PILLAR TWO - THE CURRENT STATE OF AFFAIRS

Update on Pillar 2 following the Dutch draft implementing bill of October 24, 2022.

INTRODUCTION

On December 22, 2021, the European Commission published a proposed Directive to ensure a (global) minimum level of taxation for multinational groups and for large domestic groups in the EU, known as "Pillar Two". This regulation will apply to groups with a consolidated revenue of at least EUR 750 million.

As a first step implementing the proposed Directive, the Dutch government issued a draft bill for consultation on Oct. 24, 2022. This draft serves as the basis for the final bill to be presented to Dutch parliament. The Netherlands intends to introduce the minimum tax through a separate law and thus not to include the new tax in the current 1969 Corporate Income Tax Act. Hence, in the tax consequences of future transactions will have to be assessed under both laws.

On December 13, 2022, Hungary also finally agreed to the European Commission's proposal and an agreement was reached within the European Union regarding Pillar 2. The agreement makes it more realistic that Pillar 2 must be implemented in the domestic laws of the EU Member States by January 1, 2024.

As the introduction of Pillar 2 approaches, we will briefly discuss the three measures included in the Dutch draft implementing bill as well as some of the possible complications we foresee with the draft bill.

THREE MEASURES

The draft bill includes three measures, being the introduction of:

- the Domestic Top-up Tax;
- the Income Inclusion Rule; and
- the Undertaxed Profits Rule.

The Domestic Top-up Tax

The Domestic Top-up Tax applies when the effective corporate tax rate in the Netherlands is lower than 15%. In this situation, group entities established in the Netherlands will be liable for the qualifying Domestic Top-up Tax. The Dutch legislator opted for this taxation in the draft bill with the aim of securing Pillar 2 tax revenue for the Netherlands. By introducing a qualifying Domestic Top-up Tax, the Netherlands has the ability to collect a surtax on the profits of Netherlands-based low-taxed group entities of a multinational group.

The Income Inclusion Rule

Subsidiaries whose shares are held by an ultimate parent entity whose established in another country, that has introduced the Income Inclusion Rule, will in principle (indirectly) suffer additional levy to result in the minimum levy of 15%, over the domestic profits of the subsidiaries. if the profits of the subsidiaries are effectively below 15%. For majority subsidiaries this in principle determined on a per country basis. For minority subsidiary this will be determined on a standalone basis.

In practice however, Dutch subsidiaries will not be confronted with the Income Inclusion Rule, because the Netherlands intends to introduce the Domestic Top-up Tax, as a result of which Dutch subsidiaries will always effectively pay at least 15% tax.

The Undertaxed Profits Rule.

To the extent no Income Inclusion Rule is applied by the group's ultimate parent country, any remaining top-up tax is levied from the various group entities pursuant to the Undertaxed Profits Rule.

The Undertaxed Profits Rule is allocated to the various subsidiary and/or permanent establishment countries in proportion to the number of employees (expressed in full-time equivalents) and tangible assets of the group in those countries. This way, the top-up tax is allocated to various countries based on the group's physical presence in those countries.

COMPLICATIONS OF THE DRAFT BILL

As can be read in the various responses to the draft bill, many questions remain unanswered. We will briefly highlight two of the potential complications

Tax treaties

Little attention has been given in the draft bill on the potential complications with tax treaties in force. Particularly with the Income Inclusion Rule and the Undertaxed Profits Rule, tax treaties may come into play, as both rules might result in taxation of foreign profits.

Tax treaties include rules dividing taxation rights to both treaty countries. If on the basis of the Income-Inclusion Rule and the Undertaxed Profits Rule profits arising in one country are mandatorily taxed in (an)other country(ies) in accordance with an allocation pro rata to, for example, number of employees, such an allocation differs from the allocation rules in the OECD Model Tax Convention ("OMTC"). The OMTC allocates income to countries based on significant people functions relevant to the economic ownership of assets and to the assumption and/or management of risks.

Upon implementation, therefore, the question will arise as to how far domestic law implementing an EU Directive shall be consistent with Articles 93 and 94 of the Dutch Constitution.

Transfer pricing

Finally, we highlight the potential complications regarding transfer pricing. As already indicated in the Dutch Professional Association of Tax Advisors' comments on the draft bill, in order to determine the qualifying income or loss of a group entity, any income on transactions between group entities located in different countries that is not included in the financial reporting of both group entities or is not determined in accordance with the Arm's length principle, must be adjusted.

Countries may interpret the Arm's length principle differently. As a result, subsidiaries may in the end not be subject to an effective 15% rate. The question that remains unanswered is how "not in accordance with the Arm's length principle" should be interpreted.

CONCLUSION

Now that all EU Member States have agreed to the draft Directive, introduction of the minimum tax becomes a reality. The draft Directive is very complex. Should you have any questions about the Directive, the Dutch draft implementing bill and the consequences for your company, please contact one of our specialists.

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