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PILLAR TWO

OVERVIEW AND INSURANCE INSIGHT

Pillar Two (also referred to as the "Global Anti-Base Erosion" or "GloBE" rules) represents one Pillar of the OECD's Base Erosion and Profit Shifting (BEPS) initiative, which began in 2013. Pillar Two, together with Pillar One (which aims to address tax complexities arising from the digitalization of the economy) represents the most sweeping change in international tax principles in the modern era.

The rules for Pillar Two are extremely complex and will require information gathering and computations which many groups historically have been unable to perform. Pillar Two applies to "Multinational Enterprises" (MNEs) that have consolidated global annual revenue of EUR750M or more in at least two of their last four fiscal years immediately preceding the tested year. Although Pillar Two is not intended to apply to wholly domestic entities, in practice, depending on how domestic regulations are drafted to implement the GloBE rules, wholly domestic entities may also be impacted.

We expect tax insurance to play a meaningful role in mitigating risks as Pillar Two is implemented. As with other tax issues, we foresee tax insurance most commonly deployed as part of an M&A process, but there should also be opportunities for companies to insure filing positions that are not related to an M&A process.

OVERVIEW OF PILLAR TWO RULES

INCOME INCLUSION RULE AND QUALIFIED DOMESTIC MINIMUM TOP-UP TAX

Pillar Two establishes a 15% minimum tax rate, based on a company's book income, subject to certain adjustments (e.g. net tax expense, dividends from controlled affiliates and fair market value revaluations). Investments in payroll and fixed assets reduce the income in a jurisdiction subject to the minimum tax.

In other words, under the Pillar Two rules, MNE groups should pay a minimum tax rate of 15% in each jurisdiction in which they operate. To this end, the guidelines set out a series of calculations to (i) determine the "Effective Tax Rate" (ETR) in each country and (ii) calculate the corresponding top-up tax at the level of the ultimate parent company if the ETR in a given country is lower than 15%. Importantly, as the 15% ETR is calculated on a per-country basis, it is highly likely that Pillar Two will result in some companies realizing a global ETR that is higher than 15%.

If the ETR of a group company is less than 15%, the "Income Inclusion Rule" (IIR) applies and the income of lower-tier entities is attributed to their ultimate parent. The IIR imposes a top-up tax on the ultimate parent where its subsidiaries have low-taxed income.

As an alternative to the IIR, income of a company that is subject to an ETR below 15% can be subjected to a "Qualified Domestic Minimum Top Up Tax" (QDMTT) by the jurisdiction in which the company is tax resident in order to increase the company's ETR to 15%. The application of a QDMTT avoids lower-taxed income becoming subject to additional taxes under the IIR at the ultimate parent level.

UNDERTAXED PAYMENTS RULE (UTPR)

In circumstances where the jurisdiction of an ultimate parent company or an intermediate parent entity has not yet implemented an IIR, Pillar Two also contains a backstop rule known as the "Undertaxed Payments Rule" (UTPR) which allows local jurisdictions to collect a portion of the top-up tax that would otherwise have been paid to the ultimate parent (or intermediate parent) company's jurisdiction under the IIR.

The UTPR allocates a portion of the top-up tax to each local jurisdiction using a two-factor formula calculated according to the payroll and property located in each local jurisdiction.

The UTPR has been fully adopted in some domestic legislation passed in OECD member states but is not expected to be operational until 2025.

SUBJECT TO TAX RULE

As an additional backstop to the UTPR rule, the "Subject to Tax Rule" (STTR) provides that developing countries may impose up to a 9% withholding tax on cross-border payments from local companies to related parties located in a country that fails to subject the income to at least a 9% nominal income tax rate.

The STTR rule is a complementary treaty-based rule that does not impose a tax obligation per se, but allows jurisdictions to impose a tax at a certain rate where they otherwise would be unable to do so under other treaty provisions. It is intended to be implemented by amending existing income tax treaties between the source country of the payments and the relevant destination country, or by including it in new treaties, if applicable.

CURRENT IMPLEMENTATION STATUS

In order to implement Pillar Two, individual countries need to pass enabling domestic legislation. As of January 2024, the UK, the EU and Nordic countries have passed enabling legislation. In Asia, Japan, Malaysia, South Korea and Vietnam have also passed enabling legislation.

HOLDOUTS

United States

The US has yet to move forward with explicit Pillar Two legislation. There has been considerable historical debate around whether and when the US will fully conform to the Pillar Two rules, with the debate roughly divided along US political party lines.

It is possible that the US will succeed in having its existing international tax regime accepted "as-is" by the OECD. Both the US "Corporate Alternative Minimum Tax" (CAMT) enacted in 2022 and the US "Global Intangible Low-taxed Income" (GILTI) regime enacted in 2017 are close in spirit to the Pillar Two tax rate determination mechanics, but are not totally conforming.

For example, the GloBE rules make more adjustments to book income and adjustments for deferred tax assets and liabilities that are not made for purposes of the CAMT, and the GILTI rules treatment of foreign tax credits would need to be amended to fully conform to the GloBE rules. If the OECD does not accept the US rules "as-is," conforming changes to US legislation will be required in order to avoid unintended negative impacts on US parented groups.

Other Jurisdictions

Significant other holdouts from the Pillar Two implementation process include China, India and most of the countries in Latin America.

CHALLENGES AHEAD

Before looking at specific risks which we expect to see materialize out of Pillar Two implementation, one aspect is clear: due to the sweeping changes that Pillar Two makes in the global tax regime, many uncertainties and challenges will need to be addressed in the context of ongoing operational compliance and M&A transaction processes.

RISK ALLOCATION

Transaction documents will need to allocate Pillar Two risks between buyers and sellers. To do this, buyers will want to protect themselves against top-up taxes incurred prior to closing and secondary tax liabilities arising where acquired entities bear joint and several liability for top-up taxes arising in the seller's group. Representations and warranties will need to contain assurances around the accuracy of financial and tax information relevant to the Pillar Two position of the seller's group.

DUE DILIGENCE

The implementation of Pillar Two will pose various challenges for tax due diligence, including difficulties accessing relevant information and the time-consuming task of scrutinizing multiple tax regimes and accounting standards.

For RWI/W&I policies to offer any meaningful protection against Pillar Two risks, tax due diligence scopes will need to be widened to suitably review and capture the full extent of any pre-closing Pillar Two exposures. However, certain outcomes of the application of Pillar Two will not be capable of cover as they will not be ascertainable at, or immediately after, the time of sale.

Realistically, we expect that future RWI/W&I policies will begin to contain a general exclusion for any Pillar Two liabilities. This exclusion will need to be rebutted with thorough and conclusive due diligence. However, we do expect that certain risks arising from the application of the Pillar Two rules will be capable of coverage under specific tax insurance policies.

ANTICIPATED RISKS

While many Pillar Two risks will likely come to light over time, we believe the following risks are among those that deserve careful attention. Where a more likely than not filing position is taken with respect to these risks, we anticipate that specific tax insurance would be available to cover the position.

ANNUAL REVENUE THRESHOLD

It may not be clear whether a group falls below the EUR750m threshold. For example, a group could have debt in its structure that is treated as equity for tax purposes. Therefore, there would be a risk that the company had an equity stake in an entity for tax purposes that the company does not include in its consolidated financials or anticipate including in its Pillar Two calculations.

ENTITY INCLUSION

A critical aspect of Pillar Two is understanding the ultimate parent of a multinational group. Under the IIR, only the ultimate parent of an entity is required to include the income of that entity for purposes of determining any incremental tax to be paid on that income. We expect that determining whether an entity is includable could be challenging in the context of certain joint venture vehicles with complex capital structures. We also expect that private equity firms, funds and holding company structures will present a number of complex issues around entity inclusion.

REVENUE INCLUSION/EXCLUSION

We expect that there will be some uncertainty as to whether boot or earnouts included in consideration in an acquisition will be included as taxable income in GloBE calculations. If these payments are excluded for purposes of determining income tax in the jurisdiction of the entity receiving the boot or earnouts but are included in the ultimate parent's taxable income under the GloBE rules, then incremental tax could be triggered.

SUMMARY OF SUBMISSION GUIDELINES

While it is too soon to say with specificity what background materials will be required for Pillar Two submissions, it is anticipated that the following will need to be provided:

- An analysis of a group's Pillar Two tax position
- A summary of the facts that create an uncertainty regarding a group's Pillar Two filing position
- Legal analysis that supports the group's filing position

TAX INSURANCE PLACEMENT PROCESS

1. FACT GATHERING & SOLICITATION OF QUOTES

We evaluate the facts and legal framework underlying the relevant tax issues, drawing on the extensive tax experience of our market-leading team. We then analyze how best to structure a tax solution considering each tax insurer's unique risk appetite and present a detailed and customized submission to suitable insurers. This "pre-underwriting" analysis ensures that our clients obtain the most favorable response possible.

Once we identify interested insurers, we work closely with them to avoiding surprises later in the process – our goal is to ensure that the insurer fully understands the tax risks at issue and that we, in turn, fully understand their underwriting approach and appetite for the risk. At the end of this phase of the process, the insurers prepare formal quotes (referred to as Non-Binding Indications).

2. RECOMMENDATION OF A TAX INSURER

We prepare a detailed written report recommending the optimal insurer based on a holistic analysis of coverage/exclusions, policy costs and insurer profile (including relative risk appetite, underwriting approach and overall reputation), among other considerations.

3. UNDERWRITING & POLICY NEGOTIATION

Once the client selects an insurer, the formal underwriting process commences. During underwriting, the insurer and their advisors review all available tax analysis and conduct a fulsome review of all relevant documentation and facts. There may also be an underwriting call so the insurer can discuss any outstanding questions with the client and their advisors.

In parallel with underwriting, we draw on our team's experience in placing over 1,000 policies across virtually every jurisdiction globally to negotiate the terms and conditions of the tax insurance policy.

4. CLAIMS PROCESS

Finally, if a claim is filed, our team, which includes dedicated claims specialists, will advocate for the client during the entirety of the claim process to ensure full and expeditious recovery pursuant to the policy.

HWF

ABOUT US

We are an independent advisor and broker of transactional and tax risk insurance which facilitates value creation and risk mitigation. We provide bespoke tax insurance solutions that mitigate tax liabilities arising in the lifecycle of investment structures and operational companies.

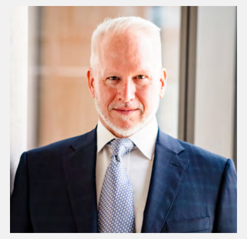
Our team, comprising of individuals who have significant insurance, legal and tax backgrounds with extensive advisory, broking and underwriting experience, have advised on over 5,000 transactions and structured over 1,300 policies in over 50 jurisdictions. In addition, we have offices in London, Dubai, Frankfurt, Munich, Paris, Warsaw and New York and specialists dedicated in their focus on the MENA, CEE and Southern European regions.

This collective expertise allows us to provide specialist insight with an advisory focus, taking ownership of any insurance structured and allowing our clients to focus on the wider transaction.

We would be happy to provide references if required and for further details about us please see hwfpartners.com.

HWF has led the first independent European W&I market claims study, using data from 16 insurers over a 7-year period, view the report in full here.

KEY CONTACTS



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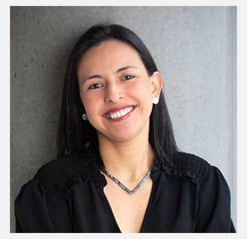

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