Chapter 5.2: Substance-Based Income Exclusion (SBIE)

Learning Objective

After completing this chapter, you will be able to calculate the Substance-Based Income Exclusion (SBIE) using the payroll and tangible asset carve-outs, apply the correct transition rates for each fiscal year, and determine the Excess Profit subject to Top-Up Tax.

Introduction

The Substance-Based Income Exclusion represents one of Pillar Two's most significant concessions to business reality. The framework's architects recognised that not all income in a low-tax jurisdiction represents tax-advantaged "excess profits." A manufacturing plant employing hundreds of workers, a distribution centre holding substantial inventory, a research facility with expensive equipment—these operations generate returns attributable to genuine economic activity, not to tax planning. Subjecting such "normal" returns to minimum taxation would unfairly penalise groups that have located real substance in countries with competitive tax rates. The SBIE addresses this by carving out a fixed percentage of payroll costs and tangible asset values from the Top-Up Tax base. The result: only "Excess Profit"—income beyond what normal returns on employees and physical assets would justify—is subject to Top-Up Tax. This design rewards substance and penalises hollow structures, aligning the framework's incentives with the broader goal of ensuring that taxing rights follow real economic activity.

1. What SBIE Does

The Substance-Based Income Exclusion reduces the amount of income subject to Top-Up Tax by recognising that genuine economic substance (employees and physical assets) represents real business activity deserving a fixed return.

1.1 The Concept

```
                                                      SBIE
                                                       ↓
┌──────────────────────────────────────────────────────────────┐
│                    Net GloBE Income                            │
│  ┌───────────────────────────────────────┬──────────────────┐  │
│  │        Substance-Based                │    Excess        │  │
│  │        Income Exclusion               │    Profit        │  │
│  │        (SBIE)                         │                  │  │
│  │                                       │    ← Subject     │  │
│  │        ← Excluded from                │      to          │  │
│  │          Top-Up Tax                   │      Top-up      │  │
│  │                                       │      Tax         │  │
│  └───────────────────────────────────────┴──────────────────┘  │
└──────────────────────────────────────────────────────────────┘
```

1.2 The Formula

```
 Excess Profit = Net GloBE Income − SBIE

Top-Up Tax = Top-Up Tax % × Excess Profit
```

Key insight: SBIE reduces the **base** on which Top-Up Tax is calculated, not the rate. Higher substance = lower Top-Up Tax.

2. SBIE Components

Article 5.3.2 defines the SBIE amount as the sum of two carve-outs for each Constituent Entity in the jurisdiction:

```
SBIE = Payroll Carve-out + Tangible Asset Carve-out
```

2.1 Component 1: Payroll Carve-out (Article 5.3.3)

```
Payroll Carve-out = Eligible Payroll Costs × Payroll Rate
```

2.2 Component 2: Tangible Asset Carve-out (Article 5.3.4)

```
Tangible Asset Carve-out = Carrying Value of Eligible Tangible Assets ×
```

3. Transition Rates (Article 9.2)

The SBIE percentages are **higher** in early years and **reduce** over a 10-year transition period to the permanent rates of 5%.

3.1 SBIE Transition Rate Table

Fiscal Year (beginning in)	Payroll Rate	Tangible Asset Rate
2024	10.0%	8.0%
2025	9.8%	7.8%
2026	9.6%	7.6%
2027	9.4%	7.4%
2028	9.2%	7.2%

Fiscal Year (beginning in)	Payroll Rate	Tangible Asset Rate
2029	8.4%	6.6%
2030	7.6%	6.0%
2031	6.8%	5.4%
2032	6.0%	4.8%
2033	5.2%	4.4%
2034+	**5.0%**	**5.0%**

Practical implication: In early transition years, the higher rates provide greater SBIE—reducing Top-Up Tax exposure. As rates decline, more income becomes subject to Top-Up Tax.

The ten-year transition period serves a deliberate policy purpose: giving MNE Groups time to restructure their operations in response to the new rules. Groups with substantial low-tax operations based on genuine substance receive significant protection in early years, with that protection gradually declining as the framework matures. The transition rates also acknowledge that the "correct" percentage—the normal return on substance—is inherently uncertain. Starting high and reducing over time allows real-world experience to inform whether the permanent 5% rates are appropriate. Groups should factor the declining rates into long-term planning: an operation that generates no Top-Up Tax today due to generous SBIE may trigger liability in future years as the carve-out shrinks. This creates natural pressure to either increase substance or accept rising Top-Up Tax exposure.

3.2 Which Year's Rate Applies?

Use the rate for the **fiscal year** being calculated based on when the fiscal year **begins**: - FY beginning 2025: Use 2025 rates (9.8% / 7.8%) - FY beginning 2024: Use 2024 rates (10.0% / 8.0%)

Note: Consult domestic implementing legislation for the specific rule applicable in each jurisdiction.

4. Eligible Payroll Costs (Article 10.1)

4.1 What Qualifies

Category	Examples	Included?
Salaries and wages	Base salary, hourly wages	✅ Yes
Bonuses and allowances	Performance bonuses, housing allowance	✅ Yes
Stock-based compensation	Share options, RSUs (expensed amount)	✅ Yes
Employee benefits	Medical insurance, pension contributions	✅ Yes
Payroll taxes	Employer social security, fringe benefits tax	✅ Yes
Retirement benefits	Employer pension fund contributions	✅ Yes

4.2 What Does NOT Qualify

Category	Why Excluded
Capitalised payroll	Already in tangible asset carve-out (avoid double-counting)
Contractor payments	Not "employees" under Article 10.1
International shipping payroll	Excluded income under Article 3.3
Payroll for excluded entities	Investment Entities excluded from SBIE

4.3 Eligible Employees Definition

An **Eligible Employee** is an employee (including part-time) of a Constituent Entity who performs activities for the MNE Group in the jurisdiction.

Critical test: Where does the employee **perform activities**?

Scenario	Treatment
Employee works 100% in Jurisdiction A	100% of payroll costs → Jurisdiction A
Employee works 70% in Jurisdiction A, 30% in Jurisdiction B	70% → A, 30% → B
Employee works less than 50% in any single jurisdiction	Proportionate allocation required

5. Eligible Tangible Assets (Article 10.1)

4.1 What Qualifies

Asset Type	Examples	Included?
Property, plant and equipment	Buildings, machinery, vehicles	✅ Yes
Natural resources	Mining rights, oil and gas assets	✅ Yes
Leased assets (ROU)	Right-of-use assets under IFRS 16	✅ Yes
Licensed assets	Government licences on land	✅ Yes

4.2 What Does NOT Qualify

Asset Type	Why Excluded
Intangible assets	IP, goodwill, software (not "tangible")
Financial assets	Investments, receivables
Cash and equivalents	Not tangible productive assets
Inventory	Current asset, not long-term productive asset
Assets under construction	Not yet in use (until capitalised)

5.3 Carrying Value

Use the **accounting carrying value** (net book value) from financial statements:

```
Carrying Value = Cost − Accumulated Depreciation − Impairment
```

June 2024 Administrative Guidance clarification: Use the **accounting** carrying value, not GloBE-adjusted carrying value. Any adjustments to derive GloBE Income do not affect SBIE calculation.

The distinction between tangible and intangible assets is fundamental to SBIE's policy design. Tangible assets—factories, equipment, buildings—represent physical investment that is inherently tied to a location. An MNE cannot move a manufacturing plant as easily as it can relocate IP ownership. By rewarding tangible assets but not intangibles, the framework incentivises the kind of investment that creates local jobs, requires local suppliers, and contributes to the local economy. Intangible assets, by contrast, have historically been the vehicle for profit shifting—easy to relocate, difficult to value, and often generating returns disproportionate to any local presence. Their exclusion from SBIE is intentional and reflects the framework's skepticism of profit allocations based primarily on IP ownership.

5.4 Average Carrying Value

Article 5.3.4 requires using the **average** of opening and closing carrying values:

```
                        Opening Carrying Value + Closing Carrying Value
Average Carrying Value = ─────────────────────────────────────────────────
                                              2
```

Example:

Asset	Opening NBV	Closing NBV	Average
Factory	€10,000,000	€9,500,000	€9,750,000
Equipment	€2,000,000	€1,800,000	€1,900,000
Total	**€12,000,000**	**€11,300,000**	**€11,650,000**

6. Location Rules (Article 5.3.5)

6.1 The 50% Threshold

If an employee or tangible asset is located in a jurisdiction for **50% or less** of the time, only the proportionate share of the carve-out applies.

6.2 Mobile Employees

Scenario: An employee is based in the UK but travels extensively.

Jurisdiction	Days Worked	% of Year	Treatment
UK (home base)	150	60%	60% of payroll → UK
Germany	60	24%	24% of payroll → Germany

Jurisdiction	Days Worked	% of Year	Treatment
France	40	16%	16% of payroll → France

Total = 100% — Full payroll cost is allocated across jurisdictions.

6.3 Mobile Assets

Scenario: A shipping container travels between jurisdictions.

Jurisdiction	Days Located	% of Year	Treatment
Netherlands	200	55%	55% of carrying value → Netherlands
Belgium	165	45%	45% of carrying value → Belgium

The location rules for mobile employees and assets create practical compliance challenges but serve an important purpose: ensuring that substance is credited where it actually operates, not merely where it is legally based. A sales executive who spends most of their time visiting customers in multiple countries contributes substance to each of those countries, not just their home jurisdiction. Similarly, a fleet of trucks that operates across borders generates economic activity wherever they are used. These rules require groups to track employee time and asset locations with greater precision than many HR and asset management systems currently provide—an operational investment that Pillar Two compliance demands.

7. SBIE Cannot Create a Loss

Critical rule: The SBIE cannot reduce Excess Profit below zero.

```
Excess Profit = MAX(0, Net GloBE Income − SBIE)
```

If SBIE exceeds Net GloBE Income, the excess is **lost**—it cannot be carried forward or used to offset other jurisdictions.

7.1 Example: High-Substance, Low-Profit Jurisdiction

Item	Amount
Net GloBE Income	€2,000,000
Payroll Carve-out	€1,800,000
Tangible Asset Carve-out	€1,500,000
Total SBIE	**€3,300,000**
Excess Profit	MAX(0, €2M − €3.3M) = **€0**

Result: No Top-Up Tax, but €1,300,000 of "wasted" SBIE cannot be used elsewhere.

The "no loss" rule and the prohibition on carrying forward excess SBIE reflect a deliberate policy choice: substance should shield income from Top-Up Tax, but it should not create negative Top-Up Tax or be transferable across jurisdictions or time periods. This prevents groups from accumulating substance in one jurisdiction and using it to shelter income in others, or from building up SBIE "credits" during low-profit years to offset high-profit years. Each year and each jurisdiction stands on its own. Groups with high-substance, low-profit operations may find this frustrating—they have genuine investment but cannot fully utilise the SBIE benefit—but the alternative would create opportunities for manipulation that the framework seeks to prevent.

8. Stratos Worked Example: Complete SBIE Calculation

8.1 Data for FY 2025

Stratos has identified two low-taxed jurisdictions from Chapter 5.1: - **Singapore** (ETR 9.81%) - **Ireland** (ETR 11.80%)

Germany (ETR 23.00%) is not low-taxed, so no SBIE calculation is required.

8.2 Singapore SBIE Calculation

Step 1: Gather payroll data

Entity	Eligible Payroll Costs
SG Singapore Pte Ltd	€850,000

Step 2: Gather tangible asset data

Asset	Opening NBV	Closing NBV	Average
Office building	€1,200,000	€1,150,000	€1,175,000
IT equipment	€180,000	€150,000	€165,000
Leased vehicles (ROU)	€95,000	€80,000	€87,500
Total			**€1,427,500**

Step 3: Apply FY 2025 transition rates

Component	Base	Rate	Carve-out
Payroll	€850,000	9.8%	€83,300
Tangible Assets	€1,427,500	7.8%	€111,345
Total SBIE			**€194,645**

Step 4: Calculate Excess Profit

```
 Net GloBE Income:                    €4,000,000
Less: SBIE:                          (€194,645)
```

```
                                                ─────────────
Excess Profit:                                  €3,805,355
```

8.3 Ireland SBIE Calculation

Step 1: Gather payroll data

Entity	Eligible Payroll Costs
SG Ireland Ltd	€4,200,000

Step 2: Gather tangible asset data

Asset	Opening NBV	Closing NBV	Average
Office building	€8,500,000	€8,200,000	€8,350,000
R&D equipment	€2,100,000	€1,900,000	€2,000,000
Data centre	€5,400,000	€5,100,000	€5,250,000
Leased assets (ROU)	€620,000	€580,000	€600,000
Total			**€16,200,000**

Step 3: Apply FY 2025 transition rates

Component	Base	Rate	Carve-out
Payroll	€4,200,000	9.8%	€411,600
Tangible Assets	€16,200,000	7.8%	€1,263,600
Total SBIE			**€1,675,200**

Step 4: Calculate Excess Profit

```
 Net GloBE Income:                    €15,000,000
Less: SBIE:                          (€1,675,200)
                                     ____________
Excess Profit:                       €13,324,800
```

8.4 SBIE Summary

Jurisdiction	Net GloBE Income	SBIE	Excess Profit
Singapore	€4,000,000	€194,645	€3,805,355
Ireland	€15,000,000	€1,675,200	€13,324,800

Key observation: Ireland has significant substance (high payroll and tangible assets), which reduces its Excess Profit by over €1.6M. Singapore has less substance relative to income.

9. Multi-Entity Jurisdictions

When a jurisdiction has multiple Constituent Entities, calculate SBIE for **each entity** and aggregate:

9.1 Example: Ireland with Two Entities

Entity	Payroll Costs	Tangible Assets (Avg)
SG Ireland Ltd	€4,200,000	€16,200,000
SG Dublin Services Ltd	€1,800,000	€3,400,000
Jurisdiction Total	**€6,000,000**	**€19,600,000**

SBIE Calculation (FY 2025):

Component	Base	Rate	Carve-out
Payroll	€6,000,000	9.8%	€588,000
Tangible Assets	€19,600,000	7.8%	€1,528,800
Total SBIE			**€2,116,800**

Jurisdictional blending applies: The combined SBIE reduces the combined Net GloBE Income.

10. Election Not to Apply SBIE (Article 5.3.1)

An MNE may elect **not** to apply SBIE for a jurisdiction in any fiscal year.

10.1 When to Consider This Election

Scenario	Recommendation
SBIE exceeds Net GloBE Income (wasted SBIE)	Election irrelevant—no Top-Up Tax either way
Minimal payroll/assets relative to income	May simplify compliance if SBIE is immaterial
QDMTT applies and covers liability	May skip SBIE if QDMTT already collects full Top-Up Tax

Practical note: This election is rarely beneficial. SBIE always reduces or eliminates Top-Up Tax liability.

11. Common Pitfalls

11.1 Pitfall 1: Using Gross Rather Than Net Book Value

Error: Including accumulated depreciation in tangible asset value.

Correct approach: Use **net book value** (carrying value after depreciation).

11.2 Pitfall 2: Including Intangible Assets

Error: Adding software or patents to the tangible asset carve-out.

Correct approach: Only tangible assets qualify. Intangibles are excluded.

11.3 Pitfall 3: Double-Counting Capitalised Payroll

Error: Including payroll costs that were capitalised into an asset (e.g., construction labour) in both carve-outs.

Correct approach: Capitalised payroll is excluded from the payroll carve-out—it's already in the tangible asset base.

11.4 Pitfall 4: Forgetting the Average Calculation

Error: Using only closing NBV for tangible assets.

Correct approach: Use the **average** of opening and closing carrying values.

11.5 Pitfall 5: Applying Wrong Year's Transition Rate

Error: Using 2024 rates for a FY 2026 calculation.

Correct approach: Apply the transition rate for the **fiscal year** being calculated.

11.6 Pitfall 6: Ignoring Location Rules for Mobile Employees

Error: Allocating 100% of a travelling employee's payroll to their home jurisdiction.

Correct approach: Allocate based on **time spent** performing activities in each jurisdiction.

12. SBIE Calculation Worksheet

Use this worksheet for each low-taxed jurisdiction:

```
 SBIE CALCULATION WORKSHEET
Jurisdiction: _________________________
Fiscal Year: _________________________
Transition Rates: Payroll ______% | Tangible Assets ______%

SECTION A: CONSTITUENT ENTITIES
List all CEs in this jurisdiction (excluding Investment Entities):

| # | Entity Name |
|---|-------------|
| 1 | ___________ |
| 2 | ___________ |
| 3 | ___________ |

SECTION B: PAYROLL CARVE-OUT
B1  Eligible Payroll Costs (all CEs)           €__________________
B2  Less: Capitalised payroll                  (€__________________)
B3  Less: International shipping payroll       (€__________________)
B4  Net Eligible Payroll Costs (B1-B2-B3)      €__________________
B5  Payroll Transition Rate                    __________________%
B6  PAYROLL CARVE-OUT (B4 × B5)                €__________________

SECTION C: TANGIBLE ASSET CARVE-OUT
C1  Opening carrying value (all CEs)           €__________________
C2  Closing carrying value (all CEs)           €__________________
C3  Average carrying value ((C1+C2)÷2)         €__________________
C4  Less: Assets under construction            (€__________________)
C5  Net Eligible Tangible Assets (C3-C4)       €__________________
C6  Tangible Asset Transition Rate             __________________%
C7  TANGIBLE ASSET CARVE-OUT (C5 × C6)         €__________________
```

```
SECTION D: TOTAL SBIE
D1  Payroll Carve-out (B6)                        €__________________
D2  Tangible Asset Carve-out (C7)                 €__________________
D3  TOTAL SBIE (D1 + D2)                          €__________________

SECTION E: EXCESS PROFIT
E1  Net GloBE Income (from Chapter 5.1)           €__________________
E2  SBIE (D3)                                     €__________________
E3  EXCESS PROFIT (MAX(0, E1 - E2))               €__________________

    If E3 = 0: No Top-Up Tax for this jurisdiction.

SECTION F: VERIFICATION CHECKLIST
□ Correct transition rates applied for fiscal year
□ Average carrying value used (not just closing)
□ Capitalised payroll excluded
□ Intangible assets excluded
□ Location rules applied for mobile employees/assets
□ Investment Entities excluded
```

13. Policy Rationale

Why does SBIE exist?

13.1 The Theory

GloBE targets **excess profits**—income beyond what genuine business operations would generate. The SBIE recognises that:

1. **Employees** represent real economic activity
2. **Tangible assets** represent physical investment
3. A **fixed return** on these factors should be excluded from minimum taxation

13.2 The Formula Logic

Factor	Rate	Justification
Payroll	5-10%	Return on human capital investment
Tangible Assets	5-8%	Return on physical capital investment

The rates approximate a "normal" return on these investments, excluding it from the minimum tax calculation.

13.3 Who Benefits Most?

Business Type	Payroll	Tangible Assets	SBIE Benefit
Manufacturing	Medium	High	**High**
Distribution	High	Medium	**Medium-High**
Retail	High	Medium	**Medium-High**
IP Holding	Low	Low	**Low**
Financial Services	High	Low	**Medium**
Tech (asset-light)	Medium	Low	**Low-Medium**

Practical implication: MNEs with significant manufacturing or distribution operations in low-tax jurisdictions benefit most from SBIE.

The SBIE represents Pillar Two's recognition that a global minimum tax should target undertaxation of mobile profits, not genuine business returns on local investment. By excluding a fixed percentage of payroll and tangible assets, the framework ensures that operations with real employees and physical infrastructure receive proportionate relief. This design choice has profound implications for business strategy: groups considering where to locate new operations can now factor SBIE into their analysis, potentially favouring jurisdictions where substantial investment produces meaningful carve-outs. The exclusion of intangible assets from SBIE is equally deliberate—IPheavy structures without corresponding human capital or physical presence receive minimal protection, reflecting the framework's skepticism of profit allocations disconnected from genuine activity. For compliance purposes, groups must build robust data collection processes to capture payroll costs, track asset carrying values, and apply location rules for mobile employees and assets. The SBIE calculation is only as accurate as the underlying substance data, making investment in HR and fixed asset systems essential for accurate Pillar Two reporting.