Pillar 2: What does it mean for private markets?

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1. New tax rules enforce fairness in a rapidly digitising and global economy

2. Most private market managers are out of scope, but not all

3. Below we break down the regulations and explain how managers can assess whether they are in scope

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As part of the inter-governmental response to the continuing digitisation of the global economy, more than 140 countries have agreed to implement Pillar 2 tax rules. These rules ensure large multinational enterprises pay a minimum level of tax in each jurisdiction where they operate. Given the way the legislation is drafted it is likely that most private market managers will be out of scope – however for those who are, the consequences will be significant. ***Gaëtan Grein*** *breaks down the rules and how to test your exposure.*

The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting, referred to as the BEPS 2.0 Project, brought together 135 jurisdictions in October 2021 to establish new rules for how large multinational enterprises ("MNEs") would be taxed to ensure fairness and to broaden the response to a global, digital economy. The Two-Pillar Solution agreed upon is designed to stabilise the global tax landscape, reduce profit shifting, and curb harmful tax competition by limiting the possibility of a race to the bottom on corporate tax rates.

Pillar 1 was introduced in 2019 and legislated taxing rights over global business income in market countries. Pillar 2 goes further with the main component being the Global Anti-Base Erosion Model Rules (GloBE Rules), which are designed to ensure that MNEs within the scope of the rules pay a minimum level of tax on the income arising in a specific period in each jurisdiction in which they operate, regardless of where they are headquartered or the jurisdictions they operate in. To achieve this, there are two main rules arising from Pillar 2 – the Income Inclusion Rule ("IIR") and the Under-Taxed Payment Rule ("UTPR") – under which will be applied a system of top-up taxes that brings the total amount of taxes paid on the MNE's excess profit in a jurisdiction up to a minimum rate of 15%.

Given the high threshold of consolidated revenue of €750m and the non-consolidation exemption that is available to most funds, we anticipate that most private market managers are unlikely to be subject to Pillar 2. However, funds should undertake a formal assessment of their groups and consider whether any may meet the revenue threshold. If any do, then the next step is to consider any exemptions or exclusions available to any group entity.

An example of how a MNE might fall within the scope of Pillar 2 is if an entity is a subsidiary of a group where the ultimate parent entity (UPE) is in scope. The UPE is the top of the ownership control chain and is not owned by another entity. In addition, a stand-alone UPE is considered an MNE Group if it has at least one permanent establishment located in another jurisdiction.

Overview of how the assessment is made

The assessment as to whether an entity is in scope of Pillar 2 is mainly driven by whether an entity prepares consolidated accounts or is being consolidated in accordance with an authorised or registered accounting standard and whether the group meets the €750m revenue threshold for at least two out of the last four years. This four-year test is based on two of the four fiscal years immediately preceding the tested fiscal year. In the context of a merger, look at the sum of the revenue of each group to meet the €750m threshold. Conversely, there are special rules for demergers.

One consideration is that there are differences in revenue considerations under Pillar 2 against the applicable accounting standards. Whilst excluded entities are not subject to Pillar 2, they are taken into account when verifying whether the group's annual revenue meets the €750m threshold.

This is why it is extremely important when doing the scoping analysis to understand both taxation and accounting principles. Pillar 2 is complex, so it is beneficial to have a Pillar 2 tax expert to review any differences in revenue considerations under the rules. However, for funds that have a fund administrator in place, the administrator can play a crucial role in the scoping analysis particularly on the consolidation and revenue assessment, including disclosures that are part of the annual accounts.

In terms of disclosures, accounts will have to follow the requirements of the applicable accounting standards (such as IAS 12) and, where applicable, the specific accounting rules published in each relevant country on Pillar 2. Generally, the accounts will need to disclose the impact of Pillar 2 in the accounts covering both qualitative and quantitative information. It is important to note that the disclosures for entities which are impacted by Pillar 2 should be tailored rather than generic disclosures. This means managers will need inputs from Pillar 2 tax experts, especially when it comes to the quantitative disclosures.

Investment fund exemption rules

For investment funds to be exempt, the fund, or its management, must be subject to the regulatory regime for investment funds in the jurisdiction in which it is established or managed.

Entities that are owned by one or more of the excluded entities are also excluded if specific ownership thresholds (85% or more) and activity conditions are satisfied (e.g. hold assets such as real estate or invest funds and only carry out ancillary activities, or that mostly derive income that is excluded from the GloBE tax base).

Pillar 2 definitions and additional exclusions

- The definition of ‘group’ is according to accounting standards, therefore the parent entity must prepare consolidated accounts under IFRS or local GAAP. This means consideration also needs to be given to accounting exemptions (e.g. IFRS 10). However, not all accounting consolidation exemptions are allowed under the directive.
- MNEs in scope of the rules must calculate their effective tax rate for each jurisdiction where they operate.
- Top-up tax is levied at parent level if any subsidiaries in member

jurisdictions are not paying at least 15% tax in their resident jurisdiction. This means that tax will be levied on consolidated revenue. A de minimis exclusion applies where there is a relatively small amount of revenue and income in a jurisdiction.

- The following entities – as well as MNEs who do not meet the €750m group revenue threshold – are also out of scope (regardless of revenue), however their revenue is still taken into account for purposes of the consolidated revenue test:

1. Governmental entities.
2. International organisations and non-profit organisations are exempt to preserve domestic tax exemptions for sovereign, non-profit and charitable entities.
3. Pension Funds, investment funds, real estate investment vehicles (such as REITs) are exempt to preserve the widely shared tax policy of not wishing to add an additional layer of taxation between the investment and the investor.

For private markets managers who are unsure of whether they are in scope of the new Pillar 2 rules, or would like more detail on how to apply for an exemption, getting tax advice is a good start and your fund administrator is able to help with the scoping exercise.

To discuss any points raised in this article please contact us below.