a covered tax under the GloBE rules.

135. It is clear, however, that a tax need not determine the taxpayer's precise change in wealth to qualify as an income tax. A definition of covered taxes that required taxpayers and administrators to undertake further technical analysis of the precise terms of each type of tax in order to determine whether a particular tax took into account an appropriate amount of relevant expenses incurred in the generation of that income would be cumbersome to apply and lead to uncertainty in the determination of the ETR. Accordingly, the definition of covered taxes includes taxes that allow for a simplified estimate of net profit. For example, a tax that allows deductions for some but not all expenses of earning the relevant income, would be considered an income tax provided the deductible expenses can reasonably be considered to have been incurred in connection with deriving that income. Similarly, a tax on income that allows a standardized deduction in place of actual expenses is generally considered an income tax if such standardised deduction is based on a reasonable method for estimating such expenses. A tax imposed on gross income or revenue without any deductions (i.e. a tax on turnover) would not be considered an income tax. The design and substantive character of such turnover taxes generally have more similarities to consumption or sales taxes. The definition of covered taxes therefore does not apply to a tax on a gross amount unless such a tax is in lieu of an income tax (see Section 3.2.3).

136. Taxes or surcharges imposed on the net income from specific activities, such as banking or the exploration and production of oil and gas, irrespective of whether or not they apply in addition to a generally applicable income tax, would also fall within the general definition of a covered tax. That would include a separate resource levy that is imposed on the net income or profits from the extraction activity (or a component of a multi-component levy that is imposed on net income or profits). However, resource levies closely linked to extractions, for example, those that are imposed on a fixed basis or on the quantity, volume or value of the resources extracted rather than on net income or profits, would not be treated as covered taxes except where these levies satisfy the "in lieu of" test described below.

137. A supplementary tax which applies a top-up tax to the net income of domestic entities would also fall within the definition of a covered tax. Supplementary taxes that apply on an alternative basis - that is other than net income - would not, however, fall within the general definition of a covered tax as they are not taxes imposed on net income. As set out above, taxes on net income imposed at state and local government level are covered taxes, even where they are deductible for the purposes of income taxes imposed at national government level. Tax paid on net income allocated to a jurisdiction under Pillar One would also be treated as a covered tax under the GloBE (see Section 3.3.4. on *Adjustment for Pillar One Outcomes* for discussion of adjustments to the GloBE tax base).

138. Under an imputation credit regime, the tax that is imposed by a jurisdiction on a corporation's income gives rise to a credit, which can be attached to a subsequent distribution and used by a resident shareholder to shelter or reduce the tax payable under the laws of the same jurisdiction on that distribution. An imputation system is designed to ensure a single level of tax on corporate income whereby a portion of the tax paid by the corporation is creditable against the shareholder's tax liability arising from dividend distributions. Thus, in a sense, part of the tax paid by the corporation can be thought of as the pre-payment of the shareholder's tax liability. However, the fact that a shareholder may subsequently be entitled to an indirect credit for the tax paid by the corporation on the underlying income, does not prevent the corporation tax from being treated as a covered tax. Imputation regimes that protect resident shareholders from the imposition of economic double taxation under the laws of the same jurisdiction on the same income are equivalent, in this sense, to other mechanisms, such as foreign tax credits, exemptions and preferential rates, designed to protect domestic shareholders from economic double taxation on distributions of previously taxed income. Corporation tax paid under an imputation system that seeks to prevent economic double taxation at the resident shareholder level (and does not provide credits or refunds to non-residents) is properly treated as a covered tax provided the resident shareholder is subject to tax. Where, however, the imputation regime allows for a refund of taxes to be paid in respect of distributions made to a non-resident shareholder who is not subject to tax under domestic law, the regime has gone beyond relieving economic double taxation of the same income under the laws of the same jurisdiction, rather it is providing a refund of covered taxes paid in prior years. Accordingly, a distribution paid to a non-resident that gives rise to a refund of covered taxes (either to the company or to the shareholder) that relates to a distribution paid to a non-resident should be treated as a refund or reduction in covered taxes in the year such distribution is made. Similarly, where an imputation regime allows for a refund of taxes to be paid in respect of distributions made to a resident corporate shareholder which is not generally subject to tax on such distributions (e.g. due to a participation exemption) and is not an Excluded Entity[1], it should be treated as a reduction in covered taxes in the year such distribution is made. However, where an imputation regime allows a refund of taxes to be paid in respect of distributions made to a resident shareholder that is generally subject to tax, or which is an Excluded Entity, it should not be treated as a reduction in covered taxes under the GloBE.

3.2.3. Taxes in lieu of a generally applicable income tax

139. The definition of covered taxes includes taxes in lieu of a generally applicable corporate income tax. A generally applicable corporate income tax could be one that applies to all resident corporations or one that typically applies to those resident corporations that are members of a large multinational group. A generally applicable corporate income tax would also include an income tax imposed on a corporation but which also applies to other taxable persons such as individuals. The "in lieu of" test includes taxes that are not covered under the generally applicable income tax definition but which operate as substitutes for such taxes. This test, which will be familiar to some tax administrations in the context of their foreign tax credit rules, would generally include withholding taxes on interest, rents and royalties, and other taxes on other categories of gross payments such as insurance premiums, provided such taxes are imposed in substitution for a generally applicable income tax.

140. The "in lieu of" concept also covers taxes that are imposed on an alternative basis, such as taxes based on number of units produced or commercial surface area, and which are used as substitutes for a generally applicable income tax under the laws of the jurisdiction. Where, for example, a jurisdiction imposes a simplified methodology for calculating the income on a particular category of business or investment and this tax is imposed in substitution for a generally applicable income tax then that tax should be treated as falling within the definition of a covered tax. This includes a tax on deemed return for investments in foreign equity. It also includes taxes such as tonnage taxes that use income earning capacity as a proxy for income and are designed to act as a substitute for corporation tax. Generally when a taxpayer elects into a tonnage tax regime, the taxpayer opts out of the normal corporate income tax

rules.[2] A tax imposed on an alternative basis (i.e. other than net income) levied at state or local government level, which is creditable against a generally applicable income tax levied at national government level, would also qualify as a covered tax under the "in lieu of" test to the extent that it is credited against income tax in the same jurisdiction. Such local taxes can be considered as being in substitution (partially or fully) for a generally applicable income tax and an administratively efficient way of transferring resources from national to local government within the same jurisdiction. A tax that is imposed on an alternative basis that applies in addition to, and not as substitute for, a generally applicable income tax under the laws of the jurisdiction would not fall under the "in lieu of" test for covered taxes.

3.2.4. Taxes on retained earnings and corporate equity

141. Some jurisdictions impose taxes on the net equity of a corporation in addition to corporate income tax. The equity or capital of a corporation is composed of its retained earnings (i.e. the undistributed portion of the after-tax income in the Profit and Loss statement) and the contributions made by shareholders. Taxes on corporate equity may be inherently interlinked with the design of the corporate income tax systems. For example, it may be possible under the laws of a jurisdiction to credit corporate income tax against a corporate equity tax so that a company is allowed to reduce the corporate equity tax up to the amount of corporate income tax that it pays in that jurisdiction. Taxes on corporate equity may also act as a supplement to corporate income tax as part of a jurisdiction's overall approach to the taxation of a corporation's activities in that jurisdiction. For example, some taxes on corporate equity may incorporate a minimum tax element to their design. Such taxes on corporate equity are therefore an integral part of the overall system of corporate taxation in those jurisdictions. From an economic perspective, a tax on net equity can be seen as an ex ante income tax on the company. For these reasons, these type of taxes based on corporate equity should be treated as covered taxes under the GloBE rules.

3.2.5. Taxes based on multiple components

142. Some jurisdictions impose taxes that have multiple components to the base. Where all the components of the tax base fall within the definition of income or profit covered by the GloBE rules then the tax should as a whole, be included within the definition of covered taxes. Other taxes may be levied in respect of a corporation's activities in a jurisdiction, and are administratively and conceptually part of the system of corporate taxation in these jurisdictions but may include both an income and a non-income element. Where such taxes are predominately a tax on an entity's income and it would be administratively burdensome to split the tax into separate income and non-income components then such taxes should be treated as fully covered under the GloBE rules. This approach would minimise the complexity of the GloBE rules and avoid the additional administrative and compliance burden of requiring the different components of such taxes to be split out for the purposes of the ETR calculation. Furthermore, it is consistent with the general principle that the definition of covered taxes should focus on the underlying character of the tax and avoid the need for a legalistic analysis of the technical nuances of particular taxes imposed by each jurisdiction.

143. An example of a covered tax with multiple components is the corporate Zakat levied by the Kingdom of Saudi Arabia, which is described in Example 3.2.5-1A. As described in that example, the Zakat operates as a tax on income or equity or both and is therefore properly considered a covered tax for the purposes of the GloBE rules.

3.2.6. Taxes on distributed profits

144. In line with the principle to address temporary differences, the timing of a levy does not have any bearing on the definition of covered taxes. Accordingly, taxes imposed on the income of a distributing corporation at the time it distributes the income are covered taxes, irrespective of whether the income distribution is attributable to current or previously accumulated retained earnings (see Section 3.3.6 for

more detail on the modification to the GloBE ETR computation for entities subject to a distribution-based corporate income tax).

3.2.7. Taxes paid under CFC rules

145. Taxes paid in accordance with Controlled Foreign Corporation (CFC) rules are considered covered taxes for the purposes of the GloBE provided that they are imposed on the income of the CFC that is attributed to shareholders in the parent jurisdiction. Such CFC taxes should be assigned, where possible, to the jurisdiction in which the underlying income arises (i.e. to the jurisdiction of the CFC) and should be excluded from the ETR computation if the underlying income is excluded (see Section 3.4.2 on *Assignment of income and taxes of entity to each jurisdiction* for the approach for the treatment of CFC income and related taxes in the ETR calculation under the GloBE).

3.2.8. Non-covered taxes

Consumption and sales taxes

146. Consumption taxes, such as sales taxes and value-added taxes (VATs), are not covered taxes under the GloBE rules. Such taxes are calculated by reference to the consideration for a defined supply and are not taxes on the net income of a taxpayer.

Excise taxes

147. Excise and other taxes on inputs are not covered taxes under the GloBE rules. Such taxes arise in relation to a specific input which do not represent an accretion of income.

Digital services taxes

148. Digital services taxes (DSTs), as currently contemplated by a number of Members of the Inclusive Framework, are generally designed to apply to the gross revenues from the provision of certain digital services and so would not be considered an income tax. DSTs are generally designed to apply in addition to, and not as substitutes for, a generally applicable income tax under the laws of a jurisdiction, and so would not fall under the “in lieu of” test for covered taxes either.

Stamp and other transfer taxes

149. Stamp duty, ad valorem taxes and other taxes that are imposed on a particular transaction are not taxes on income or taxes in lieu of an income tax. They are therefore outside the scope of the covered tax definition.

Payroll taxes and social security contributions

150. Payroll taxes and other employment based taxes, as well as social security contributions, are not covered taxes under the GloBE rules. Payroll taxes and social security contributions are not imposed on the employer in respect of its income. This follows the well-established view of payroll taxes and social security contributions as being levied on labour income (i.e. wages and in some cases personal income) as opposed to business profits. Rather, payroll taxes and social security contributions are typically deductible from business profits in the same way that wages are deducted from business profits. Payroll taxes and social security contributions will also be included in the payroll component of the proposed formulaic substance-based carve-out from the GloBE (see Section).

Property taxes

151. Taxes based on ownership of specified items or categories of property are distinguishable from taxes based on a corporation's equity and should not be covered taxes under the GloBE rules. Taxes on corporate equity are generally levied on a broader range of assets than property taxes. Property taxes are based on the assessed value of the property, often without regard to whether the property is subject to a liability. They are not based on income, retained earnings, or corporate equity. Neither are they taxes imposed in lieu of a generally applicable income tax.

152. Furthermore, including property taxes in covered taxes would give a preference to owned assets over leased assets. In many cases, ownership versus lease of assets are business structure or finance decisions. In other cases, the treatment of a financing arrangement as a purchase or lease depends on accounting rules that do not implicate the policy of the GloBE. There is no apparent reason to favour ownership of assets over leasing of assets under the GloBE.

153. A property tax that reduced the assessed value of taxable property based on liabilities associated with the property might be considered similar to corporate equity taxes because corporate equity is the difference between the value of an entity's assets and its liabilities. However, equity taxes are not generally based on the specific assets held by a company, although the equity tax base could be reduced by certain categories of assets. Moreover, corporate equity is determined by taking into account all liabilities of the corporation, not just liabilities associated with specific assets. Adjustments to the assessed value of property for liabilities against the property is more akin to a valuation method under a property tax than a tax that is predominantly on previous income. Accordingly, property taxes are not included in the definition of covered taxes under the GloBE rules.

3.3. Tax base

GloBE tax base calculated by reference to consolidated financial accounts

Profit or loss determined in accordance with financial accounting standard

The starting point for determining the GloBE tax base is the profit (or loss) before income tax as determined using the relevant financial accounting standard, which may include items previously included in other comprehensive income. Certain items of income are removed from and certain items of expense are added back to the profit (or loss) before income tax to arrive at the GloBE tax base.

Financial accounting standard

The relevant financial accounting standard for calculating the GloBE tax base is the financial accounting standard used by the parent in the preparation of its consolidated financial statements.

Acceptable accounting standards

The acceptable financial accounting standards are IFRS and any equivalent financial accounting standard. Equivalent financial accounting standards include the generally accepted accounting principles of Australia, Canada, Hong Kong (China), Japan, New Zealand, the People's Republic of China, the Republic of India, the Republic of Korea, Singapore, and the United States.

In addition, an MNE should be permitted to use any generally acceptable accounting standard permitted by the body with legal authority in the Ultimate Parent Entity's tax jurisdiction to prescribe, establish, or accept accounting standards for financial reporting purposes, provided the use of that standard will not result in material competitive distortions in the application of the GloBE rules.

Determining profit (or loss) before tax of each entity

Entity-level financial information that is used in preparing the parent's consolidated financial accounts can be used, even if such financial information is not prepared in strict accordance with the parent's financial accounting standard where (a) it is reasonable to do so, (b) the information is reliable, and (c) the use of such information does not result in material permanent differences from the accounting standard of the parent.

Determining income of permanent establishment and head office

Profit (or loss) before tax of a permanent establishment is determined based on the income and expenses that are treated as arising for tax purposes in the jurisdiction where the permanent establishment is located. Transactions between the permanent establishment and the head office that are taken into account in determining the taxable income of the permanent establishment are taken into account in determining the profit (or loss) before tax of the permanent establishment and the head office under the GloBE rules.

Intercompany items

Income, gains, expenses, and losses attributable to transactions between members of the GloBE tax group should be recorded in the entity level financial accounts in accordance with the arm's length principle. Intercompany items can be excluded, however, to the extent the transaction is between group members in the same jurisdiction.

Items held in consolidation

Purchase accounting adjustments held in consolidation should not be pushed down or otherwise allocated to specific entities. Other items maintained at the consolidated level should only be taken into account in the GloBE tax base of a Constituent Entity where those items can be reliably and consistently traced to that entity.

Dividends and equity method profit (or loss)

The GloBE tax base excludes dividends received from a corporate entity, except dividends on stock in corporations in which the MNE Group owns a low percentage of the equity interests, and profit (or loss) attributable to an investment in an entity accounted for using the equity method of accounting..

Dispositions of stock and fair value accounting gain (or loss)

The GloBE tax base generally excludes gain (or loss) arising from dispositions of stock, including mergers. The acquired entity is required to use the historical carrying value of its underlying assets to compute its GloBE tax base after the acquisition. An exception to these rules applies to stock transactions between parties tax resident in the same jurisdiction that are treated as taxable asset sales in that jurisdiction. Gains and losses arising under fair value accounting for stock should be excluded from the GloBE tax base to the same extent gain or loss on actual sale of the stock would be excluded.

Covered taxes

Covered taxes, including taxes that are not treated as income taxes for financial accounting purposes, are not deductible in the computation of the GloBE tax base.

Stock-based compensation expense

Stock-based compensation expense is only allowed as a deduction in the GloBE tax base computation for a jurisdiction to the extent it is allowed as a deduction in the local tax base of the jurisdiction of the entity that employed or contracted with the party receiving the stock-based compensation. However, MNEs may reduce the GloBE tax base by stock-based compensation expense as recognised for financial accounting purposes (rather than local tax purposes), in those jurisdictions that do not have a corporate income tax system.

Bribes, kickbacks and other illegal payments

Bribes, kickbacks (and other illegal payments) are not allowed as a deduction to the GloBE tax base.

Fines and penalties

A fine or penalty imposed by government on an entity is not allowed as a deduction to the GloBE tax base of a jurisdiction if the fine or penalty, including a periodic penalty, incurred by the entity in the jurisdiction equals or exceeds EUR 50,000.

Investment returns of life insurance policy holders

Any earnings on assets beneficially owned by a life insurance policy holder that are included in the income of an insurance company pursuant to the financial accounting standard used by the company for GloBE purposes must be removed from the insurance company's GloBE tax base.

Adjustment for Pillar One Outcomes

Pillar One applies before Pillar Two. Depending upon the final design of Pillar One, an adjustment may be required to the GloBE tax base to properly reflect Pillar One outcomes.

Modification to determination of annual depreciation expense

Depreciation expense allowed with respect to tangible property of a Constituent Entity in computing the GloBE tax base may be determined based on depreciation rules applicable in the computation of taxable income in the Constituent Entity's tax jurisdiction.

Modification to tax expense computation for entities subject to a distribution-based corporate income tax

A shareholder of a Constituent Entity that is subject to a corporate income tax on distribution of its income may elect to increase the tax expense included in the numerator of the GloBE ETR computation of the jurisdiction up to the minimum tax rate, but not more than the amount of distribution tax that would be due if all of the income for the year were distributed (deemed minimum tax). The subsidiary must recapture the amount of such deemed minimum tax to the extent that corporate income tax is not paid upon distribution of income within [X] years after the year in which the income was derived.

3.3.1. Profit or loss determined in accordance with financial accounting standard

154. As directed in the Programme of Work, the Inclusive Framework first considered the possibility of calculating the GloBE tax base using the parent jurisdiction's rules for computing domestic taxable income or the income of controlled foreign companies (CFC). Leveraging the existing tax base calculation rules that a country uses for CFC purposes might initially seem to have the advantage of facilitating a tax administrations implementation and administration of the rules. However, CFC rules typically do not apply to all the subsidiaries in an MNE Group and, when they do apply, they usually only capture certain types of low-tax passive income.[3] In contrast, the GloBE rules will apply to all the subsidiaries in the group and

all types of income. Therefore, Members of the Inclusive Framework considered that using the tax base calculation rules in the Parent's jurisdiction of residence would entail significant compliance costs due to the need for each foreign subsidiary to re-calculate all of its income in accordance with the tax base of another jurisdiction. These re-calculations could lead to situations where technical and structural differences between the calculation of the tax base in the parent and subsidiary jurisdiction could result in an otherwise highly-taxed subsidiary being treated as having a low ETR for reasons unrelated to the policy underlying the GloBE rules. For example, differences between jurisdictions in the treatment of carry-forward losses and in the timing of the recognition of income and expenses could impact the calculation of the ETR in different jurisdictions. Such differences could result in the application of the rule in cases that do not give rise to the policy concerns that are intended to be addressed by the GloBE rules.

155. Structural differences in the calculation of the tax base between jurisdictions could also complicate the application of the GloBE rules and undermine its policy objectives, including the policy of ensuring transparent outcomes. For example, two jurisdictions may apply the same minimum tax rate to the income of entities pursuant to their income inclusion rules. However, if one jurisdiction has a different tax base from the other, this could result in significantly different outcomes for similarly situated entities, undermining the policy intent of creating a transparent and level playing field already reflected in the agreement on a minimum ETR equal to a fixed percentage. Finally, from the perspective of the application of the undertaxed payments rule it would be impossible to design an effective tax rate test that required a group entity making a related party payment to re-compute the recipient's income according to the tax base rules in the paying entity's tax jurisdiction. This could result in requiring taxpayers to re-compute the income many times over, possibly hundreds of times for larger groups.

156. In order to improve compliance and administration and to neutralise the impact of structural differences in the calculation of the tax base, the Programme of Work called for the exploration of simplifications to help address the issues arising from the use of the tax base in the parent jurisdiction. One simplification identified in the Programme of Work was to start with the relevant financial accounting rules. The net income calculated for financial accounting purposes could then be subject to any necessary and agreed adjustments to arrive at the GloBE tax base.

157. Use of financial accounts as a starting point for determining the tax base under the GloBE rules offers numerous advantages. From a compliance and administration perspective, it facilitates the coordination of the GloBE rules operating in different jurisdictions and eliminates the need to re-calculate the taxable income of each foreign subsidiary under the rules of the jurisdiction applying the GloBE rules. It also improves the transparency of outcomes under the GloBE rules and reduces distortions among jurisdictions based on differences in the tax base.

158. Importantly, the use of financial accounts to determine the GloBE tax base builds on existing internationally agreed standards. Although there are variations in financial accounting standards among jurisdictions, International Financial Reporting Standards (IFRS) and the generally accepted accounting principles (GAAP) of many Inclusive Framework jurisdictions have far more commonalities than differences. Moreover, there are no other uniform international standard methods of measuring the income of an entity, and it is not feasible to create, from the ground up, a new international accounting standard for computing profit (or loss) before tax under the GloBE rules.

159. The financial accounts of the entity are used to determine the entity's profit (or loss) before tax. Profit (or loss) before tax is the preferred profit measure under the GloBE rules for several reasons. First, it takes into account the actual costs of doing business, including all operating and non-operating expenses. Second, it is the most comparable financial accounting measure to taxable income, but, critically, it is computed without regard to special local tax exclusions, deductions and tax accounting conventions that would undermine the policy objectives of the GloBE rules. Therefore, using profit (or loss) before tax as a measure of profit for computing the GloBE tax base should limit the risk of the GloBE tax

base diverging significantly from the tax base of the MNE Group under local corporate income tax rules, where such a divergence would be inconsistent with the policy objectives of the GloBE rules.

160. Most commonly used accounting standards, including IFRS, do not strictly define profit (or loss) before tax. Profit measures other than net income, such as profit (or loss) before tax, are typically referred to as non-GAAP measures, and MNE Groups have some flexibility in how to calculate them.

161. For the purposes of the GloBE rules, it will be necessary to establish a consistent way for MNE Groups to determine profit (or loss) before tax using their separate entity financial accounts. One option would be to adopt an additive approach, which would define the various income and expense items that should be included. Alternatively, a deductive approach would assume that all items included in the computation of net income for purposes of the group's consolidated financial accounting statements should be included in the computation of profit (or loss) before tax, but would identify specific items that should be excluded for specific policy reasons. Inclusive Framework on BEPS members have agreed that the latter approach is the preferred one as it is likely to be simpler for MNE Groups to apply given that it merely requires exclusion of a limited number of items.

Other comprehensive income

162. Generally, financial accounting profit (or loss) does not include other comprehensive income (OCI). However, some items of income or loss reported in OCI are "recycled" through the profit and loss statement. OCI is reported on a company's balance sheet, under the equity section. The items included in OCI may include gains and losses on certain debt and equity investments, foreign currency exchange gains and losses, and changes in liabilities under pension plans. Certain revenue, expenses, gains, and losses appear in OCI before a third-party transaction has been completed. For example, if a company has invested in an interest-bearing bond and the value of that bond changes due to changes in market interest rates, then the company might be required to recognise that change in value as a gain (or loss) in OCI. Once the company sells or redeems the bond, it will then realise the transactional gain (or loss) associated with the bonds, and the realised gain (or loss) will be reported in the income statement and impact profit (or loss) before tax. Some items that are included in OCI may also be subject to tax in the local jurisdiction. In most cases, however, this will only be expected to give rise to a temporary or timing difference between local tax base and the GloBE tax base.[4]

163. In other cases, the corresponding gain (or loss) can generally be expected to be excluded from the GloBE tax base. The GloBE rules do not directly recognise items of OCI as includible in the GloBE tax base. However, such items will be included in the GloBE tax base if and when they are recognised as profit (or loss) for financial accounting purposes, provided they are not otherwise excluded from the calculation of the GloBE tax base under another rule. In this regard, an adjustment may be necessary to ensure that all of the gain (or loss) is included in the GloBE tax base in cases where only the current portion of the total gain (or loss) on disposition is included in the profit (or loss) for financial accounting purposes. This situation could arise where an asset is disposed and previous increases or decreases in fair value in respect of that asset have already been reflected in the OCI. These corresponding carrying value adjustments should be taken into account in determining the gain or loss in the year of disposition.

3.3.2. Use of parent entity's consolidated financial accounting standard

164. The starting point for the GloBE tax base is the financial accounts of each Constituent Entity of the MNE Group prepared in accordance with the financial accounting standard used by the parent entity of the group in the preparation of its consolidated financial statements.

165. There are two advantages to using the parent entity's accounting standard. First, the use of a single standard helps minimise mismatches in the treatment of transactions between Constituent Entities that may arise due to the use of different accounting standards in different jurisdictions. Second, the

standards used to prepare financial accounts for Constituent Entities will, in many cases and particularly for those MNE Groups that are listed, follow the standard used in the parent jurisdiction. This is because, in many cases, maintaining financial accounts for all Constituent Entities using a single standard facilitates the preparation of consolidated financial statements and quarterly reporting for those groups. In those cases where a Constituent Entity's accounts are not regularly maintained in accordance with the accounting standard of the parent entity there will typically be mechanisms in place that allow those accounts to be converted into or derived from the parent entity's standard as part of the consolidation process.

3.3.3. Acceptable financial accounting standards

166. The use of any accounting standard for purposes of the GloBE rules, including the standard used by the parent entity in preparing its consolidated financial statements, is always subject to the caveat that the standard, itself, must be a reliable and acceptable financial accounting standard.

167. Agreement on acceptable accounting standards is an important part of the consensus on the GloBE rules. It is recognized that financial accounting standards promulgated by independent accounting standard setting bodies tend to converge over time. Inclusive Framework on BEPS members expect that the financial accounting standards that are acceptable for use in determining the GloBE tax base will increase in the future and that a financial accounting standards could lose that status only in rare and unusual circumstances.

IFRS and equivalents

168. The rule accepts IFRS as adopted by the parent jurisdiction. IFRS is the most commonly used and accepted financial accounting standard worldwide. IFRS were established by the International Accounting Standards Board (IASB) in order to create a common accounting language, so that financial statements can be consistent and reliable from company to company and country to country. Jurisdictions adopt IFRS by conforming their local generally accepted accounting principles (GAAP) to IFRS. However, some jurisdictions have adopted IFRS with minor modifications, including different effective dates for the application of specific IFRS rules.

169. In addition, the GloBE rule accepts any financial accounting standard that is equivalent to IFRS. Equivalency with IFRS can be assessed based on the work of the IASB as well as the work of securities regulators that allow other accounting standards in financial reports of publicly accountable companies.

170. The IASB works with accounting standard authorities of different jurisdictions in an effort to converge these different accounting standards. The IASB provides information on the status of IFRS adoption and convergence projects in many jurisdictions on its website. For example, the IASB notes on its website that the accounting standards used for publicly listed entities in the People's Republic of China, the Republic of India, the Republic of Korea, and Singapore are substantially converged with IFRS standards. Similarly, the IASB notes that Australia, Hong Kong (China), and New Zealand have adopted IFRS "nearly word for word as their national accounting standards".[5] IFRS as adopted by all of these jurisdictions are considered IFRS for purposes of the GloBE proposal. However, the IASB generally does not undertake an evaluation of the overall comparability of each jurisdiction's local financial accounting standards with IFRS. Thus, assessments of equivalency to IFRS for purposes of the GloBE rules cannot be based solely on the work of the IASB.

171. Securities regulators in Inclusive Framework jurisdictions may issue guidance authorising foreign issuers of securities to use financial statements that are prepared under an accounting standard different from the accounting standards generally applicable to domestic issuers. Each regulator has its own process for authorising the use of an alternative accounting standard and the basis on which this authorisation is made may not be publicly disclosed. However, in general, the regulator will consider

whether the alternative accounting standard provides investors with substantially similar financial information about the issuer such that an investor acting on such information is likely to make the same decisions about the acquisition or disposal of the issuer's securities. For example, European Union securities regulators have recognised that the GAAP of Canada, Japan, the People's Republic of China, the Republic of India, the Republic of Korea, and the United States are generally equivalent to IFRS. Determinations by securities regulators for a significant number of jurisdictions that use IFRS as the primary reporting standard to allow foreign issuers to use financial statements prepared under an alternative financial accounting standard provides a strong indication that the alternative financial accounting standard is equivalent to IFRS.

172. The assessments made by the IASB and the reciprocal recognition of accounting standards by different regulators provide a strong indication that any differences between IFRS and the GAAP of Australia, Canada, Hong Kong (China), Japan, New Zealand, the People's Republic of China, the Republic of India, the Republic of Korea, Singapore, and the United States would not provide a material competitive advantage or disadvantage to an MNE Group using any of these standards vis-à-vis an MNE Group using IFRS. Furthermore, Inclusive Framework members are not aware of any differences between IFRS and these standards that would create material competitive distortions in the GloBE tax base, nor did the December Public Consultation (OECD, 2019[3]) bring to light any material distortions in response to this specific point. Accordingly, these accounting standards are considered equivalent to IFRS.

Other generally accepted financial accounting standards

173. As a result of the EUR 750 million consolidated revenue threshold described above in Section , a significant majority of MNEs subject to the GloBE rules are expected to be publicly accountable or listed companies (i.e. companies whose shares or debt is traded on a public securities exchange) that prepare consolidated financial statements under IFRS or an equivalent standard. There will, however, be some MNE Groups that are listed but prepare consolidated financial reports based on standards other than IFRS or an equivalent and MNE Groups that are not listed. Non-listed MNE Groups may be headquartered in a jurisdiction that requires IFRS for listed companies, but they may prepare their financial statements using the local accounting standard. It is not proportionate or reasonable to require such MNE Groups to prepare financial accounts under a different accounting standard solely for purposes of complying with the GloBE rules if their existing accounting standard is recognised by an appropriate authority and it does not result in material competitive distortions under the GloBE rules. Thus, the rule would permit an MNE Group to use any generally acceptable accounting standard permitted by the body with legal authority in the tax jurisdiction of its Ultimate Parent Entity to prescribe, establish, or accept accounting standards for financial reporting purposes, provided the use of that standard would not result in a material competitive distortion in the application of the GloBE rules.

174. In an accounting context, a material competitive distortion is an outcome that departs significantly from the result that would be realised under IFRS in a way that materially affects the ETR under the GloBE. In the case an IF member identifies a potential material competitive distortion associated with a certain element of a particular accounting standard, a review process would be initiated within the Inclusive Framework. If the relevant element was in fact deemed to be a material competitive distortion, then that particular element would be required to be brought into line with IFRS for purposes of the GloBE rules. The review process and relevant criteria will be established as part of the implementation of the model rules described in Section.

3.3.4. Adjustments for permanent differences

175. Section 3.3.1 above sets out a basic approach for computing profit (or loss) before tax for each Constituent Entity under the accounting standard of the parent entity as the starting point for the GloBE tax base. This Section sets out the adjustments to net income that are required in order to more closely

align the GloBE tax base with the computation of taxable income under the rules of the jurisdiction where the MNE operates. Adjustments may be required where differences between tax and financial accounting could have a disproportionate impact on the outcomes under the GloBE rules.

176. Differences between the relevant financial accounting standard and tax accounting rules generally can be categorized as giving rise either to permanent differences that will not reverse in a future period or temporary (i.e., timing) differences that will reverse in a future period. This chapter is focused on permanent differences. Temporary differences are addressed through the use of carry-forwards as described below in Chapter.

Evaluating permanent differences

177. Each Inclusive Framework jurisdiction has its own unique combination of additions to and exclusions from financial accounting income to arrive at taxable income. It is therefore implicit in the decision to use financial accounts as the starting point for determining the GloBE tax base that certain permanent differences will arise between that local tax base and the GloBE tax base. If there is agreement on a common tax base for the GloBE rules it follows that such permanent differences are to be expected and it would not be possible or desirable, from either a policy or a design perspective, to develop a comprehensive set of adjustments that will bring the GloBE tax base fully into line with the tax base calculation rules of all Inclusive Framework members. Nevertheless, some adjustments to financial accounts are appropriate based on the policies of the GloBE rules and tax policy more generally.

178. In order to justify adopting or rejecting potential adjustments to the financial accounts to arrive at the GloBE tax base, it is necessary to evaluate permanent differences using an agreed set of principles. The pertinent principles for evaluating permanent differences are materiality and commonality. Specifically, in order to avoid disproportionate outcomes that are out of line with the intended outcomes under GloBE, a Constituent Entity's profit (or loss) before tax, as determined under the applicable financial accounting standard, should only be adjusted to exclude material items that are commonly excluded from the tax base of Inclusive Framework jurisdictions. Furthermore any adjustments should be kept to a minimum in order to minimise complexity. Set forth below is an exclusive list of adjustments to financial accounts that have been agreed by the Inclusive Framework as being necessary and appropriate for calculating the GloBE tax base. In keeping with the desire to minimise both the number and complexity of required adjustments, the adjustments described in this Section that exclude income do not require a correlative exclusion of expenses, other than some covered taxes, attributable to that income.

Dividends and equity method accounting

179. The GloBE rules generally require the GloBE tax base and covered taxes of Constituent Entities to be determined on a separate entity basis. Dividends received from other Constituent Entities would ordinarily be included in the separate entity computation of profit (or loss) before tax and thus would be included in the starting point of the GloBE tax base. Similarly dividends received from a corporate entity in which the shareholder holds a minority interest, commonly referred to as "portfolio dividends", will also be included in the profit (or loss) before tax of the subsidiary receiving the dividend. In many jurisdictions, dividends are wholly or partially excluded, from the taxable income of a corporate shareholder. This permanent difference between the financial accounting treatment and the rules for taxing dividends under local law could give rise to a GloBE tax liability in respect of dividends unless the GloBE rules permit the taxpayer to make a corresponding adjustment for the purposes of calculating the GloBE tax base.

Intra-group dividends

180. Dividends distributed from one Constituent Entity of an MNE Group to another Constituent Entity of the same MNE Group must be excluded from the GloBE tax base because they represent income that has already been included in the GloBE tax base. Failure to exclude such dividends from the recipient's GloBE tax base could result in double taxation of the same income, which would be inconsistent with the policies of the GloBE rules. This rule applies irrespective of whether the Constituent Entity receiving the dividend owns a controlling interest in the distributing Constituent Entity.

Portfolio dividends

181. In many Inclusive Framework jurisdictions, dividends are excluded, in whole or in part, from the taxable income of a corporate shareholder (including through the use of a dividends received deduction). These dividend exclusion rules are often referred to as participation exemptions. Dividend exemptions, exclusions, or credits are usually granted under local law in recognition of the fact that the dividend is generally paid out of retained earnings that have already been subject to tax in the hands of the distributing company. Taxing these dividends under the GloBE rules would therefore give rise to the risk of over taxation.

182. However, some Inclusive Framework on BEPS jurisdictions do not apply their dividend exemption to all dividends received by taxpayers in their jurisdictions. Some Inclusive Framework on BEPS jurisdictions exempt dividends only if the shareholder owns a certain percentage of the equity interests in the distributing corporation (for example, 10% or more). Other jurisdictions also include a holding period requirement to their exemption qualification criteria. In addition, dividend exemptions in a number of Inclusive Framework on BEPS jurisdictions do not extend to trading securities held by financial services businesses, securities dealers and securities traders.

183. Accordingly, in many cases portfolio dividends received by an MNE Group will be subject to income tax under local law. If these dividends were excluded from the GloBE tax base, the corresponding taxes would need to be excluded as well. In addition, dividends and gains from sales of securities represent a core business activity of financial services businesses and securities traders and dealers. If such income were excluded from the GloBE tax base, it would also be appropriate to exclude the expenses incurred in deriving that income to prevent such expenses from reducing income otherwise appropriately included in the GloBE tax base. Accordingly, exclusion of dividends and gains on trading stock held by these enterprises would likely create a need to develop expense allocation rules.

184. The dividend exclusion rule under the GloBE rules contains an exception for dividends received from a corporation in which the MNE Group owns a low percentage of the equity interests. A percentage ownership test is more administrable than an exception that relies on a definition of financial services business or securities dealers and traders. However, it is anticipated that an exception based on a low percentage of equity ownership will also apply to most of the trading stocks in a financial services businesses or securities dealer. This exception eliminates the need to exclude taxes associated with these dividends and the allocable expenses.

185. Recognising the need for certainty and consistency and the advantages of bright-line mechanical rules, the Inclusive Framework on BEPS considers that a general dividend exclusion based on the holder's percentage ownership is the most straight-forward option and one that is in line with the policy outcomes under the GloBE rules. Further work is necessary, however, to decide the appropriate ownership threshold, both for the exclusion of dividends and the exclusion for gains and losses on the disposition of stock described below. The determination of the threshold will be based on a survey of existing participation exemptions of various Inclusive Framework on BEPS jurisdictions. Consideration will also be given to whether there should be different rules for dividends on stock in domestic and foreign corporations. In addition, depending on the final design of rules for excluding dividends and gains on portfolio from the

GloBE tax base, the Inclusive Framework on BEPS needs to consider whether the related expenses should also be excluded and how those expenses should be measured.

Use of equity method

186. As explained in Chapter, Associate entities and joint ventures are not Constituent Entities. Ownership interests in Associate entities and joint ventures are generally accounted for using the equity method. Under the equity method, the owner includes in income its proportionate share of the entity's after-tax income or loss and increases or decreases the carrying cost of the investment by the same amount. The income included by the owner under the equity method is thus equal to the amount of dividends the owner would have received if the entity had distributed its annual income. Actual distributions reduce the carrying cost of the investment but are not included in the owner's financial accounting profit (or loss).

187. For tax purposes, a shareholder with a significant interest in a foreign corporation will not ordinarily be required to include the income of that entity in the shareholder's taxable income until distribution, absent a CFC or similar rule. The equity method, however, includes the owner's proportionate share of the entity's after-tax income or loss in the year earned by the Associate entity of joint venture. Nonetheless, the equity method income is more like dividend income than consolidated income because the amount included in the shareholder's income is the net income of the entire investment on an aggregate basis.

188. Accordingly, the rule generally excludes both income and loss attributable to an interest in an entity that is accounted for by the MNE Group under the equity method from the income of the shareholder. Section. sets out special rules for the treatment of investments in Associate entities and joint ventures under a simplified income inclusion rule.

189. The determination of whether an entity is an Associate or joint venture is based on the ownership of that entity held by the MNE Group. Thus, if twenty Constituent Entities of the same MNE Group each own 5% of the same entity, that entity is a Constituent Entity of the MNE Group, not an Associate entity of each Constituent Entity shareholder.

Gain (or loss) from the disposition of stock

190. In many Inclusive Framework jurisdictions, gains arising from the disposition of stock are exempt from tax. The rationale for excluding such gains from taxation is similar (but not identical) to the rationale for excluding tax on dividends. To the extent the gain on the stock represents retained earnings, these amounts may have already been subject to tax in the issuer's jurisdiction. Similarly, to the extent the gain on the stock represents unrealised gains in assets held by the company it may be subject to tax in the issuer's jurisdiction in the future. Gain or loss on the disposition of stock that is included in the financial accounting income of the seller but excluded from the seller's taxable income would represent a permanent difference. If the difference is not adjusted for under the GloBE rules, gains on disposition will result in a lower GloBE ETR for the seller (and potential tax liability under the GloBE rules) and losses will result in a higher GloBE ETR. The rule eliminates this permanent difference by excluding from the seller's GloBE tax base all gains (or losses) arising in connection with dispositions of stock, including mergers.

191. However**,** similar to the treatment of dividends, gains and losses on the disposition of stock in a corporation in which the MNE Group owns less than a certain percentage of the equity interests are included in the GloBE tax base.

192. In a stock acquisition, the purchaser acquires the target entity's stock from the selling shareholders. After the acquisition, the underlying assets of the target entity are neither "stepped-up" nor reduced to fair value for tax purposes. Instead, the target entity accounts for its underlying assets using their historical carrying value. However, for financial accounting purposes, the purchaser recognises the acquired assets at fair value. If the target entity prepares separate financial statements, a question arises as to whether the historical carrying value of the target entity's underlying assets or the stepped-up carrying

value should be reflected in the target entity's separate financial statements. Pushdown accounting refers to the latter. Pushdown accounting is not permitted under IFRS, but other accounting standards, including US GAAP, allow pushdown accounting in certain circumstances.

193. Pushdown accounting results in the carrying values of some of the target entity's underlying assets being stepped-up to fair value for financial accounting purposes, which usually results in higher depreciation and amortization expense, which, in turn, leads to lower financial accounting income for the acquired entity. Because financial accounting income is the starting point for the GloBE tax base, the target entity's profit will generally be lower if pushdown accounting is permitted, which will increase the target entity's ETR, perhaps above the minimum rate.

194. For example, assume the same facts as described in the example above. After the acquisition, Corp C will account for Target B's underlying assets at their stepped-up carrying value (i.e., EUR 200) for purposes of preparing its consolidated financial accounts. In the case that Corp C pushes down the purchase accounting adjustments to Target B, Target B's stand-alone financial accounts will be based on the stepped-up carrying value of its underlying assets (i.e., EUR 200). However, for local tax purposes, Target B will compute its taxable income based on the historical carrying value of its underlying assets (i.e., EUR 50). This difference will result in more depreciation and amortization expense for financial accounting purposes than for tax purposes, which will result in a smaller GloBE tax base and a higher GloBE ETR for Target B.

195. The stock gain exclusion rule neutralises this effect by requiring the target entity to use the historical carrying value of its underlying assets to compute its GloBE tax base after the acquisition. The justification for this rule is that the purchase price of the target entity is equal to the present value of the estimated future income of its underlying assets. If the target entity was not sold then all the income generated by its underlying assets would be included in its GloBE tax base. On the other hand, if the target entity is sold, and a stepped-up carrying value is permitted, then the target entity's GloBE income will be reduced by higher depreciation and amortization expense, which would result in a portion of the income generated by its underlying assets being excluded from the GloBE tax base. The rule ensures that all the income generated by the target entity's underlying assets is included in the GloBE tax base. Furthermore, the rule eliminates a potentially material difference between different accounting standards (i.e., those that permit push-down accounting and those that do not).

196. However, if the seller and purchaser of a target entity and the entity itself are tax resident in the same jurisdiction and that jurisdiction treats the disposition of stock as a deemed asset sale for tax purposes in the target entity's jurisdiction (for both the seller and the purchaser) and imposes tax on the deemed asset sale at or above the minimum rate, then the target entity can use the stepped-up carrying value of its assets for purposes of computing its GloBE tax base. The justification for this exception is the gain (or loss) from the deemed asset sale has been subject to tax at or above the minimum rate.

Equity interests accounted for under the fair value accounting method

197. Some equity interests, usually interests below a 20% threshold, are accounted for using the fair value method. The fair value method re-values the equity interest periodically and changes in value are reported as gain or loss, either in the profit and loss statement or in the other comprehensive income section of the balance sheet. These gains and losses should also be excluded from the GloBE tax base to the extent gains and losses from actual sales of such securities would be excluded from the GloBE tax base.

Covered taxes

198. As noted above in Section 3.3.1, the GloBE tax base will be determined by starting with net income of the relevant entities and removing certain items of income and adding back certain expenses to arrive

at a profit (or loss) before tax. Covered taxes are the most obvious expense that needs to be added back to net income to determine profit (or loss) before tax. Moreover, because covered taxes are included in the numerator of the ETR fraction, it would be inconsistent with the policy of GloBE to also allow them as a deduction in the computation of the denominator of the fraction. Accordingly, covered taxes are not treated as an expense in the computation of the GloBE tax base.

199. Financial accounting distinguishes between income taxes and other taxes. Income taxes, as defined for financial accounting purposes, are typically separately reported in the profit and loss statement. Taxes that are not considered income taxes are treated like operating expenses and may not be separately identified in the income statement. The definition of covered taxes under the GloBE rules is broader than the definition of income taxes for financial accounting purposes, and therefore, both covered taxes identified as income taxes in the financial accounts and other covered taxes must be added back to the net income to determine profit (or loss) before tax.

Stock-based compensation

200. Generally, for tax purposes, a corporation is entitled to deduct the value of stock-based compensation based on the ultimate market value of the stock. For example, a corporation may be able to deduct the present value of the stock option at the time of issuance or over the term of the option and then the difference between the present value at the time of issuance and the ultimate market value when the option is exercised by the holder. For financial accounting purposes, companies generally account for stock based compensation based on the present value of the stock option at the time of issuance and amortize that amount over the vesting period. In this case, if the market value of the stock increases over the life of the option, the corporation will deduct an amount for tax purposes that is higher than the amount expensed for financial accounting purposes, which is a permanent difference. This difference between financial accounting income and the local tax base will generally result in a lower GloBE ETR, perhaps below the minimum tax rate.

201. There is a different policy behind the treatment of stock-based compensation for financial accounting and tax purposes. Financial accounting rules focus on the economic position of the reporting entity, where changes to the ownership of the entity are reflected in adjustments in respect of earnings per share. Tax policy tends to treat the issue of stock-based compensation as an expense of the company and as income of the option holder, similar to other compensation for services rendered to the company. The tax policy justification for allowing the corporation to deduct the ultimate market value of the stock option is that the option holder will include the same amount in its taxable income.

202. The rule eliminates the permanent difference by allowing stock-based compensation as a deduction in the GloBE tax base computation to the extent it is allowed and at the same time applied as a deduction in the local tax base computation. In other words, the rule conforms the treatment of stock-based compensation to the local tax treatment. In principle, the rule applies to stock-based compensation for employees and non-employees. However, if the local tax base applies different rules for employees and non-employees, the GloBE tax base would conform to those rules. This rule is consistent with the principles for evaluating permanent differences. In particular, stock-based compensation can be material and some form of deduction is commonly allowed by Inclusive Framework jurisdictions. Furthermore, the deduction is consistent with ensuring a single level of taxation in respect of these instruments.

203. However it is recognised that allowing stock-based compensation to reduce the GloBE tax base only to the extent it is deductible for local tax purposes means that stock-based compensation would never be deductible from the GloBE tax base for jurisdictions that do not impose a corporate income tax, even if the compensation income is subject to tax in the local jurisdiction. As a result, MNEs are allowed to reduce the GloBE tax base by stock-based compensation expense as recognised for financial accounting purposes (rather than local tax purposes), in those jurisdictions that do not have a corporate income tax

system. This special rule is subject to the condition described in Section 3.4.1 below that the item of expense must be able to be reliably and consistently traced to the entity in the relevant jurisdiction.

Bribes

204. Bribes are treated as expenses under financial accounting rules but are not deductible for tax purposes in most Inclusive Framework jurisdictions. A tax deduction for this item is disallowed for public policy reasons. Bribery hinders competition, distorts trade and harms consumers and taxpayers. It can also undermine public support for government. Denying a tax deduction serves as a strong symbol of a common international commitment to combat bribery. Therefore, members of the Inclusive Framework consider that a bribe should not be deductible under the GloBE rules.

205. To the extent a bribe reduces financial accounting income but is disallowed for tax purposes it represents a permanent difference. This difference between financial accounting income and the tax base will result in a higher GloBE ETR. The rule eliminates this permanent difference by disallowing a deduction for bribes in the GloBE tax base.

206. Bribes may be relatively easy to identify as they are commonly disallowed for local tax purposes. Furthermore, adjusting for this item is not expected to result in any significant added complexity and compliance costs because bribes are generally rare and non-recurring items.

207. As a practical matter, bribes may not be identified as such by local tax authorities until several years after the payment is actually made. The rules applicable to post-filing adjustments to local tax liability would apply when the bribe is discovered and disallowed for local tax purposes.[6]

208. Consistent with the principles for evaluating permanent differences, this rule recognises that bribes, while rare, can be material and a deduction for this expense is commonly disallowed in Inclusive Framework jurisdictions.

Fines and penalties

209. Similar to bribes, fines and penalties imposed by a government are commonly disallowed for tax purposes. However, the policy rationale is slightly different. The policy rationale for denying a deduction for bribes is primarily to show a common international commitment to combat bribery and therefore under no circumstance should a bribe be deductible, for any purpose, and in any amount. Whereas the policy rationale for denying a deduction for fines and penalties is to limit the economic cost to only the person that committed the act; which would be diluted if the taxpayer were allowed to share the burden of the penalty with all taxpayers (by way of tax deduction for it).

210. However, fines and penalties, particularly those for minor offenses such as traffic tickets, are more frequent than bribes and vary widely in amount. They can range from a EUR 50 traffic ticket incurred by a trucking company to a multi-million euro fine for securities law violations incurred by a large bank. Recognising the de minimis nature of many fines and penalties, the GloBE tax base excludes deduction of only fines and penalties of EUR 50,000 or more. The exclusion therefore applies only to large fines (EUR 50,000 or more in equivalent currency) but it includes fines that may be levied in respect of the same activity on a periodic basis (e.g. daily fines) that in the aggregate equal or exceed EUR 50,000 in a single year. A periodic fine or penalty includes a fine or penalty that is assessed periodically until corrective action is taken, but does not include separate fines that are for the same type of offense committed upon multiple occasions, such as traffic tickets. The purpose of the threshold is to continue to allow deductions for smaller fines that may not be specifically recorded as separate items in the accounts of the Constituent Entity. This approach avoids the complexity of tracking small fines and penalties for GloBE purposes while at the same time preventing MNEs from escaping a top-up tax because of a few large, non-deductible, fines or penalties. It is also in line with the public policy considerations supporting an adjustment for bribes and consistent with the principles for evaluating permanent differences, including materiality. Interest charges

for late payment of tax or other liabilities to a governmental unit are not considered fines or penalties for this purpose.

Gains and losses on restructuring

211. Transfers of assets among Constituent Entities in connection with a restructuring or reorganisation of the MNE Group commonly benefit from a tax deferral provision. Generally, the gains and losses on transfers of assets in connection with a reorganisation are deferred by requiring the acquiring entity to take the same carrying cost in the asset as the transferor of the asset. This preserves the built-in gain or loss on the asset at the time of the reorganisation and will be realised through use of the asset in the production of income or upon sale or other disposition outside the group. Transactions between group members are similarly eliminated in consolidation under financial accounting rules. Under the GloBE rules, however, gains and losses on transactions between Constituent Entities will generally be recognised under separate company accounting. The difference between the local tax deferral rules and the GloBE separate company accounting rules would tend to lower the ETR in jurisdictions from which the assets are transferred, possibly creating GloBE tax liability.

212. Given the commonality of tax rules in Inclusive Framework on BEPS jurisdictions that allow for gain and loss deferral in connection with reorganisations as well as the materiality of the differences between these local tax rules and the GloBE rules, Inclusive Framework on BEPS members consider it appropriate to provide a mechanism to mirror the local tax deferral under the GloBE rules. In general, it is anticipated that an MNE Group would exclude the gain or loss on a transfer of property, including intangible property, between two Constituent Entities and reduce (increase) the basis of the property in the hands of the acquiring Constituent Entity by the amount of the excluded gain (loss) if the transfer was made in connection with a non-taxable reorganisation or re-structuring. Further work, however, is required to develop and refine the mechanisms that will achieve the appropriate outcomes and to delineate the circumstances under which the rules will apply.

Covered taxes on excluded income

213. Intra-group dividends may be subject to a net basis tax in the shareholder's jurisdiction or subject to a withholding tax in the jurisdiction of the distributing Constituent Entity. Although the dividend is excluded from the GloBE tax base, such taxes represent new or additional taxes on the income of the distributing Constituent Entity that has been included in the GloBE tax base. Thus, such taxes are properly taken into account in computing the ETR of the Constituent Entity that earned the underlying income. See Section 3.4.2.

214. In some cases, a Constituent Entity of an MNE Group may be liable for covered taxes on income from an ownership interest in an entity that is not a Constituent Entity. For example, a Constituent Entity may be subject to a withholding tax on portfolio dividends received from an investment in a corporation or subject to tax under a CFC regime on a minority ownership interest in a CFC.

215. Similarly, a Constituent Entity that owns a minority interest in a partnership or other tax transparent entity or arrangement that is accounted for using the equity method for financial accounting purposes may be subject to net basis tax on its share of a partnership's, entity's, or arrangement's net income. Because income the interest is accounted for using the equity method of accounting, however, it is generally excluded from the Constituent Entity owner's GloBE tax base.

216. Any tax paid in connection with excluded income must be excluded from the numerator of the GloBE ETR computation for the jurisdiction of the owner. The rationale for this exclusion is that these items of income are permanently excluded from the GloBE tax base and hence the denominator of the GloBE ETR calculation. Therefore, it is appropriate to correspondingly exclude any taxes on these items of income from the numerator of the GloBE ETR calculation. The key distinction between taxes imposed on intra-

group dividends and taxes imposed on other excluded dividends and equity method income is that the underlying income that funded the intra-group dividend was previously included in the MNE Group's GloBE tax base when earned, whereas the income that funded the other dividends and equity method income is excluded from the GloBE tax base. Taxes paid on any dividends included in the GloBE tax base are included in the numerator of the ETR computation.

217. Like taxes on dividends, taxes on stock gains may arise in connection with sales of stock in a Constituent Entity or a non-Constituent Entity. Because of the rule that excludes gains (or losses) from the seller's GloBE tax base arising in connection with the disposition of stock, any corporate taxes imposed on the seller's gain generally should be excluded from the numerator of the GloBE ETR calculation in the seller's jurisdiction.

Investment returns of life insurance policy holders

218. Certain life insurance products provide both an insurance policy and an investment return to the owner of the policy. The life insurance company manages the investment component for the benefit of the policy owner. The investment assets are nominally owned by the life insurance company but the assets or the earnings on, and proceeds from disposition of, the assets are beneficially owned by the policy owners. Some accounting standards may require the life insurance company to include the investment returns on the policy holders' assets in its profit (or loss) statement with an adjustment to the equity section of the balance sheet to reflect the fact that the earnings do not belong to the company. Investment earnings that inure exclusively to the benefit of policy holders should not be included in the insurance company's GloBE tax base. Accordingly, if an insurance company's financial accounting standards include earnings beneficially owned by policy holders in the income of the insurance company, a permanent adjustment to the insurance company's GloBE tax base is required with respect to those earnings. Any covered taxes arising in respect of such income must also be excluded from the GloBE ETR computation.

Adjustment for Pillar One Outcomes

219. Pillar One applies before Pillar Two. Depending upon the final design of Pillar One, an adjustment may be required to the GloBE tax base of one or more jurisdictions to properly reflect Pillar One outcomes.[7] Covered taxes associated with that income would need to be assigned accordingly.

3.3.5. Modification to address immediate expensing and accelerated depreciation of assets

220. Immediate expensing and accelerated depreciation of business assets is one of the most common income tax incentives offered by jurisdictions. Consequently, these tax incentives likely will be a common cause of significant temporary differences. These tax incentives may cause the ETR in the jurisdiction to fall below the minimum tax rate, producing tax liability under the income inclusion rule, and resulting in significant and frequent IIR tax paid and ultimately IIR tax credits. The GloBE tax liability arising from this temporary difference will disgorge the tax benefits intended by the tax incentive. Furthermore, in capital-intensive businesses, there is a significant risk that continuous re-investments in assets may prevent the use of the IIR tax credits for an extended period of time and perhaps for the life of the business, potentially leading to over-taxation.

221. The carry-forward rules described in Chapter ensure that tax is paid up to the minimum rate *over time*. However, they can also reverse, in whole or in part, the timing benefit intended to be produced by domestic tax rules allowing immediate expensing and accelerated depreciation for tax purposes. A solution to prevent the GloBE rules reversing these timing benefits will be developed as part of the development of model rules (see Section). This solution must, however, be workable and keep complexity to a minimum.

Broadly, the Inclusive Framework on BEPS has considered two potential solutions, as described in the paragraphs below.

222. One approach considered would leverage deferred tax accounting used by the Constituent Entity with respect to depreciable property that is eligible for immediate expensing or accelerated depreciation for tax purposes. Deferred tax accounting neutralises the effect on the ETR of immediate expensing and accelerated depreciation for tax purposes, just like any other temporary difference. Leveraging from deferred tax accounting principles, the carry-forward approach could be modified such that the numerator of the ETR fraction (i.e., taxes paid) is increased by the deferred tax liability associated with an investment in property or accelerated depreciation during the year. To avoid the tax being double-counted in the numerator, however, a corollary rule would be needed to reduce the covered taxes otherwise computed in each subsequent year by the annual decrease in the deferred tax liability with respect to the asset. However, this approach suffers from the problem of allowing the tax expense to be determined based on estimates of taxes to be paid in the future as well as the other shortcomings associated with deferred tax accounting.

223. Another approach would be to compute the GloBE tax base using the cost recovery allowance or depreciation rates and conventions that the MNE used for local tax purposes in place of the depreciation rates and rules used for financial accounting purposes. Under this approach, the local tax depreciation rules would be applied to the carrying cost of assets as determined for financial accounting purposes. The relevant depreciation rules would include depreciation rates, depreciation periods, and placed in service conventions. It would not, however, permit deductions in excess of the actual cost of the asset. This approach would significantly reduce temporary differences in respect of the carrying cost of depreciable property.[8]

224. The use of the tax depreciation rules rather than the financial accounting depreciation introduces additional complexity into the computation of the GloBE tax base and represents a departure from the policy of determining the GloBE tax base using financial accounts. However, using the tax depreciation rules would eliminate a significant temporary difference and reduce both the frequency and amount of IIR tax paid due solely to temporary differences. Overall, this modification to the financial accounts to determine the GloBE tax base may be less burdensome from a compliance and administration perspective than a proliferation of IIR tax credits.

225. An additional complexity associated with immediate expensing and accelerated depreciation arises from the capitalisation of depreciation to inventory costs. Differences between book and tax accounting for inventoriable depreciation expense and how those differences could be mitigated must be considered as part of the design and implementation of this special rule.

3.3.6. Modification to address distribution-based corporate income tax systems

226. Some members of the Inclusive Framework have income tax regimes that impose an income tax on a corporation when the corporation's income is distributed to its shareholders, rather than when it is earned. The tax rates in these jurisdictions may equal or exceed the agreed minimum rate of tax on the GloBE tax base, thereby ensuring that ultimately the income is not subject to a low rate of tax when the earnings are eventually distributed. Absent a distribution, however, the income is not subject to the distribution tax in the year it is earned and included in the financial accounts.[9] This means that the income would be subject to tax under the GloBE rules as the covered tax expense for the year will be below the minimum tax rate in respect of the financial income. Exempting such income from the GloBE rules entirely, however, would be inappropriate because the tax may not in fact be paid for an extended period of time, which would have the effect of permitting near permanent deferral of tax on income generated in these jurisdictions. Allowing indefinite deferral of tax on income would lead to BEPS concerns equivalent to those raised by stateless income structures.

227. Absent special rules, to avoid tax liability under the GloBE rules, MNE Groups with Constituent Entities subject to a corporate distribution tax regime would need to correctly estimate the amount of the GloBE tax base in the jurisdiction for the year before year-end and distribute enough earnings so that the local tax liability incurred on those earnings equalled or exceeded the minimum tax rate. For example, if the distribution tax rate were 20% and the minimum tax rate were 10%, the Constituent Entities in the jurisdiction would need to distribute an amount equal to half of the GloBE tax base before year-end in order to incur a local tax liability equal to the minimum tax liability on the relevant income. In practice, MNE Groups with Constituent Entities in these jurisdictions would often be liable for tax under the GloBE rules, although subsequent distributions could produce IIR tax credits that could be used to satisfy other tax liabilities.

228. In order to avoid these results, the rule allows a corporation that is subject to a distribution-based corporate income tax regime to increase its covered taxes for the year by the amount of the distribution tax that would be due on the income for the year up to the minimum tax liability for purposes of the GloBE ETR computation in the jurisdiction, but requires the corporation to recapture the increase to the extent an equal amount of distribution tax is not paid within a reasonable period of time, e.g. 2-4 years. The specified time period would be truncated on a per share basis if shares of the entity were disposed by the MNE Group before the end of the specified number of years. Corporate income taxes paid upon distribution would be charged against the annual tax increases in chronological order. Distribution taxes paid in excess of the outstanding balance of annual tax increases in prior years would go into the ETR computation for the tax year in which paid and may create a local tax carry-forward.

229. Mechanically, the numerator of the ETR fraction (i.e., covered tax expense) is increased by the amount of the distribution tax necessary to bring the tax paid during the year (in excess of the outstanding balance of accrued minimum tax) to the minimum tax on the current year's GloBE tax base, except that the increase cannot exceed the amount of distribution tax that would be paid with respect to any undistributed portion of the current year's GloBE tax base. The annual increase in covered taxes up to the minimum tax would be recorded in a memorandum account and tracked by year. Corporate income taxes paid in connection with distributions would reduce the outstanding balance of annual increases, if any, in chronological order. If the corporate income taxes paid in connection with distributions during a year exceeded the outstanding balance of annual increases at the beginning of that year, the excess would increase the numerator of the ETR fraction and reduce the amount that needed to be accrued to achieve a minimum level of tax in that year. At the end of the specified period, any outstanding balance of an annual increase would reduce the numerator of the ETR fraction, but not below zero. The reduction to the numerator of the ETR fraction essentially imposes GloBE tax liability on the unpaid accrual of minimum tax at the end of the specified period. Any amount of the outstanding balance in excess of the numerator of the ETR fraction would create an equal amount of IIR tax liability for that year. The modification to address distribution based corporate income taxes is illustrated in Annex, Example 3.3.6A and Example 3.3.6B.

3.3.7. Treatment of government grants and tax credits

230. This Section addresses how government cash grants and tax credits should be taken into account in the ETR calculation under the GloBE rules (IIR and UTPR). Specifically, an approach is set out for determining whether, and under what circumstances, the grant or credit should be treated as part of the recipient's income or as a reduction in a covered tax liability.

Accounting treatment of government grants and tax credits

231. Consistent with the general approach for determining the GloBE tax base, the starting point for determining whether the grant or tax credit should be recognised as income or a reduction to tax liability is to look to existing financial accounting rules.

232. Under IFRS the accounting treatment for government grants and other forms of government assistance is prescribed by IAS 20. That accounting standard provides that government grants should be recognised as income on a systematic basis over the periods in which the entity recognises expenses for the related costs for which the grants are intended to compensate.

233. Government grants are defined broadly under IAS 20 as assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. Government is understood broadly in IAS 20 and includes central and local government bodies as well as all sorts of government agencies and similar bodies, including at the international level. Grants are usually provided as an incentive for an entity to engage in an activity that would not be commercially justified without those grants. This includes, for example, a forgivable loan when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan (IAS 20.10). The benefit of a government loan at a below-market rate of interest is also treated as a government grant (IAS 20.10A). IAS 20 also covers other forms of government assistance whereby the action by government is designed to provide an economic benefit that is specific to an entity or range of entities qualifying under certain criteria. Excluded from the scope of IAS 20 are transactions with government which cannot be distinguished from the normal trading transactions of the entity (e.g. government procurement policy that is responsible for part of an entity's sales) and those forms of government assistance which cannot reasonably have a value placed on them, such as free technical or marketing advice and the provision of guarantees (IAS 20.35).[10] Other forms of government assistance affecting only general conditions, such as the provision of transportation or communication infrastructure available on an ongoing basis to the general public or the imposition of trading constraints on competitors, are also out of scope of IAS 20. Given that the GloBE tax base is based on the financial accounts, government assistance that is excluded from the scope of IAS 20 is not included as income in the GloBE tax base.

234. The accounting treatment of expenditure based tax credits, commonly referred to as investment tax credits (ITCs), is significantly less clear. In fact the accounting treatment of ITCs is specifically scoped out of IAS 20 (Government Grants) and IAS 12 (Income Taxes). In practice, this means that MNEs commonly account for ITCs by analogy with the requirements of IAS 20 or IAS 12. ITCs are provided by many jurisdictions to incentivise a range of business investments. ITCs can take different forms and be subject to different conditions, and entitlement to receive the ITC can be determined in a variety of ways. Some ITCs may relate to direct investment in property, plant and equipment. Other entities may receive ITCs relating to R&D or other activities. Some credits are not restricted to being realised as a reduction in current CIT. For example, where a credit exceeds the current year CIT liability, the unused credit may be carried forward to reduce future CIT or may be carried back. For some credits, the remaining portion of the credit can be used to offset other non-CIT liabilities, such as VAT or payroll taxes. Other credits may be settled directly in cash if the entity does not have sufficient taxes payable to access the credit within a certain period.

235. It is a matter of judgement to determine the most appropriate accounting treatment for an ITC based on a qualitative analysis of the legal requirements that must be met in order to generate the credit rather than a quantitative assessment of the economic outcomes for how a particular ITC is realised in practice. An ITC that is determined or limited by reference to an entity's income tax liability or provided in the form of an income tax deduction is likely to be accounted for under IAS 12 (Income Taxes) and recorded in the financial accounts as a reduction in current tax expense. If the realisation of the ITC is not dependent on the amount of taxable profit or on any past or future income tax liability generated by an entity, then it is likely to be accounted for under IAS 20 (Government Grants) and recorded in the financial accounts as other income.

236. Therefore, it is expected that generally under IFRS and equivalent accounting standards any "refundable" ITCs would be treated as income, whereas any non-refundable ITCs would be treated as a reduction in a tax liability. The term "refundable" is understood in a broad sense and covers ITCs that may become payable as cash or available as cash equivalents, including being available to be used to

discharge liabilities other than a covered tax liability. The rationale, from an accounting perspective, for treating refundable tax credits in the same way as grants is that, similar to grants, the taxpayer's entitlement to a refundable tax credit is not tied to its income or tax liability, and so in terms of economic substance grants and refundable tax credits are equivalent.

237. IFRS may treat a credit as "refundable" even if it is eligible to be refunded only after a number of years or where the taxpayer has the option to offset the credit against a non-CIT liability, such as a payroll tax or VAT liability. Most importantly, IFRS generally takes an "all-in" approach to refundability by which if a credit has some feature of potential refundability (e.g. the credit is required to be carried forward and only the unused / excess portion of the credit is refundable after a certain number of years), the entire amount of the credit is treated as income even if in practice the credit is used to offset a CIT liability, and thus may never actually be refunded.

Treatment under the GloBE *rules based on the financial accounting rules with safeguards for refundable tax credits to address risk areas*

Treatment of government grants and tax credits under the GloBE

General rule

The treatment of government grants and tax credits will be based on the financial accounting rules with safeguards for refundable tax credits to address risk areas:

(a) Where a refundable tax credit meets certain conditions, i.e. a "qualified refundable tax credit", the entire amount of the credit is treated as income (in line with the financial accounting treatment for refundable tax credits).

(b) Where a refundable tax credit does not meet the conditions, i.e. a "non-qualified refundable tax credit", the entire amount of the credit is treated as reducing a covered tax liability.

(c) For non-refundable tax credits, the entire amount of the credit is treated as reducing a covered tax liability (in line with the financial accounting treatment for non-refundable tax credits).

(d) For all government grants, the entire amount of the grant is treated as income (in line with the financial accounting treatment for government grants).

Conditions for a "qualified refundable tax credit" under the GloBE:

In order to be treated as a "qualified refundable tax credit" under the GloBE, the tax credit regime must be designed in a way so that a credit becomes refundable within 4 years from when it is first provided. Where the tax credit regime under the laws of a jurisdiction provides for partial refundability such that only a fixed percentage or portion of the credit is refundable, in order for the refundable portion of the credit to be treated as a qualified refundable tax credit, it must become refundable within 4 years from when it is first provided.

Furthermore, if a refundable tax credit regime is determined to give rise to a material competitive distortion under the review process described below, a credit granted under such a regime will not be treated as a "qualified refundable tax credit" under the GloBE.

Review process:

(a) Specific: As part of the review process for testing financial accounting standards for “material competitive distortions” described in Section 3.3.3., if an Inclusive Framework on BEPS member identifies a specific risk associated with a certain jurisdiction’s refundable tax credit regime, it can be brought to the Inclusive Framework on BEPS for review on a case-by-case basis. This specific review process would seek to identify whether the tax credit regime has been designed in a way that made it unlikely, at the time it is introduced into law, that there will be significant refunds paid to taxpayers.

(b) General: As part of a multilateral review process described in Section. looking at the operation of the GloBE rules after a certain number of years of their application, if Inclusive Framework on BEPS members identify risks associated with the treatment of tax credits and government grants that lead to unintended outcomes, the Inclusive Framework on BEPS will be asked to consider designing further conditions for a “qualified refundable tax credit” or alternative rules for the treatment of tax credits and government grants.

238. The approach treats all government grants as income and treats refundable tax credits as income where they meet certain conditions (referred to as “qualified refundable tax credits”). The conditions are intended to reduce the particular risk areas identified specifically in relation to refundable tax credits. Refundable tax credits that do not meet the conditions (referred to as “non-qualified refundable tax credits”) and all other tax credits are treated as a reduction in a covered tax liability. This approach is based on the principle underpinning the approach to the design of the GloBE rules to start with the relevant financial accounting rules subject to any agreed adjustments as necessary.[11]

239. The approach generally aligns with the financial accounting treatment for government grants and non-refundable tax credits, and, therefore, does not require adjustments for these under the GloBE rules. It also follows the accounting treatment for refundable tax credits where the terms of the credit satisfied the conditions of a qualified refundable tax credit, and only departs from the financial accounting treatment for non-qualified refundable tax credits. For a non-qualified refundable tax credit that is recorded as income for financial accounting purposes, an adjustment will be required to remove the full amount of the credit from the measure of net income in the GloBE tax base (denominator) and instead treat this as a reduction in the GloBE covered tax liability (numerator). An adjustment may also be required for a qualified refundable tax credit, to the extent that such a credit reduces corporate income tax payable for domestic tax purposes, to add this amount back to the GloBE covered tax liability (numerator) as the full amount of the credit will be treated as income in the GloBE tax base (denominator).

Conditions for a “qualified refundable tax credit”

240. Refundable tax credits are typically used by governments to incentivise activities, such as R&D, where there is significant uncertainty as to whether the expenditure will ultimately result in a net return for the investor. By making these credits refundable, the government reduces the risk associated with these types of investments and puts large and small taxpayers on an equal footing, by ensuring the subsidy is available regardless of whether the person undertaking the activity is paying taxes.

241. The conditions that a refundable tax credit would need to satisfy to be treated as a qualified refundable tax credit are intended to reduce the risk that tax credits could be used as a mechanism for distorting the GloBE ETR calculation by being legally constructed as “refundable” but with terms that make it unlikely, in practice, that the credit will actually be refunded. In particular, this risk can be specifically identified when a tax credit regime is designed in a way so that a credit is only refundable after a long period of time.

242. The primary condition to safeguard against this particular risk is to stipulate that, in order to be treated as a “qualified refundable tax credit” under the GloBE, the tax credit regime under the laws of a

jurisdiction is designed in a way so that a credit must become refundable within four years from when it is first provided. This condition is intended to be a bright-line test that should be easy to apply in order to provide certainty to taxpayers and tax administrations and minimise compliance costs. The analysis would be based on a qualitative assessment of the tax credit regime as a whole, and not on a taxpayer specific basis. Where the tax credit regime under the laws of a jurisdiction provides for partial refundability, such that only a fixed percentage or portion of the credit is refundable, in order for the refundable portion of the credit to be treated as a qualified refundable tax credit, it must become refundable within 4 years from when it is first provided. Refundable means either payable as cash or cash equivalents, including being available to be used to discharge liabilities other than a covered tax liability. Furthermore, as part of a multilateral review process set out below, further conditions could be developed to mitigate specific risks identified where refundable tax credit regimes are introduced in a way that result in material competitive distortions in the application of the GloBE rules.

Review process

243. A multilateral review process will be established to address any residual risk that refundable tax credit regimes could be designed to circumvent the condition set out above to manipulate the GloBE ETR outcomes. This review process will be designed to identify risks associated with the design of a jurisdiction's refundable tax credit regime, in particular where the terms of the tax credit are designed in a way that makes it unlikely, at the time such credit is introduced into law, that there will be significant refunds paid to taxpayers. The review process could identify hallmarks for those features of a tax credit regime that indicate risks under the GloBE rules, such as where the tax credit regime is targeted at a particular taxpayer or small group of taxpayers.

244. A specific review process focused on refundable tax credit regimes could be incorporated into the same review process that allows Inclusive Framework on BEPS members to consider whether a financial accounting standard "results in material competitive distortions in the application of the GloBE rules".[12] That is, if an Inclusive Framework on BEPS member identifies a specific risk associated with a certain country's refundable tax credit regime, it is brought to the Inclusive Framework on BEPS for review on a case-by-case basis. The logic of dealing with the review of refundable tax credit regimes as part of the same process is that the core concern is the financial accounting treatment of those refundable tax credits. Criteria will be developed to determine when a refundable tax credit regime can be brought to Inclusive Framework on BEPS for review to provide clarity and certainty to taxpayers and to minimise burdens on tax administrations. The guiding principle for this review process will be focused on identifying refundable tax credit regimes that have the effect of distorting the GloBE ETR calculation.

245. In addition to a specific review process for refundable tax credit regimes as set out above, as part of a general multilateral review of the operation of the GloBE rules after a certain number of years of their operation[13], if Inclusive Framework on BEPS members identify risks associated with the treatment of tax credits and government grants that lead to unintended outcomes, Inclusive Framework on BEPS could be asked to consider designing further conditions for a "qualified refundable tax credit" or, if necessary, explore alternative rules for the treatment of tax credits and government grants. This analysis would be based on empirical and historical data with respect to the tax credit regime as a whole, and not on a taxpayer specific basis.

246. The specified conditions for qualified refundable tax credits combined with a review process should provide sufficient disincentives to neutralise potential distortive behaviour.

3.3.8. Emergency government assistance

247. The provision of emergency government assistance (e.g. government grants and tax credits designed to mitigate the impact of Covid19) may lead to a lower GloBE ETR calculation that could trigger a top-up tax under the GloBE rules. Further consideration will be given to whether there should be a special

exemption as part of the development of the model rules (see Section) to ensure that emergency government assistance should not give rise to a tax liability under the GloBE. Such rules would establish the criteria for excluding emergency government assistance from the GloBE ETR calculation, including, for example, where the benefit is:

(a) provided by a government;

(b) limited in duration, for example the assistance is available for no longer than [x] years;

(c) intended to provide financial support in response to an external shock; and

(d) provided to a certain category of taxpayers or industry that has been, or is expected to be, materially affected by such an external shock.

3.4. Jurisdictional blending

248. The Sections above deal with the general determination of an MNE's income for GloBE purposes and the covered taxes on that income. The next Sections describe how to determine an MNE's ETR under the GloBE rules on a jurisdictional basis. Under a jurisdictional blending approach, a GloBE tax liability will arise when the ETR of a jurisdiction in which the MNE Group operates is below the agreed minimum rate. To determine the jurisdictional ETR, the MNE Group must first determine the income of each entity and then assign that income and the covered taxes paid in respect of that income to the relevant jurisdiction. More specifically, the jurisdictional ETR computation involves two steps: the first step is to determine the income of each entity in the group and make adjustments, at the entity level, in respect of consolidated items (Consolidation Adjustments); and the second step is to assign the income of and taxes paid by each entity to a jurisdiction. This Section describes the rules for making these determinations and assignments.

3.4.1. Consolidation adjustments

Consolidation adjustments

Reliance on entity level financial information

MNEs can rely on the entity-level financial information that is used in preparing the parent's consolidated financial accounts to determine the profit (or loss) before tax of each Constituent Entity, even if such financial information is not prepared in strict accordance with the parent's accounting standard where (a) it is reasonable to do so, (b) the information is reliable, and (c) the use of such information does not result in material permanent differences from the accounting standard of the parent.

Treatment of intercompany items

Income, gains, expenses, and losses attributable to transactions between Constituent Entities should not be eliminated and should be recorded in accordance with the arm's length principle. Intercompany items can be excluded, however, to the extent the transaction is between Constituent Entities in the same jurisdiction. Items recognised in consolidation

Other items maintained at the consolidated level should only be taken into account in determining the profit and loss of a Constituent Entity where those items can be reliably and consistently traced to that entity.

Reliance on entity level financial information

249. Even where a subsidiary maintains financial accounts using the parent entity's accounting standard, the subsidiary is unlikely, in many cases, to be able to produce an income statement on a stand-alone basis that would meet the rigorous standards an independent financial auditor would apply in assessing compliance with the parent entity's accounting standard. There are several reasons for this.

250. First, the materiality threshold for a subsidiary on a stand-alone basis would generally be much lower than the materiality standard of the consolidated group. The accounting treatment of a transaction or item that is out of step with the parent entity's accounting standard may be acceptable in the context of the consolidated group's financial accounts. However, on a stand-alone company basis, the transactions or items may be material such that deviation from a strict application of the accounting standard would be unacceptable.

251. Second, in the case of an acquisition, the purchaser is required to record the assets and liabilities of the acquired business at fair value based on an allocation of the purchase price (this practice is commonly referred to as "purchase accounting"). Purchase accounting commonly results in increased or decreased carrying values for fixed assets previously included in the acquired entity's financial accounts and recording new intangible assets that were not previously included in the acquired entity's financial accounts. The purchaser uses these fair value measures to prepare its consolidated financial accounts. In many cases, however, the fair value adjustments are not "pushed-down" to the acquired entity's stand-alone financial accounts. In fact, push-down accounting is not permitted under some accounting standards, including IFRS. Instead, many MNE Groups hold purchase accounting adjustments at the consolidated level, i.e., in financial accounts that are used exclusively to prepare the group's consolidated financial statements. Adjustments for purchase accounting items is further discussed below.

252. Third, similar to purchase accounting adjustments, certain other financial accounting items are maintained at the consolidated accounting level, rather than the financial accounts of stand-alone legal entities. Common examples include stock-based compensation expenses, foreign currency gain and loss, and fair value accounting adjustments related to derivatives and pension liabilities. Adjustments for stock based compensation expenses, and other items held in consolidation are discussed below.

253. Finally, it is recognised that not every MNE Group will prepare entity-level accounts. Some businesses prepare their accounts on a business line rather than an entity basis. When entity level accounts are required for local statutory or tax purposes, then these are prepared based on the business line accounts. Thus, while these local statutory accounts are derived from those that are used for consolidation purposes, they are not the basis for preparing the consolidated accounts.

254. For the reasons described above, the profit (or loss) before tax of a particular subsidiary that is used in the preparation of or derived from the preparation of the MNE Group's consolidated financial statements may not be, on a stand-alone entity basis, in perfect conformity with the parent's financial accounting standard. In fact, on a stand-alone basis, the differences could be sufficiently significant that a financial accounting auditor would require adjustments.

255. The gap between financial accounts prepared in perfect accord with the parent's accounting standard and the financial accounts that are likely to be maintained by the subsidiaries of an MNE raises a question of what it means to compute a subsidiary's profit (or loss) before tax using the "financial accounting standard used by the parent entity in the preparation of its consolidated financial statements." In other words, does the requirement mean that each subsidiary must compute its profit (or loss) before tax in strict accordance with the parent entity's financial accounting standard as if it were a stand-alone entity? Alternatively, does the requirement mean more generally that each subsidiary must start with the profit (or loss) before tax that is used in the preparation of the parent entity's consolidated financial statements?

256. The rule set out above adopts the latter interpretation. A significant benefit of using financial accounts as a starting point for the GloBE tax base is the efficiency of beginning with an income measure that has already been computed for other purposes. A requirement to compute the profit (or loss) before tax of each Constituent Entity under the more rigorous application of the parent entity's financial accounting standard than is required for that entity in the preparation of the MNE Group's consolidated financial statements would impose significant additional compliance costs. In addition, that income computation would not be subject to scrutiny by the financial accounting auditors. In contrast, the Constituent Entity's profit (or loss) before tax that is computed in connection with the preparation of consolidated financial statements under the parent entity's accounting standard is subject to audit, albeit with a materiality threshold established on a consolidated group basis.

257. As already noted above, the profit (or loss) before tax that is used in consolidation may not be a perfect application of the parent entity's accounting standard. However, if an independent auditor reviewing the consolidated financial statements would not require any adjustments to the income from that subsidiary, the same approach would be acceptable for computing the GloBE tax base. Of course, if an independent auditor required adjustments in respect of the subsidiary's financial accounts, those adjustments would be required for purposes of computing the GloBE tax base as well, unless they are related to income or expense excluded from the GloBE tax base.

258. The rule permits the profit (or loss) before tax that is used in the preparation of the consolidated financial accounts to be used in the computation of the GloBE tax base in lieu of a strict application of the Parent's financial accounting standard, but only under certain conditions that ensure data integrity. First, it must be reasonable, meaning that better financial information (i.e., financial information kept in strict accordance with the parent's accounting standard) is unavailable. This criterion could be met if the local subsidiary has no compliance or regulatory obligation to prepare stand-alone financial accounts in line with the parent's accounting standard. Second, the information must be reliable, meaning that there must be appropriate mechanisms in place to ensure that the information is recorded accurately. In this regard, the financial accounting internal controls and accounting processes employed by the subsidiary must be tested and deemed acceptable to the financial accounting auditor pursuant to Generally Accepted Auditing Standards of the parent's or subsidiary's jurisdiction. A good set of generally accepted auditing standards requires a review not only of the financial statements, but also a review of the company's internal controls and other processes which bear on the integrity of the underlying data. Third, the financial information used must not result in material permanent differences from the financial accounting standard of the parent, determined by reference to the relevant entity and not with respect to the group's consolidated materiality threshold.[14]

Treatment of intercompany items

259. Using a jurisdictional approach to blending under the GloBE rules will require transactions between Constituent Entities in different jurisdictions to be treated in the same manner as transactions with unrelated entities in order to determine the GloBE tax base for each jurisdiction. Therefore, under the rule set out above, income, gains, expenses, and losses attributable to transactions between Constituent Entities should not be eliminated and should be recorded in accordance with the arm's length principle. This has implications for both the timing and location of income.

260. In terms of timing, by not eliminating the effect of transactions between group members, a portion of the group's income or loss will be accelerated as compared to consolidated income when the buyer does not deduct its expense in the same year that the seller recognises the related income. For example, a manufacturing Constituent Entity's gain on sale to a distribution member will be offset by the distribution Constituent Entity's cost of goods sold when the latter sells those goods to a third party. If the distribution entity does not resell the goods in the same year, the combined income of all group entities on a separate company basis will exceed the group's consolidated income in that year because intercompany

transactions are eliminated in the consolidation process. When the distribution entity recognises the cost of goods sold in the subsequent year, the aggregate separate company income will be less than the group's consolidated income by the same amount. Thus, the timing of the MNE Group's income is affected by the separate company treatment, but the overall amount of income remains the same. In terms of location, by not eliminating intra-group income or loss, the MNE Group's consolidated income will be allocated between the two jurisdictions when the buying and selling entities are in different jurisdictions.[15]

261. However, jurisdictions adopting the GloBE rules may permit elimination of transactions between Constituent Entities resident in the same jurisdiction. The modification could be required or permitted at the election of the taxpayer. This would prevent a timing difference attributable to transactions between Constituent Entities resident in the same jurisdiction and likely conforms more closely to the tax accounting, consolidation, or group relief rules applicable in the jurisdiction, which would more closely align the GloBE tax base in a jurisdiction with the local tax rules. This exception is particularly beneficial in a system that addresses timing differences using a carry-forward approach.

262. If intra-group transactions are not recorded in the Constituent Entities' financial accounts based on the arm's length principle, the income and expense of each party to the transaction must be adjusted to conform to the arm's length principle. Application of the arm's length principle in the computation of the GloBE tax base is necessary to prevent misallocation of income among jurisdictions, ensure that the income of entities in each jurisdiction is taken into account at the proper time, and prevent the recognition of non-economic loses from transactions between entities in the same jurisdiction. In addition, the counterparties to an intercompany transaction are required to apply the same arm's-length price. This rule is necessary to prevent counterparties avoiding GloBE tax liability by applying transfer prices at different points within the arm's length range.

263. Transfer pricing adjustments based on the arm's length principle will often be required for tax purposes. The GloBE rules focus only on transactions between Constituent Entities within the same MNE Group and should generally follow the obligations that are imposed on those Constituent Entities under local law. Thus, requiring intra-group transactions to be reported based on the arm's length principle and at the same price under the GloBE rules may require an adjustment to the financial accounts but should not create significant additional compliance burden overall.

Items recognised in consolidation

264. Purchase accounting adjustments represent the largest and most common items of income and expense that may not be reflected in the relevant entity's separate financial accounts. When a corporation becomes a member of a consolidated financial group as the result of a stock acquisition, financial accounting rules generally require the assets of the newly acquired member to be re-valued based on their fair market values. The re-valuation results in either an increase or decrease in the carrying cost of each asset for financial accounting purposes. If the acquisition price[16] exceeds the fair market value of the tangible assets less the liabilities assumed, the relevant financial accounting rule typically will require the recording of some new intangible assets, such as goodwill. In terms of recordkeeping, however, the acquiring corporation generally will not "push down" the adjustments to the carrying value of pre-existing assets or any new intangible assets to the acquired members financial accounting records or systems. The acquiring corporation may instead account for the adjustments in its financial accounting system that is used in connection with the preparation of consolidated financial accounts, sometimes referred to as the "consolidation reporting package." This creates a potential source of discrepancy between the consolidated profit (or loss) before tax and the stand-alone profit (or loss) before tax of the acquired entity.

265. However, purchase accounting adjustments may be unnecessary for GloBE purposes given one of the rules discussed above in Section 3.3.4 in the context of adjustments for permanent differences. In particular, one of the rules is to exclude gains and losses arising from the disposition of stock. The corollary to this rule is that the acquired entity is required to use the historical carrying value of its underlying assets

to compute its GloBE tax base after the acquisition, not the post-acquisition carrying value. Therefore, the fact that the acquiring corporation may not push down purchase accounting adjustments to the acquired subsidiary is not problematic; in fact, it facilitates the correct computation of the GloBE tax base. The rule that excludes the gain (or loss) on the disposition of stock is described above in Section 3.3.4. Similarly, impairments and impairment recoveries of assets that are themselves maintained at the consolidated level should not be traced to the Constituent Entity that owns the underlying asset if the depreciation or amortisation of such assets (or the portion of the carrying cost of such assets that is held in consolidation) is not traced to the entity.

266. The parent entity of an MNE Group commonly issues stock-based compensation to employees that are on the payroll of foreign subsidiaries. In some cases, the parent will push down the compensation expense to the relevant subsidiary via a stock recharge agreement or similar arrangement. Under these agreements, the foreign subsidiary reimburses the parent entity for the costs associated with stock-based compensation issued to its employees. The foreign subsidiary may be able to claim a local deduction for the payment under a stock recharge agreement. However, local tax and accounting requirements differ in what forms of compensation are eligible, the value of the compensation that can be deducted, and accounting requirements. Some jurisdictions may allow a local tax deduction even without a recharge agreement. Other jurisdictions may not allow a local tax deduction even when a recharge agreement exists. The result is that the cost associated with stock-based compensation is pushed down to the relevant subsidiary in some cases, for example when it is required in order to receive a local deduction, but not in all cases, for example, when a local deduction is not conditioned on the existence of a re-charge.

267. Similar to purchase accounting adjustments, whether an MNE pushes down the cost of stock-based compensation may not matter for GloBE purposes given the stock-based compensation rule discussed above in Section 3.3.4 in the context of adjustments for permanent differences. In particular, the rule for stock-based compensation allows a deduction in the GloBE tax base of a jurisdiction to the extent it is allowed as a deduction in the local tax base of the subsidiary in the jurisdiction that employed or contracted with the party receiving the stock-based compensation. In other words, the treatment of stock-based compensation for financial accounting purposes is irrelevant because the rule relies on tax accounts for this particular item of expense. The use of tax accounts for stock-based compensation would be required for all Constituent Entities of the MNE Group in order to ensure consistency across group members.

268. Other financial accounting items may also be maintained at the consolidated level, rather than the financial accounts of stand-alone entities. These items may include foreign currency gain and loss and fair value accounting adjustments related to certain items. Such items should only be taken into account in determining the profit (or loss) of a group entity where those items can be reliably and consistently traced to that entity. An item can be reliably traced to an entity where it relates wholly or exclusively to that entity or it relates to a group of entities and there is a clear basis for apportioning that amount between them. This tracing method must be applied consistently by the MNE Group to items and Constituent Entities within the group and across accounting periods.

3.4.2. Assignment of income and taxes of entity to each jurisdiction

Assignment of income and taxes

Income of permanent establishments and Constituent Entities with a tax jurisdiction of residence

Profit (or loss) before tax earned by a Constituent Entity that is a permanent establishment is assigned to the jurisdiction where the permanent establishment is located. In other cases the profit (or loss) before tax earned by the Constituent Entity is assigned to its tax jurisdiction of residence.

Income of Constituent Entities without a tax jurisdiction of residence

In the case of a Constituent Entity that does not have a tax jurisdiction of residence (a stateless entity):

(a) the share of profits of each owner that is a Constituent Entity is assigned to the owner's tax jurisdiction of residence if that owner's jurisdiction treats the entity as tax transparent, and

(b) any remaining profits, including the share of profits of any owner that is a Constituent Entity whose jurisdiction does not treat the entity as tax transparent, are assigned to the stateless jurisdiction.

An owner's tax jurisdiction treats an entity as tax transparent if the owner is subject to tax on its share of the entity's income or loss in its tax jurisdiction in the same manner as if the owner directly earned its share of the entity's income or loss.

Covered taxes

Any covered tax paid by a Constituent Entity with respect to its income or income of a tax transparent entity that it owns is assigned to the same jurisdiction as the related income.

Covered taxes paid by a Constituent Entity with respect to dividends distributed by another Constituent Entity are assigned to the jurisdiction of the Constituent Entity that paid the dividend.

Overview

269. A jurisdictional blending approach under the GloBE rules requires the MNE to allocate its foreign income and taxes between the different tax jurisdictions in which it operates.[17] Generally, an MNE would be subject to tax under a jurisdictional blending approach where the tax on the income allocated to a jurisdiction was below the minimum rate. The MNE's liability for additional tax under the GloBE rules would be the aggregate of the amounts necessary to bring the total amount of tax on the income in each jurisdiction up to the minimum tax rate.

270. In order to determine, on a jurisdictional basis, whether an MNE's income is subject to a minimum level of taxation, the income earned by Constituent Entities and the covered taxes that are paid or shown as payable on the relevant return filed in respect of that income need to be correlated and assigned to the appropriate jurisdiction. Generally, the income earned by an MNE should be assigned to the jurisdiction of the Constituent Entity that earned the income, whether that Constituent Entity is a corporation or similar juridical entity or a permanent establishment of such entity, and the covered taxes paid by the MNE should be associated with the income that was the subject of the tax.

271. The starting point for determining the jurisdictional ETR is the assignment of income to jurisdictions. The rules for assigning income among jurisdictions build on the rules applicable to country by country reporting (CbCR). As noted above, the GloBE rules adopt, with some modifications, the CbCR definition of MNE Group and Constituent Entity.[18] The CbCR rules generally require MNE Groups to report

certain information in respect of Constituent Entities based on the entities' respective tax jurisdictions of residence. A permanent establishment is considered a Constituent Entity separate from its head office. For purposes of jurisdictional blending, the same approach should apply to the assignment of income among tax jurisdictions. Covered taxes in respect of a Constituent Entity's income likewise should be assigned to the Constituent Entity's tax jurisdiction. Profit (or loss) of an entity and the taxes associated therewith can only be assigned to one jurisdiction.

Assigning income

272. The income assignment rule is straightforward in the case of permanent establishments. Profit (or loss) before tax earned by a Constituent Entity that is a permanent establishment is assigned to the jurisdiction where the permanent establishment is located. This rule is consistent with CbCR. In order to avoid the risk of over-taxation, special rules may be required in respect of taxable branches, where a loss in the permanent establishment jurisdiction is taken into account in calculating the taxable income of the head office.

273. The income assignment rule is also straightforward in the case of Constituent Entities that have a tax jurisdiction of residence under the CbCR rules. Profit (or loss) before tax of such Constituent Entities are assigned to the entity's tax jurisdiction of residence. Generally, a Constituent Entity other than a permanent establishment is considered a resident in a tax jurisdiction under the CbCR rules if, under the laws of that tax jurisdiction, the member is liable to tax (other than a source-based withholding tax) therein based on place of management, place of organisation, or another similar criterion. A corporation created in a jurisdiction that does not have a corporate income tax is considered tax resident in the jurisdiction of creation, unless it is managed and controlled in a jurisdiction that does impose an income tax on the corporation on a residence basis.

274. Assigning income of Constituent Entities that do not have a tax jurisdiction of residence (stateless entities) is more challenging. As discussed in Section, this category of Constituent Entities is comprised generally of tax transparent entities and reverse-hybrid entities. A tax transparent entity is an entity or arrangement that is tax transparent in the jurisdiction of the owner and in the jurisdiction of the entity.[19] Building on the analysis in the BEPS Action 2 Report (OECD, 2015[4]), a reverse-hybrid entity is an entity or arrangement that is not tax transparent in the jurisdiction of the owner but is tax transparent in the jurisdiction in which the entity is created. An owner's tax jurisdiction treats an entity as tax transparent if the owner is subject to tax on its share of the entity's income or loss in its tax jurisdiction in the same manner as if the owner directly earned its share of the entity's income or loss. In some cases, the owner of the stateless entity may be a permanent establishment located in the tax jurisdiction in which the stateless entity conducts its business activities.

275. Under the CbCR rules, an entity that does not have a jurisdiction of tax residence is treated as a stateless entity, and, in the CbC report, its income is assigned to the "stateless" jurisdiction, which is a hypothetical jurisdiction treated as a tax jurisdiction for CbCR purposes. If the tax jurisdiction of an owner or owners of the entity treats the entity as tax transparent, the owner's share of its income is also assigned to the jurisdiction(s) of those owners. For purposes of jurisdictional blending, however, income can only be assigned to a single jurisdiction. Nonetheless, CbCR provides a useful template for assigning the income of stateless entities.

276. Adapting the CbCR approach to the GloBE rules requires the creation of a stateless jurisdiction for purposes of the GloBE rules. This stateless jurisdiction is treated the same as a tax jurisdiction for purposes of applying the GloBE rules on a jurisdictional basis. Thus, all of the income assigned to the stateless jurisdiction under this rule and the corresponding covered taxes should be aggregated for purposes of a stateless jurisdiction ETR computation and top-up tax computation.

277. The types of Constituent Entities that are treated as stateless under the rules of Section include tax transparent entities and reverse-hybrid entities. Each owner's share of the income of a stateless

Constituent Entity is assigned to that owner's tax jurisdiction, unless the owner is a Constituent Entity and its tax jurisdiction does not treat the entity as tax transparent. Thus, in the case of a tax transparent entity that is owned exclusively by Constituent Entities that are tax resident in (or, in the case of a Constituent Entity that is a Permanent Establishment, located in) jurisdictions that treat the entity as tax transparent, all of the entity's income will be assigned to the jurisdictions of those Constituent Entity owners. If the jurisdiction of a Constituent Entity owner does not treat the entity as tax transparent, the entity is a reverse-hybrid with respect to that owner and that owner's share of the entity's income will be assigned to the stateless jurisdiction. The rule also deals with situations in which non-Constituent Entities hold a minority interest in a stateless Constituent Entity of the MNE Group. The non-Constituent Entity owner's share of the income will be assigned to the jurisdiction of those owners and not taken into account by the MNE Group in the computation of the ETR or top-up tax of the stateless jurisdiction. If an owner of a stateless entity is itself a stateless entity, the rule is applied to that owner's share of the income as if that owner directly earned its share of the income.

278. As explained in Section, a business unit that is treated as a joint operation will be treated as a separate Constituent Entity if the income and expenses of the joint operation are included in the group's consolidated financial statements in proportion to the group's ownership interest in the business unit. The Constituent Entity is comprised, however, only of the MNE Group's share of the entity or arrangement as reflected in the consolidated financial statements. A joint operation may be subject to tax in a jurisdiction or may be a tax transparent entity. The general rules for determining tax residency apply to a joint operation that is treated as a Constituent Entity. Thus, the joint operation may be tax resident in a jurisdiction if it is subject to tax in that jurisdiction or, if it is tax transparent, it may be stateless. If the joint operation is a stateless entity, its income is assigned pursuant to the rules described above for stateless entities.

Assigning covered taxes

279. Covered taxes generally follow the income to which they relate under the rules for assigning covered taxes. In other words, the covered taxes associated with income assigned to a particular jurisdiction, including the stateless jurisdiction, generally are assigned to that jurisdiction.

280. Covered taxes paid with respect to the income of a permanent establishment, including taxes paid in the headquarters jurisdiction, are assigned to the location of the permanent establishment. Covered taxes paid with respect to the income of a Constituent Entity with a tax jurisdiction of residence are assigned to the Constituent Entity's tax jurisdiction. These covered taxes may be imposed by the Constituent Entity's tax jurisdiction or another tax jurisdiction. For example, withholding taxes paid in respect of a royalty received from a licensee in another jurisdiction would be assigned to the tax jurisdiction of the Constituent Entity that received the royalty. Similarly, taxes imposed on a shareholder of a Constituent Entity in respect of a dividend or under a controlled foreign company (CFC) regime should be assigned to the jurisdiction of the distributing Constituent Entity or CFC because those taxes are paid in respect of the Constituent Entity's or CFC's income. See Annex, Examples 3.4.2A, 3.4.2B, 3.4.2C, 3.4.2D, and 3.4.2G.

281. Ideally, covered taxes paid with respect to distributions of a Constituent Entity's income, including net basis taxes and withholding taxes, should be assigned to the tax jurisdiction of the Constituent Entity that earned the underlying income. However, tracking and tracing distributions through the ownership chain would be extremely complex and burdensome. Accordingly, such taxes should be assigned to the jurisdiction of the Constituent Entity that distributed the dividend that triggered the tax liability. However, a distribution from a Constituent Entity in a low-tax jurisdiction could be funded by distributions made from lower-tier subsidiaries. In such cases, net basis taxes paid by the shareholder would shelter other income of the low-taxed Constituent Entity because the distribution itself is excluded from the GloBE tax base. Targeted rules may be needed to ensure these taxes are appropriately assigned in order to address these

structures. This issue will be further considered in connection with the development of the model rules as described in Section.

282. Covered taxes arising from the sale of Constituent Entity stock are excluded from the ETR computation. Covered taxes arising from the sale of other stock are assigned to the jurisdiction of the seller to the extent the seller's gain or loss on sales of stock is included in the GloBE tax base.

283. As with other Constituent Entities, covered taxes paid or incurred on an owner's share of the income of a stateless entity are assigned to the same jurisdiction as the corresponding income. Typically, this will mean that tax imposed on each owner's share of a tax transparent entity's income will be assigned to each respective owner's tax jurisdiction. For example, partners of a partnership that is a Constituent Entity may be taxable in their jurisdiction on their share of the partnership's income. However, if the owner is located in a tax jurisdiction that does not treat the stateless entity as tax transparent it may impose tax on distributions from the stateless entity or impose tax on the owner's share of the stateless entity's income under a CFC regime. In such cases, the covered taxes paid by the latter should be assigned to the stateless jurisdiction along with the income. The assignment of income and related taxes for stateless entities is illustrated in Annex, Examples 3.4.2E, 3.4.2F, and 3.4.2G.

284. Under the jurisdictional blending approach, covered taxes are assigned to the jurisdiction of the Constituent Entity that earned and recorded the related income. Consequently, covered taxes collected by the tax authority in one jurisdiction, such as withholding taxes and CFC taxes, may be taken into account in the ETR computation of another jurisdiction. These "cross-jurisdictional" taxes present some challenges for the GloBE rules, because they are typically levied at high rates and in respect of passive (and therefore highly-mobile) income. The income that triggers these types of taxes can be shifted easily to an otherwise low-taxed jurisdiction together with the associated covered taxes, to the extent the assigned income and taxes exceed the minimum rate, the excess tax credits can be used to reduce the amount of top-up tax on other income arising in the jurisdiction. Anti-avoidance rules would prevent MNE group's structuring transactions that allowed high-tax passive income to be used to shelter other income arising in a low-tax jurisdiction. Further work on the treatment of withholding taxes and CFC taxes will be done in considering the development of a targeted rule that is consistent with the policy outcomes of the GloBE and is administrable and minimises compliance costs with the outcome of this further work being incorporated into the model rules described in Section.

Computing the jurisdictional ETR

285. Generally, the ETR of each jurisdiction will be computed by dividing the aggregate of adjusted covered taxes assigned to the jurisdiction by the aggregate of the profit (or loss) before tax assigned to the jurisdiction. Where the aggregate profit before tax assigned to a jurisdiction is zero or negative (i.e. loss-making), there will be no GloBE income and no GloBE tax liability with respect to that jurisdiction for the MNE Group for that year. Adjusted covered taxes are all covered taxes reduced by covered taxes attributable to income and gains that are excluded from the GloBE tax base, such as taxes paid on dividends and gains from dispositions of stock. The amount of covered taxes included in the ETR computation of a jurisdiction under the carry-forward approach for addressing temporary differences is discussed further below in Section.

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Notes

[1] See Section 2.3 Excluded Entities

[2] If there is an exclusion from the GloBE rules for MNEs operating in the international shipping industry (see Section 2.3.6) then further consideration should be given to whether tonnage taxes should be treated as covered taxes under the GloBE.

[3] The scope of CFC rules vary among countries, and, in any case, the design of a CFC rule, even one with a broader scope than described in this paragraph, means that such a rule will not be considered similar to GloBE rules.

[4] See below Chapter 4 on *Carry-forwards and carve-out*.

[5] https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/#analysis

[6] Rules for addressing post-filing adjustments to local tax liability are discussed in section 4.2.2.

[7] See Section 3.2.2 for discussion on covered taxes. Tax paid on net income allocated to a jurisdiction under Pillar One would be treated as a covered tax under the GloBE.

[8] The rule simply applies the tax depreciation rules to the carrying value of assets as determined for financial accounting purpose. It would not conform the cost capitalisation rules of the financial accounts to the cost capitalisation rules of the jurisdiction. Thus, the depreciable base of the property for GloBE tax purposes and local tax purposes may still differ, which will result in some difference in the amount of depreciation computed for each period. Conforming the capitalisation of costs to depreciable assets with the tax cost capitalisation would, in some cases, require numerous other adjustments to the timing of various expenses.

[9] These tax regimes also contain rules intended to protect the jurisdiction's tax base from tax avoidance through the use of transactions, such as loans to shareholders, that are the economic equivalent of a distribution.

[10] Disclosure of these benefits is required under IAS 20.39(b).

[11] See para 71 of the PoW (OECD, 2019[5]).

[12] See the discussion on *'Other generally accepted financial accounting standards'* in Section 3.3.3.

[13] See the discussion on '*Multilateral review process*' in section 10.5.2.

[14] A review process for evaluating material differences and providing additional guidance on material differences could be undertaken as part of the multilateral review process envisioned in section 10.5.2.

[15] The timing of income between constituent entities in the same jurisdiction may be deferred until sale to a third party for local tax purposes under a group relief or consolidation regime. However, income from transactions with related parties outside the jurisdiction is likely to be recognised at the same time as income from transactions with third parties for local tax purposes. Thus, separate entity accounting for purposes of jurisdictional blending would conform in this respect to local taxation of the entities subject to the GloBE proposal.

[16] In the case of an acquisition of less than all the ownership of an entity, the value of the minority interest is also taken into account in determining the existence and amount of goodwill or other intangible assets of the acquired entity or entities.

[17] A worldwide blending approach under the GloBE proposal requires a similar allocation of the MNE's income and taxes, except that the income and taxes only need to be allocated between the tax jurisdiction of the Ultimate Parent Entity and a foreign tax jurisdiction. This section of the note assumes a jurisdictional blending paradigm. However, the principles apply equally to the assignment of income and taxes to the relevant jurisdictions under a worldwide blending model.

[18] It is recognised that no decision has yet been taken by the Inclusive Framework on whether the GloBE rules will adopt relevant definitions from the CbCR rules. However, given the strong correlation between the intended scope of the GloBE rules and the Country-by-Country reporting (CbCR) rules, this report assumes that the CbCR definitions will be adopted.

[19] For this purpose, the entity's jurisdiction may be the jurisdiction under the laws of which the entity was created if it is a juridical entity or the jurisdiction in which it conducts its activities if it is a contractual entity or arrangement.


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Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint
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