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ATOZ ALERT

Pillar Two Law to be amended to incorporate OECD Guidance.

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Introduction

On 12 June 2024, a draft law (the "**Draft Law**") was presented to Parliament to amend the Luxembourg law of 22 December 2023 on the minimum effective taxation of multinational enterprise ("**MNE**") groups and large national groups (the "**Pillar Two Law**") implementing the EU Directive of 15 December 2022 on ensuring a global minimum level of taxation for MNE groups and large-scale domestic groups in the Union (the "**Pillar Two Directive**"). The Draft Law incorporates clarifications, interpretations and additional technical provisions resulting from the three sets of administrative guidance published by the OECD/G20 Inclusive Framework ("**Inclusive Framework**") on BEPS in 2023 (the "**Agreed Administrative Guidance**").

The proposed amendments to the Pillar Two Law deal with a multitude of aspects of the minimum taxation rules, including clarifications, among others, on the scope of application of the rules (excluded entities, turnover definition, etc.) and on how to deal in practice with several issues, such as mismatches in accounting and tax periods within the group, as well as on specific issues related to the computation of the income and loss, the top-up tax and the domestic top-up tax (e.g. functional currency to apply). Several clarifications are also included on the transitional rules, including the country-by-country reporting safe harbour and the deferred tax assets and liabilities, as well as on administrative/filing obligations.

We describe some of the main clarifications for Luxembourg funds hereafter.

Background and purpose of the amendments to be introduced

The Pillar Two Law establishes a minimum effective tax rate of 15% for MNE or large-scale domestic groups with a combined annual turnover equal to or above EUR 750 million in at least two of the four fiscal years preceding the tested fiscal year, as per the consolidated financial statements of the group parent entity. This law,

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along with the Pillar Two Directive, is founded on the Inclusive Framework agreement on Global Anti-Base Erosion ("**GloBE**") rules that provide for a co-ordinated system of taxation intended to ensure large MNE groups pay a minimum level of tax on the income arising in each of the jurisdictions where they operate (the "**Model Rules**"), published in December 2021. In 2023, Agreed Administrative Guidance on the Model Rules was published by the Inclusive Framework and the ongoing technical work on it is set to continue through 2024, to further clarify and expand upon various aspects of these rules.

As the GloBE Model Rules require explicitly that the Pillar Two rules be applied in accordance with the Agreed Administrative Guidance, the purpose of the Draft Law is to ensure compliance of the Luxembourg Pillar Two rules with this guidance to the extent the Luxembourg legislator was not able to explicitly take into account all aspects of the guidance at the time of the Pillar Two Law's adoption.

On 17 June 2024, the Inclusive Framework already released further guidance providing notably an overview of the streamlined process for recognising qualified status for the legislation of jurisdictions implementing the GloBE rules. For that purpose, a new Q&A was released in order to clarify a "**Transitional Qualification Mechanism**" that assists jurisdictions in getting confirmation that their minimum tax rules will be accepted by other jurisdictions during a transitional period, pending a peer review process at the level of the OECD's Inclusive Framework. This mechanism also benefits MNE by providing clarity on which tax rules they need to comply with. This is of particular relevance notably to ensure that the qualified domestic top up tax ("**QDMTT**") provided for in the Pillar Two Law qualifies for the QDMTT Safe Harbour (for more information about the QDMTT, please read our article "Analysis of the last provisions introduced by the government in the law transposing Pillar Two" in our latest ATOZ Insights.

Clarifications dealing with the scope of application and definitions

Excluded entities - Investment funds and real estate investment vehicles

The Pillar Two Law applies to "constituent entities" located in Luxembourg belonging to MNE or large-scale domestic groups with a combined annual turnover equal to or above EUR 750 million, as per the consolidated financial statements of the group parent entity.

A "constituent entity" as defined by the Pillar Two Law means an entity or permanent establishment that is part of an MNE group or a large-scale domestic group. A "group" is defined as a group of entities linked by virtue of their ownership or control structure and included in the consolidated financial statements of the ultimate parent entity (also extending to entities that are excluded from consolidation based on size, materiality or on the grounds that the entity is held for sale). A group could also be a main entity and one or more permanent establishments, provided that such group is not part of another group based on the above consolidation threshold.

Entities that do not prepare consolidated accounts on a line-by-line basis may nevertheless be considered to form a group with their subsidiaries and therefore be in the scope of Pillar Two (e.g. if they are not required to prepare accounts at all or they do not prepare accounts under an acceptable accounting standard) based on the "deemed consolidation test".

The Agreed Administrative Guidance already clarified that certain investment entities (e.g. under IFRS 10) that are exempt from line-by-line consolidation and that are merely required to fair value their investments (including where majority stakes are held in subsidiary companies) do not fall within the deemed consolidation rule, i.e. such entities do not qualify as parent entities of a group.

The Pillar Two Law and the related parliamentary documents unfortunately remained silent on this particular topic.

The commentaries on the Draft Law now point out that the "deemed consolidation test" does not change the rules that apply under the applicable financial accounting standard. The purpose of this test is to determine whether a consolidated group would have existed if the application of the qualifying financial accounting standard (or another financial accounting standard) had been mandatory. If an entity, such as an investment entity, is not

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required to consolidate on a line-by-line basis under the qualifying financial accounting standard that is, or would be, applicable to it, then the "deemed consolidation" rule does in principle not require line-by-line consolidation. In addition, certain laws applicable to investment funds may contain legal exemptions from the obligation to consolidate companies held as investments, so entities benefiting from such exemptions from the consolidation obligation can generally not be considered to meet the "deemed consolidation" test.

The definition of "controlling interest" is based on the same approach: the "deemed consolidation test" does not treat a person as having a controlling interest in an entity if the applicable accounting standard does not require that person to consolidate the entity in question on a line-by-line basis. Similarly, an entity that carries out line-by-line consolidation on a voluntarily basis or under contract cannot, on that basis alone, be considered to have a "controlling interest" in entities subject to such voluntary consolidation, to the extent that this concept refers to an obligation under a qualifying financial accounting standard under which the holder of the interest is or would have been required to carry out a line-by-line consolidation of the entity held.

The commentaries thus confirm that Luxembourg-specific exemptions from consolidation for most investment funds based on the respective special laws such as for reserved alternative investment funds, specialised investment funds or companies in risk capital ("**SICAR**") are consolidation exemptions comparable to the IFRS 10 investment entity exception. This clarification provides legal certainty for Luxembourg investment fund vehicles concerned.

The Draft Law also clarifies that an investment fund or real estate investment vehicle, which is not an ultimate parent entity for the sole reason that it is not required to prepare consolidated financial statements under the qualifying financial accounting standard or an accepted financial accounting standard, is to be assimilated to an excluded entity. This provision is intended to clarify that entities held by such investment fund or real estate investment vehicles in the sense of Pillar Two are to be considered as excluded entities for the purposes of the Pillar Two Law. However, such entities still have to be taken into account for verifying whether the EUR 750 million group's annual turnover threshold is met.

Scope of application - Concept of turnover

To avoid divergent results based on the different financial accounting standards that may apply, the Draft Law aims at standardising the concept of "turnover" for the purposes of applying the EUR 750 million threshold referred to in the Pillar Two Law. Based on the Draft Law, the turnover has to be determined on the basis of the amount reflected in the profit and loss account of the group's consolidated financial statements and includes (i) income arising from the supply or production of goods, the provision of services or other activities which constitute the ordinary activities of the MNE group or large national group, before deduction of operating expenses, (ii) net realised or unrealised gains on investments, and (iii) income or gains presented separately as extraordinary or non-recurring income.

Computation of income and loss - Technical provisions of insurance companies

To avoid situations of deduction without inclusion, the Draft Law tends to align the treatment of an insurance company's technical provisions with the treatment of excluded dividends and excluded capital gains or losses which these technical provisions relate to from an economic point of view. This means that these technical provisions, which have their origin in investments made by the insurance company on behalf of policyholders, are not allowed as expenses in the calculation of the insurance company's allowable profit or loss.

Entry into force and next steps

Since the Draft Law mainly introduces clarifying provisions so as to guide taxpayers on how to interpret and apply rules which are already in force and should not, as such, introduce changes to the rules in place, the entry into force of the Draft law is aligned to the one of the Pillar Two Law and provides that the new provisions would apply to tax years starting on or after 31 December 2023.

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In this regard, the Agreed Administrative Guidance introduced by the Draft Law was all approved and published by the OECD before the Pillar Two Law came into force, so taxpayers already had access to them. Finally, the draft law related to the Pillar Two Law already expressly referred to them.

While the Draft Law may be subject to amendments over the legislative process notably to incorporate the 17 June 2024 OECD guidance, given that it incorporates clarifications and interpretations agreed upon at OECD level, there will probably be no major amendments of the Draft Law. Still, it can be expected that the Pillar Two Law will have to be amended again in the future, since the OECD guidance is still being developed and the fourth administrative guidance of the Inclusive Framework for implementation of the global minimum tax under Pillar Two has just been released.

In the meantime, taxpayers should closely follow these developments at OECD level and also any additional guidance provided by the Luxembourg tax authorities by means of developments of their FAQ released on 25 March 2024. In any case, incorporating the interpretations and clarifications agreed upon at OECD level is positive as it provides more legal certainty to taxpayers.

Based on the Transitional Qualification Mechanism Luxembourg also has to self-certify that the Pillar Two Law as amended by the Draft Law aligns with the GloBE rules. This would ensure that no additional top-up tax would effectively be due in another jurisdiction (e.g. of the ultimate parent entity) on the same income which has already been considered under the Luxembourg QDMTT.

Further, it is worth noting that the most recent OECD guidance also includes specific rules for securitisation vehicles to which the current set of rules was not adopted. It will be interesting to see whether the Luxembourg legislator will include such rules in the Draft Law given the importance of securitisation structures for Luxembourg.

Do you have further questions?

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