8 Special rules for Associates, joint ventures and orphan entities

8.1. Overview

538. This sets out rules dealing with Associates and joint ventures and with “orphan entities.” The first rule applies a simplified IIR to the income of an MNE Group that is attributable to ownership interests in entities or arrangements that are reported under the equity method. The second rule is designed to extend the application of the UTPR to “orphan” entities or arrangements that could otherwise be used to extract profit from the MNE Group for the benefit of the controlling shareholders, giving rise to a BEPS risk.

8.2. Associates and joint ventures

539. The income inclusion rule applies to the income of Constituent Entities directly or indirectly owned by the Parent applying the rule. The MNE Group’s share of the income of Associates and Joint Ventures (JVs) in which it has an equity interest is included in the group’s financial accounting income under the equity method but is excluded from the GloBE tax base as a permanent difference.

540. Excluding the MNE Group’s income from Associates and JVs, however, creates a risk of leakage and unfairness. An MNE Group could often arrange to acquire its minority interest in another MNE Group through an entity whose income is not subject to an IIR rule (including an IIR rule applicable under the split-ownership rules). Moreover, an interest in a Joint Venture represents a serious risk of leakage under the GloBE rules because the owner’s share of the JV’s income is excluded from the owner’s income. If an Associate or JV is a Parent that applies the IIR, the income of its subsidiaries will be subject to the GloBE rules. However, in many cases, a JV will be a stand-alone entity or will not have foreign subsidiaries. Thus, the income of the entity or arrangement itself will escape taxation under the GloBE rules absent a special rule to deal with interests in these entities and arrangements. Finally, while the difference between control and joint control may have some significance for financial accounting purposes, it does not seem appropriate for taxation or full exemption under the GloBE rules should turn on that distinction.

8.2.1. Not possible to require MNE Group to apply IIR on standalone basis

541. It would be very challenging, however, to apply the full set of IIR rules to the income of Associates and JVs for a variety of reasons. The MNE Group would need to get detailed information about the income and covered taxes reported in the tax returns of the entity in which it directly holds an equity interest and the subsidiaries of that entity in order to compute jurisdictional ETRs. It would also need the information necessary to compute any carve-out for the jurisdictions in which those entities are tax resident. Because the MNE Group jointly controls a JV and has significant influence over an Associate, it may be able to secure relatively detailed financial information on the Associate or JV operations. However, this information is not contained in its own financial accounts and it may have difficulty getting the jurisdiction-by-jurisdiction

information in the format and detail necessary to incorporate that information into its own GloBE computations. Moreover, it may not be appropriate to include all the income of the Associate or JV in the MNE Group's ETR computations for a jurisdiction because the minority interest could significantly affect the MNE Group's ETR in the jurisdiction. Rather, it would be more appropriate to only include the MNE Group's share of the income and covered taxes attributable to the interest in the Associate or JV in its ETR computations.

8.2.2. Simplified IIR

542. Accordingly, a simplified income inclusion rule (the Simplified IIR) may apply to the income attributable to interests in Associates and JVs. Generally, the rule would apply to the income of an MNE Group attributable to ownership interests in entities or arrangements that are reported under the equity method. The simplified IIR follows the top-down approach, where the Ultimate Parent Entity would have the priority to apply the rule. The rule does not apply, however, in the case of an entity or arrangement in which the MNE Group has a direct ownership interest and that:

a. is organised in a jurisdiction that has adopted the GloBE rules; and

b. has an ETR at or above the minimum rate

543. The second requirement is necessary because often substantially all of the income of a JV will be derived from operations in the JV's tax jurisdiction, rather than through foreign subsidiaries. Without the second requirement, the income of a JV would escape the GloBE rules if it were organised in a low-tax jurisdiction that nonetheless had adopted the GloBE rules.

544. The simplified IIR determines the ETR for the interest in each Associate or JV as a whole. Specifically, it determines the ETR for the income attributable to each entity based on the MNE Group's equity method income attributable to each investment in the entity and the MNE Group's proportionate share of the income taxes accrued by the Associate or JV and its subsidiaries, if any, for the year. This computation departs from the general IIR in three respects.

545. First, the ETR computation under the simplified IIR is effectively based on worldwide blending of the income and taxes of the Associate or JV and all subsidiaries of that entity. In many cases, the Associate or JV will not own foreign subsidiaries and the simplified IIR will not result in cross-jurisdictional blending. In other cases, however, it would be extremely complex and burdensome to apply jurisdictional blending in the context of the Simplified IIR.

546. Second, the income taxes are determined based on the financial accounting rules, including deferred tax accounting. This simplification eliminates the need to determine the amount of cash taxes paid by each Associate or JV and its subsidiaries. It also eliminates the need for the local tax carry-forward and IIR tax credits.

547. Third, the simplified IIR only takes into account taxes that are treated as income taxes for financial accounting purposes. This simplification means that the MNE Group does not have to re-compute the income and taxes of each subsidiary to determine the ETR. The applicable accounting principles are the accounting principles used to determine the amount of the MNE Group's income reported under the equity method.

548. If the ETR computed for an Associate or JV is below the minimum rate, the MNE Group's equity method income attributable to the ownership interest in the entity is multiplied by the top-up tax percentage (the difference between the minimum rate and the ETR) to determine the top-up tax attributable to that ownership interest.

549. The Simplified IIR computes the tax liability for purposes of computing the ETR based on deferred tax accounting and worldwide blending. Therefore, carry-forwards generally are not necessary and indeed would be duplicative. However, a loss carry-forward or similar adjustment is needed for Associates and

JVs organised in jurisdictions that do not have an income tax or that have an income tax rate below the minimum ETR. Therefore, the Simplified IIR could allow for a loss carry-forward in respect of an Associate or JV that is organised in jurisdiction that does not impose an income tax on the entity's income annually. In the case of an entity organised in a jurisdiction that has a tax rate below the minimum, the deferred tax asset arising in connection with a loss is determined for purposes of the Simplified IIR based on the minimum tax rate.

550. Finally, the Simplified IIR does not allow a carve-out for a fixed return. This simplification is appropriate because, because the simplified IIR is a stand-alone tax imposed on an equity investment which simply measures the overall return on that investment and (expected) the tax liability on that return. It is also expected that, in practice, the MNE Group may have significant difficulty of getting and auditing the relevant information to apply the carve-out.

551. While the scope and overall operation of simplified IIR is described in the previous paragraphs further technical work is required to develop a more detailed rule to ensure that the rule is comprehensive and effective without giving rise to undue compliance burdens for taxpayers and is co-ordinated with the operation of the GloBE rules.

8.3. Orphan entities

552. The GloBE rules apply only in respect of low-tax Constituent Entities that are members of the same MNE Group as the taxpayer. Some entities or arrangements may not meet the criteria for being part of the MNE Group (and, therefore, are not "Constituent Entities") as defined in Chapter 2, even though they may be controlled by the same shareholder or group of shareholders as the Constituent Entities forming the MNE Group. The most common situation where this could arise is where the underlying shareholder or group of shareholders of the MNE Group and the entity or arrangement consists of a fund or foundation or a group of connected individuals (such as a family) that does not, itself, form part of the MNE Group.

553. These entities or arrangements ("Orphan Entities") are non-Constituent Entities that could be used to extract profit from the MNE Group for the benefit of the common controlling shareholders, giving rise to a BEPS risk. Including the profits made by Orphan Entities in the scope of application of the UTPR would mitigate this risk. An Orphan Entity rule would define the circumstances under which these profits should be included in the scope of application of the UTPR with the aim of limiting compliance and administration costs when this risk is the most acute. Excluded Entities listed in Section 2.3 would not be considered as Orphan Entities.

554. The BEPS risks posed by these Orphan Entity structures are likely to be most significant when (i) such an Orphan Entity is connected with some or all the Constituent Entities of the MNE Group and (ii) it derives a significant revenue or a significant portion of their revenues from payments that are made directly by Constituent Entities. Therefore, as an exception to the general definition of the scope of the MNE Group, the Orphan Entity rule would treat an entity or arrangement as a Constituent Entity for the purposes of the UTPR, if the entity is a connected person and it derives more than a certain amount or a certain percentage of its annual turnover from deductible intra-group payments that were made directly by Constituent Entities of the MNE Group.

8.3.1. Connected persons

Definition of Connected Persons

"Two persons shall be "connected persons" if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

In any case, a person or enterprise shall be considered to be connected to another person if:

(a) one possesses directly or indirectly more than 50% of the beneficial interests in the other (or, in the case of a company, more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or

(b) if another person possesses directly or indirectly more than 50% of the beneficial interests (or, in the case of a company, more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in each person."

555. The definition of connected persons is based on the approach taken in the definition of "closely related" persons and enterprises in Article 5(8) and 5(9) respectively of the OECD and UN Model Tax Conventions, for the purposes of applying the independent agent and anti-fragmentation provisions in those Articles[1]. The test is the same as used for the STTR in Section 9.2 below and is similar to the control test used in consolidated accounting.

De facto control test

556. The first part of the definition sets out the general definition of "connected persons". It provides that there is a connection between persons where there is a *de facto* control relationship between them. In line with similar requirements set out in accounting standards, a de facto control test looks to the facts and circumstances between the parties in the context of other arrangements and seeks to determine whether the person has sufficient power over the entity to affect that person's investment return in that entity.

557. Factors that are relevant to the application of the de facto control test include the size of the person's shareholding relative to the size and dispersion of other shareholders, other potential voting rights held by that person through instruments such as options, warrants or convertible notes and rights arising from other contractual arrangements such as lending arrangements that provide the lender with de facto control over the business. This de facto control test means that an investor without a majority stake in a company could still be a controlling person if there are arrangements in place that provide that person with the ability to acquire a majority stake or the other shareholdings are widely dispersed and the investor holds significantly more voting rights than any other shareholder. The de facto test ensures that, in practice, a controlling investor in a company cannot sever that connection by putting in place arrangements designed to retain control but shift ownership of the equity into the hands of others. The *connected persons* test also extends to situations where a person has joint control over the parties involved in the transaction. For example, a joint venturer owns 50% of the equity interests of a joint venture. The joint venture company receives a payment from another company that is controlled by the joint venturer. In this case, both companies are considered to be connected persons for purposes of the Orphan Entity rule because they are controlled by the same person, even if one of those companies is not unilaterally controlled.

Group of persons

558. The definition set above states that two persons are connected if both of them are controlled by the same person or persons. The term "persons" refers to an identifiable group of persons that have

entered into an agreement in respect of the equity of the company or that habitually act together to exercise control over the entity. A control agreement is an agreement concerning the ownership or exercise of voting or equity interests that can be expected to have a material impact on the value of those interests. It would include, for example, shares held by different funds but under the control of a common manager. Persons who habitually act together to control an entity would include members of a family that hold a controlling stake in a company. The definition does not, however, seek to capture those situations where there is simply a set of otherwise independent shareholders that, in aggregate, hold a majority of the equity interests of two different companies.

559. The group of persons requirement means that a controlling shareholder cannot lose control of its equity holding in a company by transferring ownership to or among members of the shareholder's family. It also ensures that an entity that is spun-out of the MNE Group to a group of controlling shareholders will generally remain under common control even if that entity is no longer consolidated.

Deemed control test

560. The second part of the definition provides that the connection requirements are automatically met in certain circumstances. Under that second part, a person is considered to be connected to another person if either one possesses directly or indirectly more than 50% of the beneficial interests in the other or if a third person possesses directly or indirectly more than 50% of the beneficial interests in both. A person is therefore deemed to be connected to another person where the first person holds directly or indirectly more than 50% of the aggregate votes and value of a company's shares or of the beneficial equity interest in that company. The deemed control test means that a majority shareholder does not fall outside the scope of the rule simply because there are arrangements in place that mean that the de facto control test does not apply. For example, there may be legal or regulatory requirements in a jurisdiction that prevent a majority shareholder from fully exercising its rights over the subsidiary. While the majority holder may consider that it does not have de facto control over the entity it will be treated as a controlling shareholder by virtue of its majority stake in the subsidiary.

8.3.2. Revenue test

561. The amount or share of the annual revenue of an orphan entity that is derived from deductible intra-group payments made by Constituent Entities would be determined on the basis of the financial accounts of such an Orphan Entity, with the same methodology as the one that applies under the UTPR.

8.3.3. Application of the UTPR to Orphan Entities

562. An Orphan Entity may be included in the scope of the UTPR if treating such an entity as an Orphan Entity would result in an increase in the total amount of top-up tax that can be collected under the UTPR. Therefore, an Orphan Entity would be included only if including its income and covered taxes under the methodology described in Chapters 3 and 4 results in either:

- adding a new jurisdiction to the scope of jurisdictions for which the MNE Group computes its ETR (in the absence of any Constituent Entity being located in the same jurisdiction as the Orphan Entity) and the MNE's ETR in that jurisdiction being below the minimum rate as a result of taking into account the income and covered taxes of the Orphan Entity, or
- the MNE's ETR in the jurisdiction where the Orphan Entity is located becoming or remaining below the minimum rate after taking into account the income and covered taxes of the Orphan Entity.

563. In accordance with the methodology described in Section 8.3, the income and covered taxes of the Orphan Entity may be taken into account to compute a (revised) top-up tax percentage for the jurisdiction where it is located. Subsequently, this top-up tax percentage is applied to the Adjusted GloBE income of the Orphan Entity in order to determine the amount of top-up tax attributed to the Orphan Entity.

Such top-up tax may then be allocated to UTPR Taxpayers in accordance with the methodology described in Section 7.4. For that purpose, the payments that such an Orphan Entity receives from or makes to Constituent Entities are taken into account to allocate the top-up tax. If the Orphan Entity is located in the Ultimate Parent Jurisdiction, the overall cap provided in Section 7.5.2 applies by including the intragroup revenue of such an Orphan Entity. The data that relates to the computation of the income and the covered taxes of the Orphan Entity as well as the amounts and structure of intra-group payments involving the Orphan Entity would be subject to the same filing and documentation requirements as those that are provided for any Constituent Entity that is located in a low-tax jurisdiction for the purpose of applying the UTPR.

564. An Orphan Entity that would be located in a jurisdiction that introduced the UTPR, however, would not be allocated any top-up tax. This results from the condition described previously under which an Orphan Entity is included in the scope of the UTPR on the condition that the MNE's ETR in the jurisdiction where the Orphan Entity is located is below the minimum rate after taking into account the income and covered taxes of the Orphan Entity.

565. While the scope and overall operation of a rule for Orphan Entities is described in the previous paragraphs, further technical work is required to develop a more detailed rule to ensure that the rule is comprehensive and effective without giving rise to undue compliance burdens for taxpayers and is co-ordinated with the operation of the GloBE rules. For instance, further technical work needs to be done with regard to the determination of a revenue test that would ensure the rule applied to those entities that are more likely to present BEPS risks. The outcomes from this work will be incorporated into the development of model rules as described in Section 10.5.1.

Note

[1] It is noteworthy that the same approach – a two component rule with a de facto control test and deemed control above a 50% participation level – is also adopted in paragraph 6 of the alternative fees for technical services article provided for in paragraph 26 of the Commentary on Article 12A of the 2017 UN Model Tax Convention. A similar control test could also be applied in the context of rules for addressing the profit shifting risks raised by orphan entities in the context of the undertaxed payments rule.

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