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SUMMARY

EUROPEAN COMMISSION ADOPTED A PROPOSAL DIRECTIVE ON CORPORATE SUSTAINABILITY DUE DILIGENCE

On 23 February 2022, the European Commission (EC) adopted a proposal for a directive on corporate sustainability due diligence (the Proposed Directive).[1]

The EU has already enacted three pieces of legislation that impose supply chain due diligence regarding human rights and sustainability issues. These pieces of legislation only concern specific industries, i.e., the mineral[2] and wood[3] industries, or require only large companies located in the EU to report non-financial information, including on human rights.[4]

At the national level, some European countries have already introduced national legislation regarding human rights due diligence. However, these national laws focus on specific human rights violations, *e.g.*, child labor or forced labor,[5] or target only large national companies.[6]

As a result, these rules have had limited implications on Japanese companies doing business in Europe.

The Proposed Directive, by contrast, will have a broader personal scope of application and will require more general human rights and environmental due diligence than the existing EU and national legislation. Therefore, the Proposed Directive would have broader impacts on Japanese companies either exporting products to the EU Member States or having subsidiaries or affiliates within the EU Member States.

1. Purpose of the Proposed Directive

The Proposed Directive aims to foster sustainable and responsible corporate behaviour throughout global value chains.[7] For this purpose, the Proposed Directive provides a set of obligations for companies regarding actual and potential human rights adverse impacts and environmental adverse impacts, with respect to their own operations, the operations of their subsidiaries, and the value chain operations carried out by entities with whom the company has an established business relationship.[8]

2. Personal Scope

The Proposed Directive will apply to the following companies:[9]

- EU companies having more than 500 employees and a net worldwide turnover of more than EUR 150 million (large EU companies)
- EU companies having more than 250 employees and a net worldwide turnover of more than EUR 40 million, at least half of which is generated in specific high-risk sectors, *inter alia*:
    - The manufacture of textiles, leather and related products (including footwear), and the wholesale trade of textiles, clothing and footwear
    - Agriculture, forestry, fisheries (including aquaculture), the manufacture of food products, and the wholesale trade of agricultural raw materials, live animals, wood, food and beverages
    - The manufacture of basic metal products, other non-metallic mineral products and fabricated metal products (except machinery and equipment).

Furthermore, the Proposed Directive will apply to the companies outside the EU that meet either of the following conditions:

- Have a net turnover in the EU of more than EUR 150 million (large non-EU companies)
- Have a net turnover in the EU of more than EUR 40 million and at least half of the net worldwide turnover is generated in the high-risk sectors listed above.

Therefore, Japanese companies that meet these thresholds will be required to comply with the due diligence requirements set by the Proposed Directive, even if they do not have a subsidiary or affiliate in the EU or their European subsidiary or affiliate is not within the scope of the Proposed Directive.

3. Due Diligence Obligations

The Proposed Directive will require companies to conduct human rights and environmental due diligence by carrying out the following actions:[10]

- Integrating due diligence into their policies
- Identifying actual or potential adverse impacts
- Preventing and mitigating potential adverse impacts, bringing actual adverse impacts to an end and minimising their extent
- Establishing and maintaining a complaints procedure
- Monitoring the effectiveness of their due diligence policy and measures
- Publicly communicating on due diligence.

The human rights and environmental conventions that companies should consider when conducting due diligence are listed in the Annex of the Proposed Directive.

The due diligence obligations will extend to business relationships with the company's value chains.[11] That is, companies should identify, prevent, and monitor actual and potential violations of human rights or environmental standards in the operations of their value chains.

There are additional obligations on large companies and EU-based companies. Large EU companies and large non-EU companies will be required to adopt a plan to ensure that their business strategy is compatible with limiting global warming to 1.5° C in line with the Paris Agreement.[12] In any EU-based company within the scope of the Proposed Directive, directors will be required to take into account the human rights, climate change and environmental consequences of their decisions when fulfilling their duty to act in the best interest of the company.[13]

4. Sanctions

National administrative authorities may impose fines in case of non-compliance based on the company's turnover. The EC will set up a European Network of Supervisory Authorities, which will facilitate the cooperation of the supervisory authorities and the coordination and alignment of regulatory, investigative sanctioning and supervisory practices.[14]

In connection with companies outside the EU, the competent authority will be that of the Member State in which the company has a branch. If the company does not have a branch in any Member State or has branches in different Member States, the competent authority will be that of the Member State in which the company generates most of its net turnover in the EU.[15]

In addition, companies should be liable for damages resulting from their failure to prevent potential adverse impacts or bring actual adverse impacts to an end.[16]

5. Next Steps

The proposal will be presented to the European Parliament and the Council for approval. Once adopted, the Member States shall transpose the Directive into the national laws within two years from its entry into force. Large EU companies and large non-EU companies, therefore, should comply with the due diligence obligations by the end of this period. Companies within the Directive's scope because of their activities in high-risk sectors, on the other hand, should do so within four years after the Directive enters into force.

It is worth noting that the Proposed Directive is highly controversial, as an exercise of due diligence in developing and emerging countries is burdensome for European businesses.

Given the sensitive nature of the rules and current controversies, the proposal is not likely to be enacted before 2023. That is, the due diligence obligations on large companies will come into force in 2025 and those on other companies in high-risk sectors in 2027 at the earliest.

The developments in sustainability regulations are not limited to the EU. On 21 March 2022, the US Securities and Exchange Commission (SEC) issued a proposal related to corporate sustainability disclosures concerning "environment, social and governance" (ESG) matters.[17] This trend of imposing ESG obligations on companies is likely to continue in the EU and the United States.

6. Implications for Japanese Companies

Japanese companies, especially those generating a net turnover in the EU of more than EUR 150 million and having value chains in countries with a risk of human rights violations, should prepare a strategy to comply with the due diligence obligations.

Japanese suppliers outside the scope of the Proposed Directive should also expect that European companies would ask to collaborate on their human rights due diligence. When collaborating with competitors by sharing resources or information, it is essential to consider compliance with applicable competition law.

Finally, the Proposed Directive would be used as a benchmark for non-EU countries examining national human rights due diligence rules, including Japan. It would be helpful for Japanese companies to follow the trends of the EU legislation to anticipate upcoming human rights and sustainability regulations in Japan or other jurisdictions.

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1 European Commission, Proposal for a Directive on corporate sustainability due diligence and amending Directive (EU) 2019/1937, Brussels, 23.2.2022 COM (2022) 71 final.

2 So-called the Conflict Minerals Regulation, Regulation (EU) 2017/821 of the European Parliament

and of the Council of 17 May 2017 laying down supply chain due diligence obligations for Union importers of tin, tantalum and tungsten, their ores, and gold originating from conflict-affected and high-risk areas.

3 Regulation (EU) No 995/2010 of the European Parliament and of the Council of 20 October 2010 laying down the obligations of operators who place timber and timber products on the market.

4 Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups.

5 UK Modern Slavery Act.

6 French Corporate Duty of Vigilance Law applies to a French company and its subsidiaries that have more than 5,000 employees in France or 10,000 employees worldwide.

7 European Commission, press release "*Just and sustainable economy: Commission lays down rules for companies to respect human rights and environment in global value chains*", 23 February 2022, https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1145.

8 Article 1 of the Proposed Directive.

9 Article 2 of the Proposed Directive.

10 Article 4 of the Proposed Directive.

11 "Value chain" is defined as activities related to the production of goods or the provision of services by a company, including the development of the product or the service and the use and disposal of the product as well as the related activities of upstream and downstream established business relationships of the company (Article 3 (g)).

12 Article 13 of the Proposed Directive.

13 Article 25 of the Proposed Directive.

14 Article 20 and 21 of the Proposed Directive.

15 Article 17 of the Proposed Directive.

16 Article 22 of the Proposed Directive.

17 The Securities and Exchange Commission (SEC), Release Nos. 33-11042; 34-99478.

DOJ TO DEVOTE SUBSTANTIAL RESOURCES TO INVESTIGATING AND PROSECUTING CORPORATE CRIME, EMPHASIZING IMPORTANCE OF EFFECTIVE COMPLIANCE PROGRAMS

In March 3, 2022, speeches at the American Bar Association's Annual National Institute on White Collar Crime (ABA White Collar Institute), US Attorney General (AG) Merrick Garland and US Assistant Attorney General for the Criminal Division (AAG) Kenneth Polite Jr. addressed the US Department of Justice's (DOJ) increased commitment to investigating and prosecuting corporate crime.

As a testament to their commitment to these resource-intensive cases, AG Garland discussed plans to hire 120 new prosecutors and 900 new FBI agents; this announcement represents a substantial surge in resources. AG Garland and AAG Polite also addressed specific ways they intend to increase enforcement efforts, including through the expanded use of data analytics. Finally, in addition to outlining substantive enforcement priorities, AG Garland and

AAG Polite emphasized DOJ's focus on individual accountability, with AG Garland reiterating that DOJ's primary goal is "obtaining individual convictions rather than accepting big-dollar corporate dispositions."

As AG Garland warned, DOJ's white-collar enforcement efforts will further "accelerate as we come out of the pandemic" and DOJ's interest in corporate crime is clearly "waxing again." Companies must therefore take proactive steps to prepare for this increased enforcement activity.

Substantial Additional Resources for Corporate Crime Enforcement

In 2021, DOJ charged 5,521 individuals with "white collar" crimes, which represented a 10% increase over 2020. During his speech, AG Garland announced that DOJ will be devoting even more resources toward its corporate crime enforcement efforts going forward. Specifically, DOJ will seek funding to hire 120 new prosecutors and 900 new FBI agents, all of whom would focus on white-collar crime. If DOJ obtains such funding, those new prosecutors and agents could supercharge DOJ's enforcement efforts. For example, 120 prosecutors is more prosecutors than there are in many US Attorneys' Offices (including in the District of Massachusetts, a district that is already active in corporate enforcement, particularly in the resource-intensive healthcare space). Adding 900 new FBI agents—a number that is similarly larger than many existing FBI field offices—could allow DOJ to pursue thousands of new corporate criminal investigations.

Expanded Use of Data Analytics

For the past two years, DOJ and other federal agencies have increasingly relied on sophisticated data analytics tools to identify and prosecute corporate crime. AG Garland specifically identified data analytics as another "force-multiplier" for DOJ. DOJ's use of data analytics will undoubtedly expand going forward. Among other things, AG Garland announced that a new squad of FBI agents has been embedded within the Criminal Division's Fraud Section to "further strengthen [DOJ's] ability to bring data-driven corporate crime cases nationwide." As DOJ increasingly relies on "big data," including vast amounts of data from other state and federal agencies, companies must ensure that they are proactively using data analytics to further their own internal compliance efforts.

DOJ's Priority Enforcement Areas

AG Garland and AAG Polite mentioned several of DOJ's specific white-collar criminal enforcement priorities during their remarks. In addition to traditional areas such as healthcare fraud, securities fraud and Foreign Corrupt Practices Act violations, companies should expect increased DOJ scrutiny in the following areas:

- **Antitrust**: AG Garland highlighted DOJ's active investigations and prosecutions of alleged criminal antitrust violations and collusive activity in government procurement. DOJ's Antitrust Division ended the last fiscal

year with 146 open grand jury investigations—the most in 30 years—and is trying or preparing to try 18 indicted cases against 10 companies and 42 individuals. AG Garland previously noted that "reinvigorating Antitrust enforcement" was a top priority for DOJ, and he requested a budget increase of 9% for the Antitrust Division (more than $200 million). Such significant additional resources will bolster the Antitrust Division's aggressive pursuit of alleged violations in their current priority areas: government procurement, labor markets, consumer products and the healthcare industry. In addition, during separate remarks at the ABA White Collar Institute, Richard Powers, the Deputy Assistant Attorney General for Criminal Enforcement in the Antitrust Division, noted that the Division is also prepared to criminally charge individual executives for violations of Section 2 of the Sherman Act (the provision prohibiting market monopolization). Charging Section 2 cases criminally is an exceedingly aggressive and controversial approach, and it something that the Division has not done in decades.

- **COVID-19 Fraud**: AG Garland reiterated DOJ's commitment to pursuing fraudulent conduct in connection with the COVID-19 pandemic. As President Biden recently announced, AG Garland will be "naming a chief prosecutor to lead specialized teams dedicated to combatting pandemic fraud." The chief prosecutor will "build on" the work of the COVID-19 Fraud Enforcement Task Force announced in May 2021. Additional pandemic-related prosecutions and investigations will likely continue for years to come and may increase in scope and complexity.
- **Cryptocurrency**: AAG Polite specifically mentioned the "emerging cryptocurrency space" as an area in which individual victims are particularly vulnerable to being "exploited by other market participants." AAG Polite referenced the recent indictment of the founder of cryptocurrency platform BitConnect in connection with an alleged $2.4 billion Ponzi scheme. His remarks follow increased cryptocurrency enforcement and regulatory activity from the US Securities and Exchange Commission (SEC), the Financial Crimes Enforcement Network (FinCEN), the Internal Revenue Service (IRS) and other federal agencies during the past year, and they demonstrate that cryptocurrency remains squarely in the DOJ's crosshairs.

DOJ's Renewed Focus on Individual Accountability

The remarks of AG Garland and AAG Polite focused heavily on DOJ's efforts to ensure that individuals are held accountable for corporate crime. AG Garland stated that DOJ's "first priority in corporate criminal cases is to prosecute the individuals who commit and profit from corporate malfeasances." AG Polite in turn noted that DOJ "prioritize[s] prosecution of individuals responsible for corporate crimes to the fullest extent of the law."

Although "individual accountability" has long been at the core of DOJ's Principles of Federal Prosecution, AG Garland and AAG Polite's statements were noteworthy since prosecutions of individuals for corporate crime had waned during the past administration. AG Garland recognized that "obtaining individual convictions rather than accepting big-dollar corporate dispositions is a difficult and resource-intensive road," but committed to marshalling the resources necessary for DOJ to pursue such prosecutions successfully.

AG Garland and AAG Polite also reemphasized DOJ's requirement that, to be eligible for cooperation credit, companies must provide DOJ "with all non-privileged information" about "all individuals involved in or responsible the misconduct at issue," regardless of "their position, status or seniority." First announced by Deputy Attorney General (DAG) Lisa Monaco last fall, AG Garland described this requirement and defense lawyers as a "force multiplier" for DOJ. DOJ now expects companies and their defense lawyers to "come clean about everyone involved in the misconduct, at every level." This is a change from the previous administration, which required only that companies make disclosures regarding those individuals the companies deem to have had "substantial" involvement in the misconduct.

KEY TAKEAWAYS

With a surge of DOJ resources focused on corporate crime (and AG Garland's clear commitment to enforcement in that area), the importance of an effective corporate compliance plan cannot be overstated. In fall 2021, DAG Monaco reiterated the import of self-monitoring, a trend that has been gaining momentum at DOJ since it first issued comprehensive compliance guidance in 2017. AAG Polite reiterated the same on March 3, 2002, providing additional insight into what DOJ will be looking for when evaluating corporate compliance programs:

- DOJ wants to know "whether you are doing everything you can to ensure that when that individual employee is facing a singular ethical challenge, he has been informed, trained and empowered to choose right over wrong."
- When misconduct takes places, DOJ will be evaluating whether your company has in place "a system that immediately detects, remediates, disciplines, and then adapts to ensure that others do not follow suit."
- Even when a CEO is not involved in wrongdoing, DOJ expects corporations to "examine whether a change in leadership is necessary" and analyze whether current leadership "modeled poor ethical behavior for the workforce, or fostered a climate in which subordinates committed wrongdoing with intent to benefit the company, or permitted weak internal controls that allowed the crimes of individuals to go undetected."

AN OVERVIEW OF OECD PILLAR 2

The Organisation for Economic Co-operation and Development (OECD)/G20 Global Anti-Base Erosion (GloBE, Pillar 2) Model Rules, published in December 2021, intend to address perceived challenges to long-standing international taxation principles from the increasing digitalization of the economy. If implemented, these rules (Model Rules) would significantly impact the taxation of multinational groups, introducing new complexity to international taxation and nullifying the benefit of tax incentive regimes employed by many countries to attract foreign investment.

Addressing the tax challenges raised by digitalization has been a priority of the OECD/G20 Inclusive Framework on base erosion and profit shifting (BEPS) since 2015. Inclusive Framework members agreed to examine proposals in the two pillars forming the basis for a long-term solution to these tax challenges. In mid-2019, a program of work to be conducted on Pillars 1 and 2 was adopted and finally endorsed by the G20 finance ministers in July 2021. As of 4 November 2021, 137 OECD/G20 countries and jurisdictions—out of the 140 members of the OECD/G20 Inclusive Framework on BEPS—representing more than 90% of global gross domestic product (GDP) agreed to join the official statement of the Two-Pillar Solution. Pillar 1 foresees reallocating international taxing rights and stabilizing the international system of tax law. Pillar 2, which was introduced jointly by the (at that time) Vice Chancellor and Finance Minister of Germany Olaf Scholz and his French counterpart Bruno Le Maire, imposes a global minimum 15% tax rate for certain multinational enterprises (MNEs) from 2023 onwards.

The OECD illustrated the most relevant aspects of Pillar 2 in a blueprint published in 2020. The Model Rules published in December 2021 add significant detail but offer limited indication as to how the rules might apply in practice. A commentary on the Model Rules to be published in the first quarter of 2022 is expected to provide additional guidance in this regard.

PILLAR 2 AT A GLANCE

Pillar 2 rules apply to multinational groups with global revenues exceeding a €750 million threshold, in line with current Country-by-Country Reporting (CBCR) obligations. A group is defined as a collection of enterprises that are consolidated for financial accounting purposes. Pillar 2 applies to the constituent entities (CEs), *i.e.*, subsidiaries included in the consolidation and permanent establishments (PEs), including branch operations and entities that are disregarded for US income tax purposes.

Pillar 2 includes two proposals that operate almost independently of each other:

1. A global anti-base erosion regime (GloBE rules) applies through an income inclusion rule (IIR) and an undertaxed payments rule (UTPR) with support from a switchover rule (SOR) as required; and
2. A minimum level of tax on certain payments between connected parties, which are deemed as having a heightened base eroding potential (subject to tax rule (STTR)).

The interaction between the two is that the top-up tax imposed under the STTR is taken into consideration for the purpose of calculating the effective tax rate (ETR) under GloBe rules.

Thus, the STTR operates in priority to GloBe rules.

The different elements of the GloBe rules can be described as follows:

1. The IIR requires the ultimate parent entity (UPE) to pay a top-up tax on its proportionate share of the income of any low-taxed CE in which the UPE has a direct or indirect ownership interest. The tax is the top-up amount required to bring the overall tax on the profits up to the 15% ETR. The IIR is a residence-based income tax rule. However, further to the OECD Model Rules, the amount of the top-up tax payable under the IIR and the UTPR are net of any Qualified Domestic Minimum Top-Up Tax (QDMTT), *i.e.*, of minimum tax included in the domestic law of a jurisdiction and shaped consistently with GloBE rules. This ensures that source countries retain the primary right to tax profits sourced in their territory at the 15% rate (if they choose to do so). The UPE is given priority for applying the IIR. If the UPE is located in a jurisdiction that has not implemented the IIR, then responsibility for applying the IIR falls on the CE that is directly owned and controlled by that UPE, and so on, down the chain of ownership.
2. The IIR is complemented by a tax treaty-based SOR that allows a jurisdiction to override the exemption method and switch to the credit method to the extent necessary to apply the IIR to the profits of a PE. This ensures equality of treatment of exempt PEs and foreign subsidiaries under GloBe rules.
3. The UTPR serves as a backstop to the IIR and is aimed at dealing with cases in which the IIR is unable to bring low tax jurisdictions in line with the 15% minimum ETR. The UTPR allocates the taxing rights over the under-taxed income (deriving from a low tax jurisdiction) to jurisdictions different from the UPE residence.

The STTR complements GloBE rules. It is a tax treaty rule that specifically targets intragroup payments, which benefit from low nominal tax rates in the jurisdiction of the payee. As mentioned above, the STTR operates before the IIR and confers a primary taxing right to the source jurisdiction. Thus, being "de facto" a priority rule under GloBE rules. To a certain extent, the STTR constitutes a counterweight for source jurisdictions against the IIR, which is a residence-based tax rule. It is activated where intragroup payments are made by an entity in one contracting state to a group entity in another contracting state that is subject to an adjusted nominal tax rate below the 15% minimum ETR. In that case, the source state may levy a withholding tax equal to the top-up tax on the gross payment.

PILLAR 2—A MORE IN-DEPTH VIEW OF GLOBE RULES

In-Scope Entities

GloBE rules apply to taxpayers who: (1) are members of a multinational group and (2) its multinational group had an annual revenue of €750 million or more in the consolidated financial statements of at least two of the four fiscal years preceding the tested fiscal year. A group will not be subject to GloBE rules if it: (1) does not have at least one subsidiary or PE located in a jurisdiction different from the one of the UPE or (2) does not meet the indicated revenue threshold.

Some specific exclusion rules are provided. The most relevant exclusions are: (1) pension funds, (2) investment funds or real estate investment vehicles qualifying as UPE, (3) nonprofit organizations and (4) governmental entities and international organizations.

Application of GloBE Rules

GloBE rules should be applied in the following steps:

1. Calculation of the ETR
2. Calculation of the top-up tax
3. Determination of the liability for the top-up tax

Calculation of the ETR

First, each CE should determine its GloBE income or loss. The CE income or loss as reported in the UPE's consolidated financial statements (before the elimination of intragroup transactions) constitutes the starting point.

Then, the CE's accounting income or loss must be adjusted to remove specific book-to-tax differences (*e.g.*, excluded dividends, excluded equity gains or losses, asymmetric foreign currency gains or losses, prior period errors and changes in accounting principles). GloBE income includes tax credits refundable within four years (Qualified Refundable Tax Credits

(QRTC)), while tax credits that do not meet such requirement are excluded. International shipping income is also excluded for GloBE purposes. Further details and rules are laid under Chapter 3 of the OECD Model Rules.

Chapter 4 of the OECD Model Rules provides the calculation of the tax attributable to the GloBE income. Covered taxes include all income taxes, including taxes on distributed profits and deemed profit distributions, accrued for financial statements purposes. Taxes due by the CE's owners and resulting from the application of a controlled foreign company (CFC) regime are allocated to the CE for GloBE purposes. As far as temporary differences are concerned, OECD Model Rules rely on deferred tax accounting concepts with some specific adjustments (*e.g.*, credit for deferred tax liabilities are capped at 15%; a recapture mechanism applies for deferred tax liabilities that have not been reversed within five years). Alternatively and with respect to losses, a taxpayer may elect to utilize a simplified GloBE loss carryforward mechanism.

The ETR is calculated on a jurisdictional basis as a result of the covered taxes divided by the net GloBE income referred to the relevant jurisdiction (*i.e.*, GloBE income of all CEs located in the jurisdiction minus the GloBE losses of all CEs located in the jurisdiction). Because tax incentives granted in the CE jurisdiction reduce covered taxes but may not affect the denominator of the ETR calculation, such incentives can reduce the ETR (and, if the relevant conditions are met, they could be totally or partially offset by the top-up tax)[1].

Calculation of the Top-Up Tax

The top-up tax rate is equal to the difference, if any, between the 15% minimum rate and the ETR of the relevant jurisdiction. It is then multiplied by the group's jurisdictional excess profit, which is defined as the group's GloBE income minus a substance-based income exclusion (SBIE) equal to 5% of the carrying value of tangible assets plus 5% of total payroll costs in the jurisdiction. The group's jurisdictional top-up tax is equal to the resulting value minus the amount of any QDMTT imposed by the relevant jurisdiction. Further details are

provided under Chapter 5 of the OECD Model Rules.

Determination of the Liability for the Top-Up Tax

After computing the group's top-up tax for each jurisdiction in which it has a CE, the entity liable for the top-up tax should be determined. The IIR constitutes the primary rule and results in the application of the top-up tax to the UPE. The UPE pays the top-up tax in proportion to its ownership interests in the CEs that have low-taxed income. If the jurisdiction of the UPE does not apply an IIR, the income inclusion applies to the highest intermediate parent entity in the group's ownership structure that is subject to an IIR.

Exceptions to this top-down approach are provided under split ownership rules, whereby the IIR must be applied by an intermediary company instead of its parent if minority shareholders outside the group hold an equity interest that represents more than 20% of that intermediary company. However, this split ownership rule does not apply if the intermediary company is entirely owned directly or indirectly by shareholders who are subject to the IIR.

As mentioned above, the IIR is complemented by a tax treaty-based SOR that allows a jurisdiction to override the exemption method and switch to the credit method to the extent necessary to apply the IIR to the PE profits.

If any top-up tax liability remains after applying the IIR, OECD Model Rules apply the UTPR as a backstop mechanism. The UTPR would be triggered, for example, where: (1) CEs are located in low tax jurisdictions, which are owned directly and indirectly by entities resident in jurisdictions that have not implemented the IIR, or (2) the UPE is resident in a low tax jurisdiction (so that there are no entities in the chain of ownership that can apply the IIR).

The UTPR operates through an adjustment (such as a denial of a deduction for otherwise deductible expenses or an equivalent adjustment provided under domestic law) that increases the tax at the level of the subsidiary. The share of the top-up tax is allocated among

jurisdictions based on the value of the group's tangible assets and the number of its employees in jurisdictions that have implemented the UTPR, with both factors given equal weight.

Further details on the IIR and the UTPR are provided under Chapter 2 of the OECD Model Rules.

Carve Outs and Transition Rules

Chapter 9 of the OECD Model Rules lays down a few transition rules.

Among them, an exclusion from the UTPR for groups in the initial phase of their international activity is provided. Such groups are defined as those that have a maximum of €50 million worth of tangible assets in all jurisdictions different from the one in which it has the highest amount of tangible assets and operates in no more than six jurisdictions. This exclusion is limited to a five-year period after the group comes into the scope of the GloBE rules for the first time. For groups that are in the scope of the GloBE rules when they go into effect, the five-year period will start at the time the UTPR rules go into effect.

Furthermore, as said above, a SBIE equal to 5% of the value of tangible assets plus 5% of total payroll costs in the jurisdiction is provided. In a transition period of 10 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% for the first five years (for both tangible assets and payroll) and by 0.4% for tangible assets and by 0.8% for payroll for the last five years.

GloBE rules also provide for a *de minimis* exclusion for jurisdictions where the group has revenues of less than €10 million and profits of less than €1 million.

GILTI Coexistence

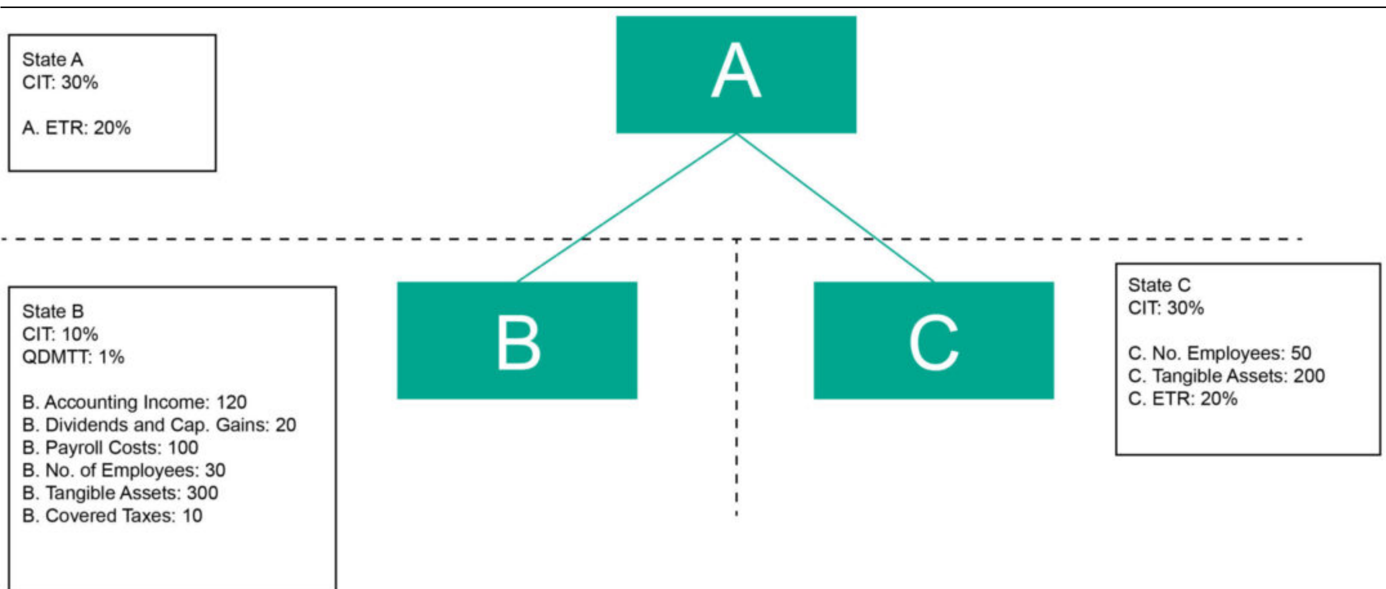
US global intangible low-taxed income (GILTI) rules and other income inclusion regimes are

currently being examined to determine if they meet the objectives of GloBE rules. In that context, the OECD has indicated that consideration will be given to the conditions under which the GILTI regime will coexist with GloBE rules to ensure a level playing field. The GILTI rules might not be considered a qualifying IIR unless US Congress modifies the GILTI regime so that it applies a 15% minimum ETR on a country-by country basis—currently an uncertain prospect. If the existing regime is not amended, US-parented groups may be subject to application of UTPRs to top-up tax amounts of their CFCs.

Additionally, regardless of whether GILTI is modified, other countries' UTPRs may apply to top-up tax calculated with respect to the US parent company and any disregarded entities or foreign branches it owns.

A NUMERIC EXAMPLE

Let's assume the following scenario:



Company A qualifies as UPE and Companies B and C are wholly-owned by Company A.

1. Calculation of the ETR in State B

- GloBE Income in State B: **100** (120-20 → B Accounting Income – B Excluded Dividends and Cap. Gains)
- Covered Taxes in State B: **10**
- ETR in State B: **10%** (10/100 → Covered Taxes in State B/GloBE Income in State B)

2. Calculation of the Top-Up Tax

- Top-up tax rate: **5%** (15%-10% → GloBE Minimum Rate – ETR in State B)
- SBIE in State B: **20** (5%*100 + 5%*300 → 5% of B Payroll Costs + 5% of B Tangible Assets)
- Group Excess Profit in State B: **80** (100 – 20 → GloBE Income in State B – SBIE in State B)
- Top-up tax (without QDMTT[2]): **4** (5%*80) → Top-up tax rate * Group Excess Profit in State B
- Final amount of top-up tax (with QDMTT): **3.2** [4-(1%*80)] → [Top-up tax – QDMTT][3]

3. Determination of the Liability for the Top-Up Tax

The company liable for the top-up tax will be determined in the following order:

- If State A implemented the IIR → **Company A** is liable for the top-up tax (3.2) on the basis of IIR
- If State A has not implemented the IIR → **Company C or Company B and C are liable for the top-up tax on the basis of the UTPR (see below).**

4. UTPR Mechanism

- **Scenario A** —> State C is the only state that implemented the UTPR
  - **Company C** is liable for the top-up tax (3.2)
- **Scenario B** —> Both State B and State C implemented the UTPR

UTPR percentage of State B: **48.75%** (50%*30/80 + 50%*300/500 50% * Number of employees in State B/Number of Employees in all UTPR States + 50% * Value of Tangible Assets in State B/Value of Tangible Assets in all UTPR States)

UTPR Percentage of State C: **51.25%** (50%*50/80 + 50%*200/500)

- **Company B** liability for the top-up tax: **1.56** (3.2*48.75%)
- **Company C** liability for the top-up tax: **1.64** (3.2*51.25%)

NEXT STEPS

As mentioned above, in the first quarter of 2022, the OECD should adopt and publish a commentary on OECD Model Rules. Further work and elaborations by the OECD are expected throughout the course of 2022 with the goal of first applying Pillar 2 rules (together with Pillar 1 rules) as from 2023.

In parallel with OECD elaborations, in December 2021, the European Commission proposed the adoption of a directive with regard to the EU area (COM 2021 823). The draft directive closely follows the OECD Model Rules but extends their scope to large-scale purely domestic groups (meaning that in the EU area, GloBE rules would also apply to groups that do not have subsidiaries/PEs in more than one jurisdiction). While the European Commission officially stated that the extension is provided "in order to ensure compliance with the EU fundamental freedoms," a few scholars raised some doubts on the compliance of the directive with those freedoms.

The draft directive also exercises an option set out in the OECD's commentary for the Model Rules to require an EU Member State of an in-scope multinational enterprise applying the IIR (as said above, usually the jurisdiction of the UPE) to ensure effective taxation at the minimum agreed level (15%) for not only foreign subsidiaries but all CEs resident in that Member State and the PEs of the group established in that Member State.

Provided that the draft directive is approved by EU institutions (remarkably, a unanimous agreement of EU Member States at the Council level is required), the relevant rules should be implemented in the domestic tax systems by the end of 2022 and should apply as from 2023.

In this respect, we also note that Spanish Budget Law for 2022 has already provided a 15% minimum tax applicable as from 1 January 2022. The minimum tax applies to taxpayers with a net turnover of at least €20 million and those subject to the tax consolidation regime (thus having a scope of application wider than both the OECD rules and the proposed EU directive).

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[1] We are assuming that State B adopts a 1% QDMTT for purely illustrative reasons (i.e. in order to allow the applicability of the IIR and UTPR mechanism). We are aware that, in case a given State decides to adopt a QDMTT, the rate of the QDMTT would likely be determined in way that the overall tax rate of the State reaches 15%.

[2] Please note that OECD Model Rules do not encompass separate steps for the calculation of the '*Top-up tax (without QDMTT)*' and '*Final amount of Top-up tax (with QDMTT)*' and include the deduction of the QDMTT in the step named '*Jurisdictional Top-up Tax*' under Art. 5.2.3.

[3] This point should be further analysed and checked also on the basis of the Commentary to OECD Model Rules to be adopted in next weeks.

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[illegible] [5][illegible][6][illegible]

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EU[illegible]EU[illegible]

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[illegible]EU[illegible]EU[illegible]duty to act in the best interest of the company[illegible][13][illegible]

4. [illegible]

[illegible]EC[illegible](European Network of Supervisory Authorities)[illegible][14][illegible]

EU[illegible]EU[illegible][15][illegible]

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5. [illegible]

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6. [illegible]

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1 European Commission, Proposal for a Directive on corporate sustainability due diligence and amending Directive (EU) 2019/1937, Brussels, 23.2.2022 COM (2022) 71 final

2 ???????????Regulation (EU) 2017/821 of the European Parliament and of the Council of 17 May 2017???EU??????????????????????????????? ??????

3 Regulation (EU) No 995/2010 of the European Parliament and of the Council of 20 October 2010 ?????????????????????????

4 Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU???

5 ??????2015?????????????

6 ?????????????????????????5,000???????????10,000????????????????????????????????

7 ??, ?????, 2022?2?23? https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1145

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11 ?? ???????????????????the related activities of upstream and downstream established business relationships of the company???????????????????3?(g)??

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17 ��������(SEC), Release Nos. 33-11042; 34-99478

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Garland[illegible]DOJ[illegible]DOJ[illegible]

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[illegible]OECD[illegible]2[illegible]

2021[illegible]12[illegible](OECD)/G20[illegible](GloBE : Global Anti-Base Erosion[illegible]2[illegible])[illegible]

2015[illegible]OECD/G20[illegible](BEPS : Base Erosion and Profit Shifting)[illegible]2[illegible]1[illegible]2[illegible]2019[illegible]2021[illegible]7[illegible]G20[illegible]2021[illegible]11[illegible]4[illegible]2[illegible]OECD/G20[illegible]BEPS[illegible]140[illegible]GDP[illegible]90%[illegible]137[illegible]1[illegible]2[illegible]([illegible])[illegible]2023[illegible]15%[illegible]

[illegible]2[illegible]2020[illegible](Blueprint)[illegible]2021[illegible]12[illegible]2022[illegible](Commentary)[illegible]

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[illegible]2[illegible](CbCR : Country-by-Country Reporting)[illegible]7[illegible]5000[illegible](CE : Constituent Entity)[illegible](PE : Permanent Establishment)[illegible](Disregarded Entity)[illegible]

[illegible]2[illegible]2[illegible]

1. [illegible](GloBE[illegible])[illegible](IIR : Income Inclusion Rule)[illegible](UTPR : Undertaxed Payments Rules)[illegible]2[illegible](SOR : Switchover Rule)[illegible]

2. [illegible](STTR : Subject To Tax Rule)[illegible]

[illegible]STTR[illegible](Top-up Tax)[illegible]GloBE[illegible]STTR[illegible]GloBE[illegible]

GloBE[illegible]

1. IIR[illegible](UPE : Ultimate Parent Entity)[illegible]15[illegible]IIR[illegible]UTPR[illegible](QDMTT : Qualified Domestic Minimum Top-Up Tax)[illegible]GloBE[illegible]15%[illegible]IIR[illegible]IIR[illegible]
2. IIR[illegible]SOR[illegible]SOR[illegible]PE[illegible]IIR[illegible]PE[illegible]GloBE[illegible]
3. UTPR[illegible]IIR[illegible]IIR[illegible]15%[illegible]([illegible])[illegible]

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[illegible]4[illegible]GloBE[illegible]CFC[illegible]([illegible])[illegible]GloBE[illegible]([illegible]15%[illegible]5[illegible])[illegible]GloBE[illegible]

[illegible]GloBE[illegible]([illegible]GloBE[illegible]GloBE[illegible])[illegible]([illegible])[illegible]

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[illegible]15%[illegible]QDMTT[illegible]GloBE[illegible](SBIE : Substance-Based Income Exclusion)[illegible]5%[illegible]5%[illegible]5[illegible]

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[illegible](split ownership rule)[illegible]20%[illegible]IIR[illegible]IIR[illegible]

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[illegible]5%[illegible]5%[illegible]10[illegible]8[illegible]10[illegible]5[illegible]0.2%[illegible]5[illegible]0.4%[illegible]0.8%[illegible]

GloBE[illegible]1000[illegible]100[illegible](de minimis exclusion)[illegible]

GILTI[illegible]

[illegible](GILTI[illegible] : Global Intangible Low-Taxed Income)[illegible]GloBE[illegible]OECD[illegible]GILTI[illegible]GloBE[illegible]GILTI[illegible]15%[illegible]GILTI[illegible]IIR[illegible]GILTI[illegible]UTPR[illegible]

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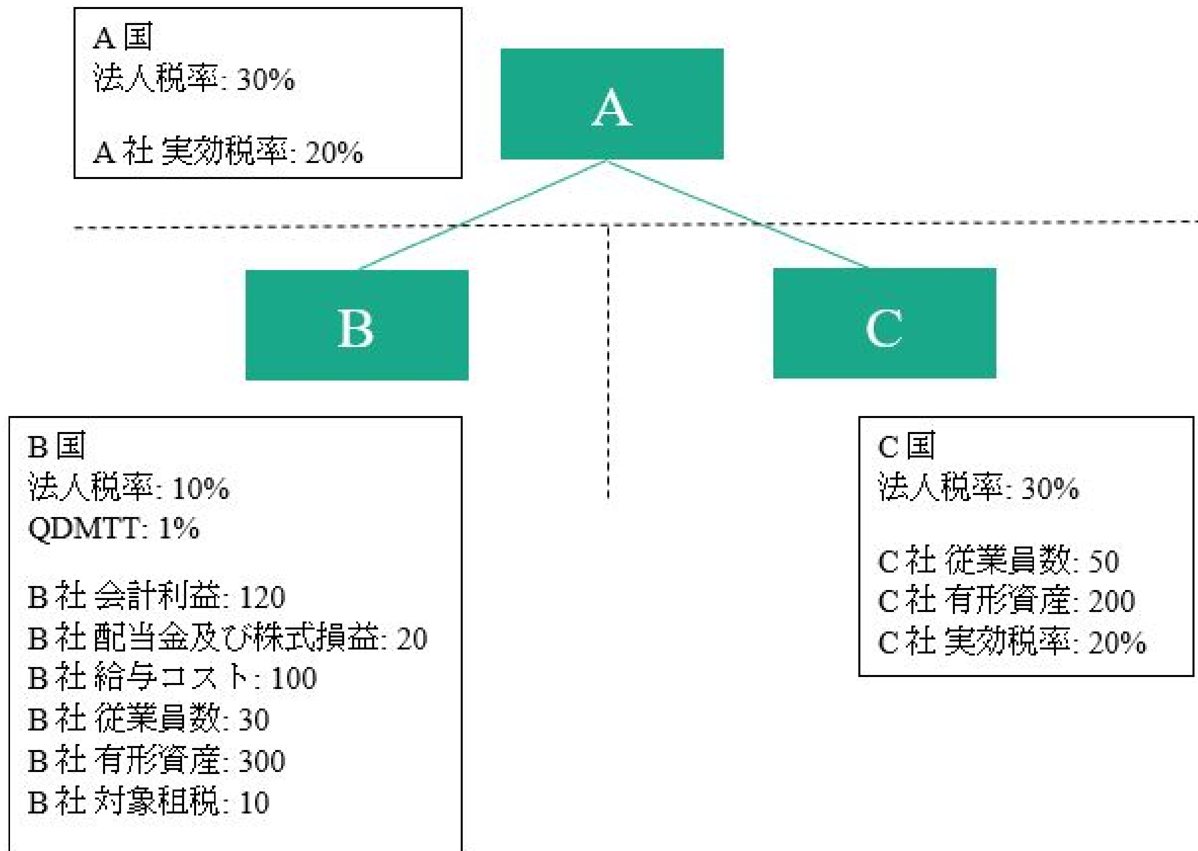

A[illegible]B[illegible]C[illegible]

1. B[illegible]*

- B[illegible]GloBE[illegible] : 100 (120-10 → B[illegible] [illegible]B[illegible] [illegible])
- B[illegible] : 10
- B[illegible] : 10% (10/100 B[illegible]/ B[illegible]GloBE[illegible])

2. [illegible]

- [illegible]: 5% (15%-10% → GloBE[illegible] – B[illegible])
- B[illegible]: 20 (5%*100 + 5%*300 → B[illegible]5% + B[illegible]5%)
- B[illegible] : 80 (100 – 20 → B[illegible]GloBE[illegible] – B[illegible])
- [illegible] (QDMTT[illegible]**) : 4 (5%*80 → [illegible]* B[illegible])
- [illegible] (QDMTT[illegible]) : 3.2 [4-(1%*80) → [illegible] – QDMTT***]

3. ��������������

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- A��IIR�������→ IIR���A���������(3.2)���
- A��IIR�������→UTPR���C������B��C� ���������(����)

4. UTPR�����

- ����A —> C����UTPR�������
  - C����������(3.2)���
- ����B —> B��C��UTPR�������

B�����UTPR�������: 48.75% (50%*30/80 + 50%*300/500 →50% * B��������/UTPR�������������������� + B��������/ UTPR���������������������)

C�����UTPR�������: 51.25% (50%*50/80 + 50%*200/500)

- B�������������� : 1.56 (3.2*48.75%)
- C�������������� : 1.64 (3.2*51.25%)

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��������2022�����������������������������������***�������(���������)�2023�������OECD��������������������

OECD������������������2021�12��EU����������(COM 2021 823)��(�����EU������������������PE�������������GloBE����������)��������������������������EU���

��PE���������(15%)����������������������EU���(������������������������)�IIR�����������������

������������(�����������������������������������)�2022�������������������������2023��������������

����������2022����������2022�1�1������15%������������������������2000�������������������������������������(����������OECD����EU��������)�

[1]

???QDMTT?1????????(IIR??UTPR?????????????)???????????????????QDMTT????????B?? ?????15%??????????????????

[2]

???????????????(QDMTT??)?????????????(QDMTT??)??????????????????????(5.2.3.?)???? ?QDMTT????????

[3] *?????3?14??????????????????*??(Commentary)*?????????????????*

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