Global Minimum Taxation – Substance-Based Carve-outs & Qualified Refundable Tax Credit (QRTC) and their impact on the effective level of taxation

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The Global Minimum Tax sets an effective minimum tax level of 15%. This does not apply in all cases. Rather, the GloBE rules also contain mechanisms such as Substance Based Carve-outs and Qualified Refundable Tax Credits, which can lead to the 15% level being significantly undercut.

Contextualization

With the Pillar Two concept, 136 of 140 members of the OECD Inclusive Framework (IF) agreed on October 8, 2021, on an integrated system of two regulations to ensure global minimum taxation of international groups with a consolidated turnover of over EUR 750 million. The aim is to achieve that the affected groups are subject to an Effective Tax Rate of 15% (ETR) in every jurisdiction in which group units are located, which means that Global Anti-Base Erosion and Profit Shifting (GloBE) below this limit should be avoided. This minimum tax level is achieved using various instruments (IIR, UTPR, QDMTT) to levy a top-up tax.

However, the GloBE rules also provide for mechanisms that provide for a resulting ETR below 15%. These are, on the one hand, downstream substance-based reductions in the assessment basis (so-called Substance-based Carve-outs) and, on the other hand, Qualified Refundable Tax Credits (QRTC). Both mechanisms are also interrelated.

Calculation system of ETR and top-up tax

The main calculation factors are the GloBE income (denominator) and the covered taxes (numerator). The starting point for determining GloBE income are the annual financial statements of the individual group units before consolidation according to the accounting standards of the ultimate parent company. The profit derived from the commercial balance sheet is finally subject to several mandatory adjustments as well as certain options (so-called Net GloBE Income). The determined so-called Net-GloBE Income of the group unit is then aggregated per tax jurisdiction (so-called Jurisdictional Blending) and is thus included in the determination of the ETR.

The amount of the covered tax payments must first be determined for each group unit. The starting point for the calculation is the current tax expense accounted for in accordance with national accounting standards, which is also subject to various adjustments to pay respect to temporary differences under commercial and tax law and to enable losses to be carried forward. The adjusted covered taxes are then included in the calculation in aggregate form, as is the GloBE income:

$$\text{ETR (per tax jurisdiction)} = \frac{Adjusted\ covered\ taxes}{Net\ GloBE\ Income}$$

If the ETR is below the limit of 15%, a top-up tax must be levied in the amount of the difference (Table 1).

	Case 1 (chart)	Case 3 (chart)
(GloBE) income	100	100
National tax (eff.)	10	10
ETR before top-up tax	10%	10%
Top-up tax Rate	5%	5%
Final burden	15	15
ETR after top-up tax	15%	15%

Table 1: ETR and the levies of the top-up tax

In Liechtenstein, the ETR of 15% will be ensured by the Liechtenstein top-up tax (QDMTT).

Substance-based Carve-outs

Substance-based exclusions influence the determination of the top-up tax by leading to a formula-based reduction in the Net GloBE Income for certain wage costs and physical assets of a tax jurisdiction, without, however, influencing the previously determined ETR (Case 4).

	Top-up tax without substance exclusion	Top-up tax with substance exclu-sion (Case 4)
ETR before top-up tax	**10%**	**10%**
GloBE income	**100**	**100**
Substance exclusion	**0**	**-5**
BMG	**100**	**85**
Top-up tax Rate	**5%**	**4.3% (85*0.05))**
Final burden	**15**	**14.3 (-0.7)**

Table 2: Substance-based Carve-outs

Qualified Refundable Tax Credits (QRTC)

In order to counteract a shift of tax competition into the area of direct subsidies, a possibility for granting non-ETR-relevant tax credits (Tax Credits) was created in the GloBE rules, which, however, as a component of the GloBE Information Return (GIR), is subject to the control of the OECD as a further tax jurisdiction.

It is important to distinguish between a QRTC and other forms of tax credits and relief (e.g., for research and development; IP box regime), since only a QRTC does not lead to a reduction of the covered taxes according to the GloBE rules and thus results in a corresponding rise of the top-up tax but is considered income and therefore only causes an increase in GloBE income.

	Top-up tax without QRTC	Top-up tax with QRTC (Case 5)
ETR before top-up tax	**10%**	**10%**
GloBE income	**100**	**100**
QRTC	**0**	**+ 10 (Einkommen)**
GloBE-Einkommen (QRTC)	**100**	**110**
Tax (eff.)	**15**	**16.5**
Final tax burden (after QRTC)	**15**	**6.5 [11+5.5-10]**

Table 3: Qualified Refundable Tax Credit (QRTC)

Substance exclusion by reducing the denominator while keeping the numerator the same permits a GloBE-compliant reduction in the ETR below 15% and thus a tax reduction (Case 1). In contrast, a QRTC has the opposite effect of increasing the tax liability, which reduces the overall tax-reducing effect of the QRTC (Case 5 of the chart).

If a tax credit or relief is not deemed a QRTC, it will be neutralized by the top-up tax (Table 1, Case 3).

Interrelationship

Both instruments reduce taxes and are not mutually exclusive. If a unit has appropriate substance, both instruments can be combined in their effect, whereby the tax-increasing effect of the QRTC (1.5%; Table 2) is ideally neutralized by the substance exceptions (-0.7%; Table 1) or can be reduced to 0.8% (Chart: Case 4+5).

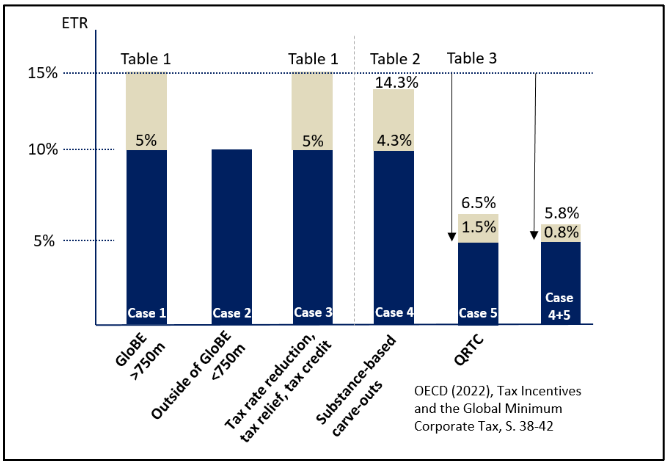

Chart: resulting burden and relief in comparison

Requirements for a QRTC

The GloBE rules specify the requirements for claiming tax credits in detail, but do not contain any specific regulations for the design of a Refundable Tax Credit (RTC), since the latter is primarily the regulatory responsibility of the individual tax jurisdictions. The GloBE rules only specify the conditions under which a RTC is considered qualified (QRTC).

A QRTC is a tax credit that must be provided in the form of cash or its equivalent unless the taxpayer has sufficient tax liability (in covered taxes) to utilize the full amount of the tax credit, i.e., it must necessarily be refundable and must not be legally or factually limited to the tax liability of the taxpayer (in covered taxes). A “cash equivalent” also includes use for a tax other than a covered tax. A tax credit that would only be available to reduce the covered taxes, i.e., which cannot be refunded in cash or offset against another tax, does not meet the requirements of a QRTC.

In addition, the payment or provision of a cash equivalent must take place within four years of the date on which the requirements for receiving the tax credit under the law of the tax jurisdiction that grants it, have been met.

However, tax amounts that are creditable or refundable under a credit scheme, as well as ordinary refunds of taxes paid in a previous period that are attributable to corrections in the calculation of the tax liability, do not qualify as QRTC.

Recommendation for action

Affected groups should analyze in good time whether and to what extent substance exclusions can be claimed by individual group members (aggregated across the respective tax jurisdictions). Depending on the level of the respective GloBE income and the substance allocations, the effects can be significant.

The question of a group's access to QRTC in the respective tax jurisdictions is likely to be even more important. The national design of a QRTC is a complex task that not only has to meet many requirements, but also has the potential to possibly develop into a quite significant competitive factor in the future.

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