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The impact of the OECD's pillar two on international M&A

With international agreement having been reached on the key aspects of the OECD's pillar two, this briefing considers the impact these rules might have in practice in an M&A context. Pillar two will affect financial modelling, as well as deal structuring and different bidders' competitiveness. There may be new contractual protections to consider and a need for more post-acquisition co-operation. With the intention that the rules are implemented in 2023/2024, multinationals will have to get to grips with these issues quickly.

Consensus (of a sort) has finally been reached on the OECD's two-pillar solution to international tax reform. Over 130 members of the OECD/G20 Inclusive Framework have signed up to the October 2021 framework agreement, including pillar two's global minimum rate of tax, with model rules published in December 2021 (the ***Model Rules***). So, what happens now?

Unsurprisingly, the focus has started to turn to implementation and what impact these rules will have in practice. This briefing focuses on M&A aspects, but a quick recap on how pillar two works is set out in the box below.

Pillar two: the basics

- Pillar two is, broadly, a mechanism for multinational groups with revenues over EUR750 million to pay at least 15% tax in each jurisdiction in which they operate.
- For groups who do not meet the 15% minimum rate:
  - Pillar two's primary approach is for the group's parent entity (or entities) to impose a top-up tax (the Income Inclusion Rule or ***IIR***).
  - The back-up is that if the parent jurisdiction(s) do not impose a top-up under the IIR, then denials of tax deductions or equivalent adjustments will be made under the Under-Taxed Payments Rule (the ***UTPR***) by other jurisdictions where the group operates, until the 15% rate is achieved.

Pillar two is likely to have wide-reaching consequences for international M&A. From a high-level perspective, it will have an uneven impact on the attractiveness of different target companies and will potentially favour certain types of bidder over others. There will be new factors to be considered when structuring a deal, and this is all before the parties start putting pen to paper. In terms of contractual protections, there will be new risks to be allocated and negotiated. And finally, the new rules will require greater levels of co-operation between the parties even after the deal is done.

Financial modelling and structural considerations

One big area where pillar two will have an effect is on M&A financial modelling. Going forward, financial models will need to factor in the impact that moving in and out of pillar two will have on the tax profile of both the potential target as well as the group making the acquisition.

To take a simple example, where a large multinational that is already in scope of pillar two is considering acquiring a smaller target, its projections in terms of the future profitability of the target will have to take into account the fact that the target will (going forward) be subject to pillar two when it was not previously. This could well influence the price that such a bidder is prepared to pay.

And this is not just a case of looking at headline tax rates and considering whether a target group operates in 'high tax' jurisdictions. For instance, care will need to be taken where financial modelling is dependent on certain tax reliefs and incentives being available. Tax incentives that are permitted under domestic law in calculating taxable income may not be 'qualified refundable tax credits' under pillar two, which could potentially drive down a group's effective tax rate (***ETR***) for pillar two purposes below 15%, even in jurisdictions where the headline rate is clearly above 15%. For instance, US environmental incentives for investing in green energy and US research credits are both non-refundable tax credits (although there are ongoing discussions to see if the benefit of these incentives can be preserved under pillar two).

For some groups, the impact may be even more stark. Where an acquisition would tip a group that was previously below the EUR 750m threshold over the line, such that the group as a whole is brought within scope of pillar two by virtue of the acquisition, then it would be necessary to consider not only the impact on the modelling of the target, but the broader consequences of the application of pillar two to the group as a whole.

In certain cases, an acquisition could have beneficial pillar two implications for a group. For instance, the Model Rules provide for jurisdictional blending, which could mean that if the target group has a higher ETR in a particular jurisdiction than the acquiring group, then the high ETR in the target group could offset the lower ETR in the acquiring group. Working out the exact implications for different combinations will not be straightforward.

Competitive tension

As well as having an impact on financial modelling, pillar two could influence the bidders who come forward and the pricing they can achieve. For instance, as the EUR750 million threshold is tested based on accounting consolidation, this potentially puts private equity fund bidders at something of an advantage as, typically, the portfolio investments of such funds will not be consolidated. This may mean they do not hit the pillar two threshold, whilst a conglomerate group considering investing in the same investments would be in scope. Equally though, private equity bidders will need to consider how pillar two might impact the universe of potential buyers when they come to sell. It could also be harder to implement 'buy and build' strategies where bolt-on acquisitions are made by the original portfolio investment, if that investment is near the revenue threshold.

Deal structuring

Once bidder and target are identified, pillar two may well impact deal structuring. At least a couple of themes have emerged already as follows.

Choice of jurisdiction

On large public mergers, there is often debate about the jurisdiction of the group holding company (or 'Topco') going forward. Pillar two seems likely only to complicate this. For example, if a jurisdiction has not implemented pillar two, or not implemented it effectively, this could make it less attractive as a Topco jurisdiction for fear that this could lead to top-up taxes or other adjustments at a local entity level. It is not too hard to imagine situations where this could be a real issue. For instance, if one side of a transaction involves a US-headed group, and it proves impossible for the US administration to amend the US GILTI rules in a way that makes them compatible with pillar two (as some currently fear), the use of a US Topco could be particularly undesirable if it means navigating both US GILTI rules and pillar two and any overlap and complexities that arise from having two incompatible tax systems operating side-by-side.

Even where pillar two has been implemented effectively, another factor in the choice of Topco jurisdiction will be how well the tax regime of a particular jurisdiction is aligned to pillar two outcomes. For instance, to the extent that pillar two preserves the impact of relevant reliefs and incentives in one jurisdiction but not another, this may well sway the decision towards the former.

Granular structuring

There will doubtless be a myriad of mismatches between current tax reliefs and structuring options available internationally and the (understandably) rather more basic Model Rules. For example, currently, US groups making corporate acquisitions often make elections to treat those acquisitions as asset purchases (a '338(g) election'), thereby obtaining a step-up in basis for US tax purposes. That would not necessarily be respected from a pillar two perspective. Similarly, the definition of a 'GloBE Reorganisation' under the

Model Rules will often not line up with existing domestic reorganisation reliefs, which could deprive the latter of their intended benefit

Contractual protections

The impact of pillar two on M&A does not stop there. Once at the negotiating table, pillar two could impact contractual drafting.

On private M&A transactions, an area that may be particularly challenging will be deferred tax liabilities (***DTLs***) and deferred tax assets (***DTAs***). Except where they are priced in (which is often not the case), the loss of DTAs is typically outside a 'traditional' pre-closing tax covenant. DTLs are similarly often not given much attention. However, under the Model Rules, DTAs and DTLs will become more important. For instance, the Model Rules provide for the recapture of amounts claimed as DTLs in calculating the ETR for pillar two purposes, where those DTLs do not become actual liabilities within five years. These rules are adapted on a disposal such that the five year period resets when the relevant entity joins a new group. However, there is still the potential for a recapture of amounts post-closing that relate to items from a pre-closing period. To the extent that this brings the acquiring group's ETR below 15%, this could result in tax being payable under pillar two post-closing. Should the risk on this be borne wholly by the purchaser? If the seller does take on some of the risk, voluntary acts and change of law exclusions will be important. Equally, a DTL reduction in a prior period could lead to more pillar two tax in a prior period but reduced tax post-closing: will this impact the pricing of deals going forward?

Although DTLs create several challenges for a traditional tax covenant, the issues are not limited to the world of deferred taxes. For instance, the UK government, in its consultation on implementation, proposes making UK entities jointly and severally liable for IIR and UTPR debts charged to those entities. The tax covenant would need to address what happens if the target is such an entity and joins another group: secondary tax liability provisions could become more important. If different jurisdictions take conflicting approaches as to whether UTPR liability stays with the group or moves with the entity, that may make matters more complicated. This problem is exacerbated by the fact that a UTPR adjustment may, in certain cases, be carried-forward to later years. This, and other points, mean tax covenant time limits will need to be carefully considered.

In another sphere, dealing with joint venture contractual documentation may become more complex. How pillar two will impact JV agreements and JV economics, including tax sharing allocations, will depend on whether the JV is tax opaque or flow-through, what level of ownership each JV partner has, or will have, over time. This can affect whether it is the JV entity that has to apply the IIR or whether this must be applied further up the chain of a JV partner. JV agreements may have to address situations where the tax position of a JV partner impacts the taxes payable by the JV entity or where a JV partner has to pay top-up taxes as a result of its investment in the JV entity: should that be shared between investors or is that a cost that results from a particular investor's status and so should be borne by that investor? One can see that high-level drafting could miss important nuances but detailed provisions seeking to address all possible outcomes could rapidly become very complicated.

Post-acquisition considerations

Even once the deal is done, pillar two may continue to rear its head. Where there are disputes about the application of pillar two, thought will need to be given as to who should have the conduct of these, noting that these will be multi-jurisdictional disputes.

Where it is agreed that the purchaser will have conduct of the dispute, they will need access to information from the seller about the wider seller group in order to engage in discussions with tax authorities on the application of pillar two.

There will also need to be a certain amount of post-acquisition co-operation to comply with the normal operation of pillar two, even outside a dispute context. In particular, purchasers will need access to historical carrying values, past DTA and DTL assessments in order to calculate current pillar two liabilities. Transaction documentation will therefore need to provide for appropriate information rights.

What next?

The OECD's current expectation is that pillar two rules will be implemented in 2023 (although there are already signs of this timetable being stretched to the limit, with the UK announcing its rules will only apply

for periods starting on or after 31 December 2023 and similar noises from the EU). Nonetheless, these issues may start becoming very real for multinationals in the coming months. There may be considerable negotiation and some time before the ground settles on what the common market standards are for dealing with these issues in international M&A transactions, but multinationals would be well advised to get on the front foot in these discussions.

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