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Pillar 2: Understanding the Substance-Based Carve-Out in Global Taxation

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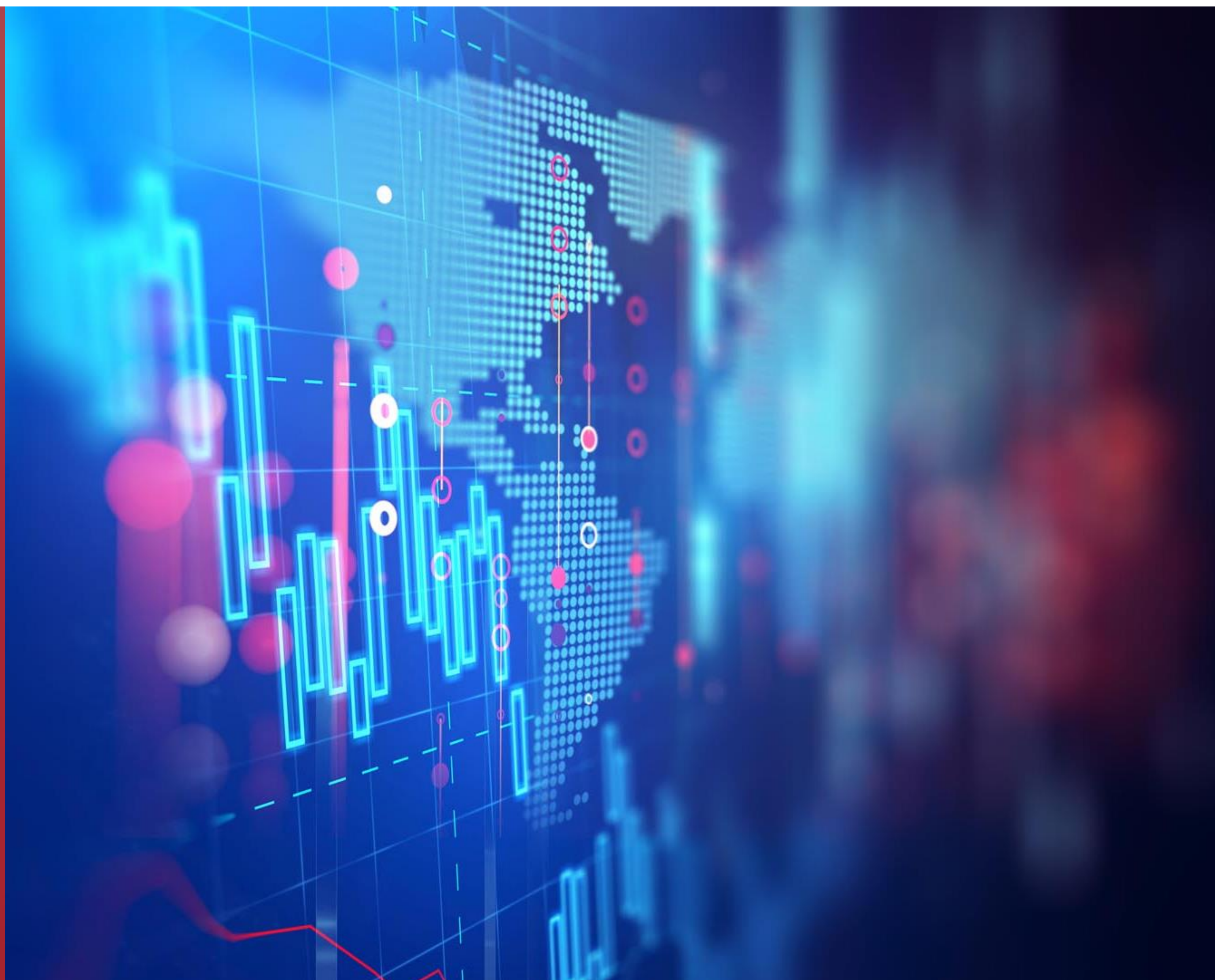

Introduction

The Base Erosion Profit Shifting (BEPS) Pillar Two is the Organization for Economic Co-operation and Development's (OECD) reform of the international tax system. On top of several high-stakes material, process, and technology impacts, BEPS Pillar Two Anti-Base Erosion introduces a global minimum tax of 15% for each country where a large multinational enterprise (MNEs) operates, if that country has agreed to BEPS Pillar Two OECD's framework. For a more complete picture of the BEPS Pillar Two global minimum tax, see our previous publication.

Within this reform of the international tax system, a new term has emerged – the Substance-Based Carve-Out. This is an essential component of the OECD's Pillar Two proposal, aimed at establishing a global minimum corporate tax rate of at least 15%. This carve-out is especially relevant in jurisdictions where local tax incentives are granted by governments that could bring the effective tax rate in a given jurisdiction and year below the 15% rate. The Substance Carve-Out could potentially shelter part of the local profits and prevent Top-Up Tax being levied, for instance in the Netherlands.

In this article, we'll go through the details of the Substance-Based Carve-Out, providing you with a solid basis for understanding and a launch point for next steps.

Policy Rationale: Focusing on Substance

The core idea behind this formulaic, substance-based carve-out based on payroll and tangible assets is to target substantive activities within a jurisdiction and shield them from the reach of the BEPS Pillar Two rules. By using payroll and tangible assets as indicators of substantive activities, tax authorities aim to exclude routine, non-controversial profits generated within a jurisdiction. These factors are generally considered less mobile and less likely to lead to tax-induced distortions. The overarching goal is to home in on "excess income," particularly intangible-related income, which poses the highest risk for Base Erosion and Profit Shifting (BEPS) concerns.

How do the substance-based carve-outs work?

Pillar Two aims to ensure that income is taxed a global minimum tax rate of 15% for multinational enterprises with a turnover of more than EUR750 million. At its core, the substance-based carve-out is a mechanism for reducing the tax base on which this global minimum tax rate is applied.

This reduction hinges on two critical factors:

- Eligible payroll costs, as defined by the OECD's Pillar Two proposal, encompass various expenditures that directly benefit employees. This includes salaries, wages, employee benefits like medical insurance, contributions to pension funds, bonuses, allowances for eligible employees, and stock-based compensation.
- Eligible tangible assets encompass the value of property, plant and equipment, natural resources, and lessee's right-of-use assets situated within the jurisdiction of the relevant Entity.

Example

Let's illustrate the mechanism and the importance of the substance-based carve-out with a simple example:

Consider a Dutch multinational company with a subsidiary that generates profits of 100 in a jurisdiction where it is taxed at an effective rate of 5% (as calculated under the Pillar 2 rules). With the proposed global minimum tax rate of 15%, the Netherlands would collect a top-up tax calculated by reference to the deficit in that jurisdiction, i.e.

$$100 * (15\% - 5\%) = 100 * 10\% = 10$$

In this scenario, without substance-based carve-outs, the multinational pays a total of 15 in taxes made up of 5 paid locally and 10 paid to the Netherlands, the country of residency of the group's ultimate parent entity.

Enter substance-based carve-outs, and the picture is very different. If the local entity has payroll costs of 100 and possesses 100 tangible assets in the relevant jurisdiction, a portion of these expenditures and assets can be subtracted from the global minimum corporate tax base, subject to taxation in the Netherlands. For a transitional period of ten years, the amount of income excluded will be 8% of the carrying value of tangible assets and 10% of payroll, declining annually by 0.2 percentage points for the first five years, and by 0.4 percentage points for tangible assets and by 0.8 percentage points for payroll for the last five years until the carve-out rate reaches to 5% in 2033. Assuming a 5% carve-out rate for both payroll costs and tangible assets, the substance-based carve-outs result in the following deduction:

$$5\% * (\text{payroll costs} + \text{tangible assets}) = 5\% * (100 + 100) = 10$$

These deductions, which arise from the carve-outs, are then removed from the global minimum corporate income tax base, upon which the Dutch top-up tax is imposed:

$$(100 - 10) * (15\% - 5\%) = 90 * 10\% = 9$$

As a result, the multinational's top-up tax obligation to Dutch authorities reduces to 9, significantly alleviating its tax burden. This capacity to have a significant impact on the amount of top-up tax payable means that substance-based carve-outs are an important consideration for multinational groups.

Relief for Capital-Intensive Industries

Particularly in capital-intensive industries like energy and infrastructure, the impact of substance-based carve outs can be significant. These sectors are marked by significant investments in tangible assets and substantial payroll expenses. The introduction of substance-based carve-outs within the global minimum corporate tax regulations is potentially helps reduce the costs of the Pillar Two charges.

For example, consider an energy group with extensive investments in infrastructure. These investments typically include tangible assets such as power plants, pipelines, and equipment, along with a sizable workforce. Substance-based carve-outs allow a portion of these assets and payroll expenses to be deducted from the overall tax base. As a result, the group can significantly lower its global minimum tax obligations, so that capital required for critical infrastructure development and sustainable energy projects is not eroded.

The Norton Rose Fulbright tax team has developed a specialized calculation tool for the substance-based carve-out. This tool is designed to assist multinational enterprises in navigating the complexities of these new regulations. It provides a practical means for companies to assess their tax liabilities and optimize their operations within the framework of substance-based carve-outs. For those interested in using this calculation tool, please contact your Norton Rose Fulbright tax contact for further guidance.

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