The impact of Pillar Two and the BEPS Actions on finance transactions

Increasing interest rates, inflationary costs and the threat of restricted growth (or even recession) continue to add pressure on borrowers. Those pressures, combined with the lower headroom on financial covenants since higher interest rates have taken hold, will mean a number of financing transactions will be under stress. That stress can be further exacerbated if there is a risk of additional tax exposure materialising, particularly in highly structured transactions. In certain markets, that has focused lenders' minds on the borrower's tax structuring and analysis, particularly with respect to the application of some of the more complex international rules coming out of the OECD/G20 BEPS Project.

In this Banking and Tax briefing, we focus on three changes that originated from the BEPS Project – the anti-hybrids rules, the corporate interest restriction and Pillar Two – and how they might impact a borrower group's structuring and financial modelling. We also consider where lenders' concerns may lie and how borrowers might be able to pre-empt those in preparing to source finance.

The upcoming implementation of Pillar Two represents a seismic development in international tax and so that is where we will focus much of our discussion.

Which aspects of the BEPS Project have impacted borrower group structuring and financial modelling?

BEPS Actions

Of the 15 BEPS Actions, two in particular are often relevant to the structuring of an investment and the financial modelling of transactions: Action 2 on hybrid mismatches and Action 4 on the limitation of interest deductions (reflected in anti-hybrids rules and corporate interest restriction rules, respectively).

In the current environment, these topics and their consequences for the tax profile of the borrower group have piqued the interest of lenders (particularly on project and real estate financings and other tightly modelled transactions involving private equity and other fund sponsors), who have a keen eye on protecting the headroom built into their financial covenants as well as their cashflows and overall returns.

Pillar Two – Global minimum tax

The latest incarnation of the BEPS Project is a two-pillar solution to address the tax challenges arising from the digitalisation and globalisation of the economy. Pillar Two of that solution aims to impose a global minimum effective rate of tax set at 15%, which should take effect from 31 December 2023 in early adopting jurisdictions (including the UK and those in the European Union complying with the relevant Directive (albeit, given the pace at which Pillar Two has been

developed, implementation timetables across Member States may vary)). As with the anti-hybrids rules and the corporate interest restriction, Pillar Two is likely to impact those transactions where assumptions are made about the ongoing tax treatment of the borrower group or where the borrower forms part of a larger, complex structure.

The anti-hybrids rules and corporate interest restriction have been around for a while now – what are they intended to capture?

The anti-hybrids rules counteract arrangements that exploit differences in the tax treatment of an entity or instrument under the tax laws of two or more jurisdictions to produce a mismatch which reduces the overall tax burden of the parties to the arrangement. The counteraction may be to deny a deduction or bring a receipt into the charge to tax. By way of example, these rules can be relevant in structures with US investors where check-the-box elections are made or in respect of structures which use convertible instruments, which are sometimes features of private equity. Please see **Structuring considerations** below for further detail.

The corporate interest restriction rules are designed to prevent groups from using interest expense to generate excessive interest deductions or using finance to generate exempt or deferred income. If the rules apply to produce a restriction, a group will be prevented from claiming deductions for interest over a certain threshold. Generally speaking, the corporate interest restriction is relevant across sectors with lenders frequently starting from the assumption that a borrower group should be able to deduct all of its interest expense.

How do the anti-hybrids rules, the corporate interest restriction and Pillar Two impact finance transactions?

We are seeing lenders becoming particularly interested in these rules on recent transactions.

The broad effect of these rules is that they will increase the amount of tax incurred by the borrower group. Where those tax charges were not originally envisaged at the time the transaction was financially modelled, they may impact the borrower's ability to service its debt obligations and meet its financial covenants, including interest cover and other debt service ratios. The level of tax risk in each jurisdiction will require additional assessment and consideration as to the allocation of risk, adding time and expense for an international group.

Further, where the anti-hybrids rules or the corporate interest restriction apply, the impact of the increased tax charge is compounded by the fact an actual payment has been made by the borrower. Not only is there an increased tax charge but because the borrower has made a payment (in the form of interest, for example), there is less cash available to service its debt, adding further pressure to cashflows and financial covenants. Since covenants have become tighter, lenders have become increasingly focused on borrowers' approaches to these points.

These rules also bring with them various structuring considerations (please see **Structuring considerations** below for further detail) including, for example, in respect of:

1 the ***anti-hybrids rules***: where there is a US connection and/or a private equity sponsor, lenders may be concerned that the existence of a hybrid entity (being, for example, an entity that is treated as tax transparent in one jurisdiction but non-transparent in another) or a hybrid instrument (being, for example, an instrument which allows the payer to deduct an amount as interest but allows the receipt to be treated as an exempt dividend in the hands of a payee) could increase tax liabilities in the borrower group beyond the originally modelled transaction;

2 the ***corporate interest restriction***: relevant for determining the extent of the group and whether it is possible to silo an investment structure from others, identifying the method that produces the most beneficial result in terms of capacity to claim interest deductions, and considering if any exemptions are available; and

3 ***Pillar Two***: in assessing whether tax incentives and reliefs in a jurisdiction reduce the effective tax rate below 15% (which could be possible even in a higher tax jurisdiction) or, as above, in determining whether it is possible to silo an investment structure from others to fall outside of the €750m revenue test or ensure that it is only exposed to top-up tax in respect of its own activities.

It is particularly important to note that arrangements within the wider holding structure but outside the borrower group can impact the borrower group's tax position under these rules. Therefore, lenders will still be interested in those arrangements (notwithstanding that they may be outside the lender's obligor group) and whether they could expose the borrower group to any increased tax costs or risks.

What is Pillar Two and how does it work?

The main component of Pillar Two is the GloBE rules, which aim to ensure that multinational enterprises pay a minimum effective tax rate of 15% in every jurisdiction in which they operate.

This is primarily achieved through two interlocking measures: the income inclusion rule and the undertaxed profits rule:

1 The main rule is the ***income inclusion rule***, which is to some extent a global standardised controlled foreign companies (CFC) rule. It is applied top-down and will give the home jurisdiction of the ultimate parent entity (or, where that jurisdiction has not implemented the Pillar Two GloBE rules, the home jurisdiction of the next highest entity in the group which has implemented the rules) the right to collect top-up tax relating to the foreign entities owned by the ultimate parent entity. Broadly speaking, the income inclusion rule operates by testing the effective tax rate paid by the group in each jurisdiction in which it operates and determining how much top-up tax should be paid to increase each jurisdiction's effective tax rate to 15%.

2 The ***undertaxed profits rule*** is the back-up rule and is intended to deal with any top-up tax that has not been allocated under the income inclusion rule. The undertaxed profits rule will work by denying deductions or making other adjustments so that the amount of tax at the level of the subsidiary increases, such that the group entities pay their share of the top-up tax remaining after the income inclusion rule.

The top-down approach to the income inclusion rule can be displaced in certain joint venture scenarios with complex consequences (please see **Pillar Two and joint ventures** below for further detail).

The **Pillar Two Model Rules** also allow countries to establish a domestic minimum tax which, if consistent with the Model Rules, will be classified as a qualified domestic minimum top-up tax (**QDMTT**). Broadly, a QDMTT is a new minimum tax imposed by a jurisdiction on entities subject to tax in that jurisdiction where the domestic or multinational group of which they are part meets the criteria to be subject to the tax. A QDMTT is intended to be charged where the effective tax rate in the jurisdiction applying it is less than 15%, ensuring that the top-up tax is collected in the "source" jurisdiction rather than in another jurisdiction.

There is also a subject to tax rule which will apply before the GloBE rules and give greater source taxing rights to developing countries in certain situations.

What progress has the UK made towards implementing Pillar Two?

The enactment of the Finance (No.2) Act 2023 on 11 July 2023 brings new legislation to implement an income inclusion rule and QDMTT in the UK, with effect from 31 December 2023.

On 18 July 2023, the UK government published draft legislation for the inclusion of an undertaxed profits rule in the next Finance Bill. The UK government previously indicated that an undertaxed profits rule would not take effect before 31 December 2024. The OECD's latest Administrative Guidance provides for a transitional safe harbour that would limit the application of undertaxed profits rules in respect of ultimate parent entity jurisdictions where that jurisdiction has a corporate income tax rate of at least 20% until the end of 2026 to allow jurisdictions time to reform their domestic rules to routinely produce effective tax rates for Pillar Two purposes of over 15% or to adopt a QDMTT.

Who will the Pillar Two rules apply to?

The GloBE rules will apply to groups that have at least one legal entity or permanent establishment outside the ultimate parent entity's jurisdiction and the revenues in the ultimate parent entity's consolidated accounts are at least €750m per year. Jurisdictions that impose a QDMTT (including the UK) may also apply them to wholly domestic groups.

A "group" for these purposes is defined by the accounting standards as a collection of entities included in the ultimate parent entity's consolidated accounts (or, where it doesn't prepare consolidated accounts, its hypothesised consolidated accounts).

There are a few points worth noting:

1 ***Even if the borrower group does not operate in any obvious low tax jurisdictions, Pillar Two could still be relevant*** – It is not a case of simply checking the headline rate of tax is over 15%. The effective tax rate is calculated using an objective measure of taxable profit which may not be compatible with domestic rules. For example, the group could benefit from reliefs or incentives in a jurisdiction that reduce the effective tax rate for Pillar Two purposes (discussed below). As such, even in sectors that traditionally do not use low tax jurisdictions, transactions that take account of reliefs and incentives in their modelling (for example, in project financing) may need to consider the impact of Pillar Two to properly assess the borrower group's tax position. In sectors such as real estate, the impact of reliefs like the UK's former capital allowances super deduction may also need to be considered.

2 ***It is an important preliminary issue to determine which entities form a group for Pillar Two purposes*** – An entity that is not consolidated with an ultimate parent entity will generally neither count towards the revenue threshold nor be subject to the main taxing provisions. For many investment structures (for example, funds, their holding companies and portfolio companies), it will be important to consider whether the investment entity exemption applies to prevent accounting consolidation under the relevant accounting standard. This can cut either way depending on the circumstances: isolating the investment could protect it from breaching the threshold and becoming subject to the Pillar Two rules or, alternatively, it could depress its effective tax rate (and therefore increase the likelihood of a top-up tax) by preventing it from taking account of group expenses in its Pillar Two computations. Lenders to the portfolio companies of funds in all sectors are likely to be interested in the conclusions of this analysis. Of course, the scope of the group and the revenue threshold should be monitored on an ongoing basis and lenders to highly geared structures should consider the risk of changes outside the borrower group affecting the Pillar Two analysis (for example, due to a parent entity of the borrower group making a parallel investment, a change of control, or the introduction of minority investors to an intermediate holding company to form a joint venture).

3 ***Excluded Entities*** – While the Model Rules confirm that both investment and real estate investment vehicles are "Excluded Entities" when they are the ultimate parent entity, the accounting consolidation rules are likely to be key to both types of funds in determining the application of Pillar Two to a borrower group. Please refer to **Investment vehicles** below for detail on the tests for investment entities and real estate investment vehicles (including real estate investment trusts (REITs)). Where an entity is an "Excluded Entity", its profits, losses and taxes are removed from the effective tax rate calculation. Its revenues, however, still count to the €750m threshold. There are also exclusions for asset holding companies and it is possible to opt-out of the above exclusions, which may be beneficial in certain circumstances. Lenders to funds and REITs may wish to see that the borrower group has considered these rules and identified their impact on its overall tax position, especially where assumptions have been made on cashflows through the borrower group.

4 ***Secondary tax liabilities may arise where the person primarily chargeable to top-up tax under the income inclusion rule or QDMTT does not pay*** – For example, under the UK rules, HMRC may issue a notice to a person (anywhere in the world) who is a member of the group, or was a member of the group at the time the top-up tax arose, to pay the tax. Other Pillar Two jurisdictions are likely to implement similar rules. It will therefore be important in a finance context to consider the extent to which the borrower group may be exposed to Pillar Two secondary liabilities relating to entities outside the borrower group with which it is, or was, associated (drawing parallels with VAT grouping considerations relevant to European financing transactions).

We see a lot of transactions involving low or no tax jurisdictions, particularly the Channel Islands, Bermuda, the BVI and the Cayman Islands. How are they going to respond to Pillar Two?

Jersey, Guernsey and the Isle of Man announced in May 2023 that they will introduce an income inclusion rule and domestic minimum tax to provide for a 15% effective tax rate for large in-scope multinational enterprises from 2025. For groups with over €750m revenues, the corporate income tax regimes of those jurisdictions will change fundamentally in the relatively near future.

On 8 August 2023, the Bermudan Government launched a public consultation on the introduction of corporate income tax in Bermuda with effect from 1 January 2025. The consultation proposes that the new corporate income tax should only apply to Bermuda tax resident entities and permanent establishments that form part of multinational groups with revenues of at least €750m. It also proposes that the tax should be designed to ensure that it is taken into account in the effective tax rate calculation for Pillar Two purposes and to use certain elements of the GloBE rules' scoping provisions, ensuring consistency and predictable outcomes in respect of Pillar Two. Excluded Entities for the purposes of Pillar Two (such as investment funds that meet the relevant definition) will be exempt from Bermudan corporate income tax. While the rate of the new tax is yet to be determined, the Bermudan Government expect it to be between 9% and 15%. The Bermudan Government is also considering whether amendments are necessary to the existing Tax Assurance Certificate regime for in-scope entities (such certificates being a guarantee that any imposition of taxes on profits and gains (amongst other things) will not be applicable to the recipient and its operations in future years) to ensure that tax is collected in Bermuda rather than elsewhere under the Pillar Two rules.

Neither the BVI nor the Cayman Islands have made a formal announcement on their approach to Pillar Two. Earlier this year, the Director of the BVI International Tax Authority said in a webinar that the BVI will need to take a pragmatic approach on what it does in response to Pillar Two, noting that it would be administratively burdensome to go from the current system to one that imposes a 15% tax.

What key talking points are there in respect of Pillar Two?

Pillar Two is a ground-breaking development for international tax. The OECD continues to fine-tune the Model Rules and jurisdictions are battling with complex issues as part of their implementation. As a result, there are plenty of talking points that will impact financing transactions. **Pillar Two talking points** below sets out a few of those points, but by way of example:

1 ***Reliefs and incentives*** – Care should be taken in assessing the impact of tax reliefs and incentives on the application of Pillar Two. Importantly, not all tax reliefs reduce a group's effective tax rate. The Pillar Two rules smooth out timing differences by looking at any deferred tax accrued in a group's accounts as well as actual tax payments (see **Pillar Two talking points** below on issues relating to the use of deferred tax in the GloBE rules). So, an accelerated capital allowances claim up to 100% in the first year should not reduce the group's effective tax rate. But, if a relief goes beyond simply accelerating the point at which tax deductions are available and increases the amount of deductions available (such as the UK's former 130% super deduction), such relief should reduce the effective tax rate by the amount of the increase in deductions. This could impact the overall value given to reliefs and incentives in any financial modelling (for example, in the projects or real estate sectors where depreciation allowances are common), which may then have a knock-on effect on finance terms.

   Ultimately, the effect that claiming tax reliefs and incentives may have on the application of Pillar Two should be assessed on a case-by-case basis. Notwithstanding the above, if a jurisdiction has a corporate income tax rate materially above the 15% minimum, an entity may have sufficient capacity to claim reliefs that impact the effective tax rate calculation without triggering any top-up tax.

2 ***Structuring and modelling*** – The Pillar Two rules are in their infancy and businesses need to grapple with the best way to deal with them. For example, in the context of real estate investment, there are various potentially relevant elections that can be made and the suitability of those elections for a particular structure will lie in the detail. Businesses may also consider taking advantage of the jurisdictional-blending concept in the Model Rules (which combines the covered taxes, profits and losses of all group entities in that jurisdiction in calculating the effective tax rate for that country) by combining a profitable investment that is highly taxed in the same holding structure as an investment with undertaxed profits. Businesses may consider the locations for their investment structures and the extent to which the rules in the relevant jurisdictions match the operation of Pillar Two. Any discrepancies between the two that impact the effective tax rate computation could cause businesses to rethink where they establish their entities. These bigger picture points could impact the design of the structures that lenders are tasked with funding.

Is there anything else that could impact our transactions?

The European Unshell Directive (also known as ATAD 3) may impact borrower structuring where the group has limited substance in a particular jurisdiction in which it is established.

The Unshell Directive aims to tackle the use of shell companies as conduit vehicles to take advantage of withholding tax exemptions under EU Directives and double tax treaties. It will introduce a minimum substance test as well as reporting requirements for companies and exchange of information obligations for tax authorities.

Entities that do not meet the minimum substance requirement will be denied a residence certificate and access to certain EU Directives and treaty benefits, changing the tax profile of the group and introducing greater tax costs.

Businesses may want to structure around these issues or introduce greater substance in the jurisdictions in which they are already established. Lenders will be keen to ensure there is no risk of increased tax costs in the group due to a failure to meet substance requirements. The implementation timetable for the Unshell Directive is not currently clear.

Structuring considerations

1 Anti-hybrids rules are often relevant where there is a US connection and/or a private equity sponsor. If there is a US connection further up the borrower's holding structure (for example, US investors), then the US tax analysis may prefer the borrower group to be subject to a check-the-box election to treat them as disregarded entities or partnerships for US federal tax purposes. In that case, if the entities of the borrower group are treated as tax opaque in their home jurisdiction, there will be a difference in the tax treatment between the home jurisdiction and the US, and a potential tax mismatch that could be subject to counteraction (by either preventing deductions or bringing an additional amount into the charge to tax). Private equity structures may also require more detailed consideration, particularly where convertible instruments are used within the structure.

2 There are different methods to calculate whether a group is subject to a restriction on its corporate interest expense and an exemption for public infrastructure projects which can also apply to real estate investments. The analysis is complex and highly fact-dependent (for example, applying the exemption may not always produce a better result). The rules apply to a "group", which takes its meaning from the accounting standards. It may be possible to structure to avoid accounting consolidation, effectively isolating each investment in its own holding structure so that it isn't tainted by other investments (which may not be funded by the same lender), maximising deductions and minimising risks to debt service.

3 There are numerous modelling and structuring considerations in respect of Pillar Two, including from an M&A perspective. By way of example, where any tax relief forms a key part of the modelling and/or structuring, the sponsor will need to determine whether those reliefs reduce the group's effective tax rate below the 15% minimum, which could in theory be possible even in jurisdictions with a higher headline tax rate. Like the corporate interest restriction, the rules apply to a "group", which is defined by accounting concepts. It may be possible to structure to avoid accounting consolidation, potentially ensuring that the group of which the borrower forms part does not breach the €750m revenue test to become subject to the Pillar Two rules (or is at least only exposed to top-up tax in respect of its own activities).

Pillar Two and joint ventures

As set out above, the top-down approach to the income inclusion rule can be displaced in certain joint venture scenarios with complex consequences (indeed, Pillar Two will be a thorny issue in general for joint ventures). Where an ultimate parent entity invests in an entity that it consolidates for accounting purposes and which falls within the definition of a "Partially Owned Parent Entity" (POPE) (which is broadly where minority investors directly or indirectly own at least 20% of the ownership interests in that entity), it is the home jurisdiction of the POPE whose income inclusion rule applies to the POPE's subsidiaries (with the ultimate parent entity's income inclusion rule being reduced by its proportion of the top-up tax charged by the POPE's jurisdiction). This means that a single group might need to deal with multiple jurisdictions' income inclusion rules, with compliance obligations in each.

Pillar Two talking points

1 ***Deferred taxes*** – Groups can include deferred tax liabilities in their effective tax rate calculations which should reduce the impact of timing differences caused by discrepancies in when income and expenses are recognised for accounting and tax purposes (for example, tax depreciation versus accounting depreciation). Such deferred tax liabilities are subject to a recapture rule if the timing difference has not reversed within five years, increasing the top-up tax in the year in which the relief was claimed (by ignoring the deferred tax liability) but payable in the then current period. Importantly for real estate investments, deferred tax liabilities arising in respect of timing differences for depreciation on tangible assets are not within the recapture rule so previous periods should not be re-opened if the deferred tax liability has not unwound within five years.

2 ***Reliefs and incentives*** – In addition to the points on reliefs and incentives already mentioned, it is worth noting that the deferred tax liabilities referred to above must be recast at a maximum tax rate of 15%, even if the actual tax rate in the relevant jurisdiction is higher. In a high tax jurisdiction, this is likely to result in the effective tax rate for Pillar Two purposes being significantly below the effective tax rate based on the accounts with a "full" deferred tax liability. The revaluation alone is unlikely to reduce the

effective tax rate below 15% where the deferred tax liability is dealing only with timing differences. If, however, there are permanent differences (for example, because a relief or incentive increases the amount of deductions available), then the revaluation of deferred tax liabilities may (further) reduce the effective tax rate below 15%, triggering (more) top-up taxes. Lenders and borrowers will need to think carefully about whether (and to what extent) any tax incentives are devalued by the operation of Pillar Two.

3 ***Staggered implementation*** – Jurisdictions are at different stages in their implementation of Pillar Two. Groups with an ultimate parent entity in a jurisdiction that is not as progressed but with intermediate entities in early adopting jurisdictions (such as the UK) will need to establish processes in respect of the early adopters before adapting to deal with the ultimate parent entity's home jurisdiction once Pillar Two is implemented there. This imposes a significant compliance burden. Moreover, the OECD is still refining the rules and any changes at that level could have repercussions for domestic legislation, meaning that the Pillar Two analysis at the outset of a transaction could require updating during the life of the relevant financing or, if there is no Pillar Two analysis available at origination because rules have not been implemented in the relevant jurisdictions, lenders will be required to take a view.

4 ***The US and Pillar Two*** – The US is not adopting Pillar Two but has its own anti-base erosion rules (for example, GILTI). The interaction of those rules with Pillar Two is not straightforward. Structures with a US connection within the scope of Pillar Two will need to carefully consider the impact of both sets of rules.

Investment vehicles

Investment funds for the purpose of the "Excluded Entities" rules need to meet seven conditions (including being designed to pool assets from a number of investors and the entity or its management being subject to a relevant regulatory regime). The real estate investment vehicles exception is aimed at a vehicle which provides for a single level of taxation either in its hands or the hands of its interest holders (with at most one year of deferral), holds predominantly immovable property and is widely held (e.g. REITs).

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