Chapter 4.5: Tax Allocation Between Entities

Learning Objective

After completing this chapter, you will be able to allocate Covered Taxes between Constituent Entities using the Article 4.3 framework, including PE tax allocation, CFC tax push-down with passive income limitation, hybrid entity allocations, and distribution tax reallocation.

1. When Tax Allocation Is Required

Article 4.3 requires tax allocation in five scenarios:

Scenario	Article	Direction of Allocation
PE income	4.3.2(a)-(b)	Main Entity → PE
CFC regimes	4.3.2(c)	Parent → CFC subsidiary
Hybrid entities	4.3.2(d)	Owner → Hybrid Entity
Reverse hybrids	4.3.2(d)	Treated separately
Distributions	4.3.2(e)	Recipient → Distributor

Core principle: Tax follows income. If Income is allocated to Entity B for GloBE purposes, the tax on that income should also be in Entity B's Covered Taxes.

2. PE Tax Allocation (Article 4.3.2(a)-(b))

2.1 The Issue

When a Constituent Entity operates through a foreign PE: - The PE is treated as a **separate Constituent Entity** for GloBE - The PE's income is included in the PE's jurisdiction - But the **Main Entity** may pay tax on the PE income in its home jurisdiction

2.2 The Allocation Mechanism

Step 1: Identify the PE's share of the Main Entity's taxable income - Extract from corporate tax return workings - Use the income attribution to the PE

Step 2: Calculate the Main Entity's tax liability on PE income - If PE income is taxed at a separate rate: Use that rate - If blended: Allocate proportionally based on PE income share

Step 3: Push down the allocated tax - Remove from Main Entity's Covered Taxes - Add to PE's Covered Taxes

2.3 Allocation Formula

```
Tax Allocated to PE = Main Entity's Tax × (PE Taxable Income ÷ Total Ta
```

2.4 Worked Example: UK Company with German PE

```
Stratos Holdings plc (UK):
  Total taxable income:       €50,000,000
  Income attributable to German PE: €8,000,000
  UK corporate tax at 25%:    €12,500,000

Tax Allocation:
  PE share = €8,000,000 ÷ €50,000,000 = 16%
  Tax to PE = €12,500,000 × 16% = €2,000,000
```

```
Result:
  UK Main Entity Covered Taxes:  €12,500,000 - €2,000,000 = €10,500,000
  German PE Covered Taxes:       +€2,000,000 (added to any German tax)
```

2.5 PE Loss Scenario (Article 4.3.4)

When a PE has a GloBE Loss: - The loss may be treated as an expense of the Main Entity (per Article 3.4.5) - Subsequent PE income is allocated to the Main Entity until the loss is recaptured - Associated Covered Taxes are also allocated to the Main Entity

Cap: Tax allocated to Main Entity cannot exceed:

```
PE Income × Highest Corporate Rate in PE Jurisdiction
```

3. CFC Tax Push-Down (Article 4.3.2(c))

2.1 The Issue

When a Parent Entity pays CFC tax on a subsidiary's undistributed income: - Parent records the CFC tax in its accounts - But the income remains in the CFC's jurisdiction for GloBE

3.2 The Three-Step Push-Down

Step 1: Identify CFC tax in Parent's current tax expense - UK CFC charge - US Subpart F / GILTI (special rules apply) - Other CFC regimes

Step 2: Determine the CFC to which the income relates - Match CFC tax to specific subsidiary - For blended regimes (GILTI), use allocation rules

Step 3: Push down the tax - Remove from Parent's Covered Taxes - Add to CFC's Covered Taxes - Apply Passive Income Limitation (Article 4.3.3)

3.3 Allocation Diagram

```
BEFORE PUSH-DOWN:

┌─────────────────────────────────────┐
│ Parent Co (UK)                      │
│ ├── Own tax: €5,000,000             │
│ └── CFC tax on Sub: €400,000        │ ← Tax here
│     Total: €5,400,000               │
└─────────────────────────────────────┘
              │
              ▼
┌─────────────────────────────────────┐
│ Sub Co (Singapore)                  │
│ ├── Local tax: €200,000             │
│ └── CFC tax: €0                     │
│     Income: €5,000,000              │ ← Income here
│     ETR: 4.0%                       │
└─────────────────────────────────────┘

AFTER PUSH-DOWN:

┌─────────────────────────────────────┐
│ Parent Co (UK)                      │
│ └── Own tax: €5,000,000             │
│     (CFC tax removed: -€400,000)    │
└─────────────────────────────────────┘
              │
              ▼
┌─────────────────────────────────────┐
│ Sub Co (Singapore)                  │
│ ├── Local tax: €200,000             │
│ └── Pushed CFC tax: +€400,000       │ ← Tax pushed here
│     Total: €600,000                 │
│     Income: €5,000,000              │
```

```
│     ETR: 12.0%                          │ ← Higher ETR
└─────────────────────────────────────────┘
```

4. Passive Income Limitation (Article 4.3.3)

4.1 Why the Limitation Exists

Without a cap, a high-tax parent could push down excessive CFC tax to eliminate all Top-Up Tax in a low-tax subsidiary—defeating the purpose of GloBE.

4.2 The Formula

For **passive income** only, the push-down is limited to the **lesser of:**

```
 (a) Actual CFC tax on the passive income
(b) Top-Up Tax % × Passive Income taxed under CFC regime
```

Where: - **Top-Up Tax %** = 15% − CFC's ETR (before push-down) - **Passive Income** = Dividends, interest, royalties, rent, annuities, certain gains

4.3 Step-by-Step Application

Step 1: Calculate CFC's ETR before any push-down

```
Pre-push ETR = CFC's Local Tax ÷ CFC's GloBE Income
```

Step 2: Determine Top-Up Tax Percentage

```
Top-Up Tax % = 15% − Pre-push ETR
```

Step 3: Calculate the cap

```
Cap = Top-Up Tax % × Passive Income under CFC regime
```

Step 4: Apply limitation

```
Push-down Amount = MIN(Actual CFC Tax, Cap)
```

2.4 Worked Example

```
SG Singapore Pte Ltd:
  GloBE Income: €5,000,000
  Local Singapore tax: €250,000 (5% ETR)

  Passive income taxed under UK CFC: €2,000,000
  UK CFC tax on passive income: €500,000 (25%)

Step 1: Pre-push ETR = €250,000 ÷ €5,000,000 = 5%

Step 2: Top-Up Tax % = 15% − 5% = 10%

Step 3: Cap = 10% × €2,000,000 = €200,000

Step 4: Push-down = MIN(€500,000, €200,000) = €200,000

Result:
  Only €200,000 pushed to Singapore (not €500,000)
  Remaining €300,000 stays in UK Parent's Covered Taxes

  Singapore post-push ETR:
    (€250,000 + €200,000) ÷ €5,000,000 = 9.0%
    Still below 15% → Top-Up Tax still applies
```

4.5 What Constitutes Passive Income

Category	Examples
Dividends	Portfolio dividends, deemed dividends

Category	Examples
Interest	Loan interest, bond interest
Royalties	IP licensing fees
Rent	Property rental income
Annuities	Structured payments
Gains	Gains on assets producing above income

Note: Active business income is NOT subject to the passive income limitation—full push-down is permitted.

5. Hybrid Entity Allocations (Article 4.3.2(d))

5.1 Tax Transparent Entity (Owner Taxed)

When the owner is taxed on the hybrid's income: - Owner's tax on hybrid income → Push down to hybrid entity

Same three-step process as CFC push-down: 1. Identify owner's tax on hybrid income 2. Allocate to hybrid entity 3. Apply passive income limitation

5.2 Reverse Hybrid Entity (Entity Taxed)

When the entity is taxed but treated as transparent by owner: - Tax stays with the entity - No push-down required (entity already has the tax)

5.3 Allocation Example

```
 US Parent owns 100% of Luxembourg SCS (hybrid):
  Luxembourg treats SCS as transparent → No Luxembourg tax
  US treats SCS as corporation → US taxes SCS income

US Parent:
```

```
  Tax on SCS income: €600,000

Allocation:
  Push €600,000 to Luxembourg SCS
  Apply passive income limitation if applicable

Result:
  Luxembourg SCS Covered Taxes: +€600,000
  US Parent Covered Taxes: -€600,000
```

6. Distribution Tax Allocation (Article 4.3.2(e))

6.1 The Rule

Withholding tax on dividends paid from one CE to another is allocated to the **distributing entity**, not the recipient.

6.2 Rationale

The distribution relates to profits of the distributor. Allocating the withholding tax to the distributor's Covered Taxes ensures the tax is matched with the income.

6.3 Allocation Mechanism

```
 Recipient Entity (receives dividend):
  Gross dividend: €1,000,000
  Withholding tax: €150,000 (15%)
  Net received: €850,000

  Financial accounts show: WHT expense €150,000

GloBE Allocation:
  Remove €150,000 from Recipient's Covered Taxes
  Add €150,000 to Distributor's Covered Taxes
```

6.4 Deemed Distributions

Per Administrative Guidance (AG 2.6), the same rule applies to deemed distributions: - If ownership interest is treated as equity for: - Tax purposes in the jurisdiction imposing tax, AND - Financial accounting purposes - Then the tax is allocated to the distributing entity

6.5 Impact on ETR

For Distributor: - Covered Taxes increase - ETR increases - Top-Up Tax exposure decreases

For Recipient: - Covered Taxes decrease - But dividend is likely excluded income under Article 3.2.1(b) - Net effect: neutral (both numerator and denominator reduced)

7. Cross-Crediting Systems (June 2024 Guidance)

7.1 The Four-Step Formula

For jurisdictions with foreign tax credit systems allowing cross-crediting:

Step 1: Determine foreign-source income - Income treated as foreign source under domestic rules

Step 2: Calculate tax on foreign-source income - Apply allocation formula based on income categories

Step 3: Determine excess FTC limitation - Compare FTCs allowed vs. used

Step 4: Allocate residual tax - Push down based on entity-by-entity income shares

7.2 Basket Approach

If the jurisdiction uses multiple FTC baskets: - Apply the four-step formula separately for each basket - Common baskets: General, Passive, GILTI (US)

7.3 GILTI Exception

Important: The June 2024 formula does NOT apply to US GILTI.

GILTI uses the temporary allocation rule from February 2023: - Allocate GILTI tax based on each CFC's share of tested income - Apply passive income limitation separately

8. Deferred Tax Allocation

8.1 Five-Step Formula (June 2024 Guidance)

For deferred tax push-down to CFCs:

Step 1: Identify deferred tax attributable to CFC income

Step 2: Determine the CFC's share of deferred tax

Step 3: Calculate GloBE-adjusted deferred tax (15% cap)

Step 4: Apply passive income limitation

Step 5: Allocate to CFC's Adjusted Covered Taxes

8.2 Five-Year Election (Article 4.3.2)

An MNE can elect to **exclude** deferred tax allocations for a jurisdiction: - Election is made on jurisdictional basis - Deferred tax is excluded from both: - The CE receiving the allocation - The parent/main entity making the allocation - Simplifies compliance but may affect ETR adversely

9. Tax Allocation Decision Flowchart

```
                     START
                       |
                       ▼
        ┌───────────────────────────────┐
        │  What type of tax requires    │
        │  allocation?                  │
        └───────────────────────────────┘
                       |
```

```
                             │
         ┌───────────────────┼───────────────────┬─────────────────┐
         │                   │                   │                 │
         ▼                   ▼                   ▼                 ▼
    ┌─────────┐         ┌─────────┐         ┌──────────┐      ┌──────────
    │ PE Tax  │         │ CFC Tax │         │ Hybrid   │      │ WHT on
    │         │         │         │         │ Entity   │      │ Dividend
    └─────────┘         └─────────┘         └──────────┘      └──────────
         │                   │                   │                 │
         ▼                   ▼                   ▼                 ▼
    ┌─────────┐         ┌─────────────┐     ┌──────────┐      ┌──────────
    │ Push to │         │ Is income   │     │ Push to  │      │ Push to
    │ PE      │         │ PASSIVE?    │     │ Hybrid   │      │ DISTRIB-
    │         │         └─────────────┘     │ Entity   │      │ UTOR
    └─────────┘                │            └──────────┘      └──────────
                               │                   │
                      ┌────────┴────────┐          │
                     YES               NO          │
                      │                 │          │
                      ▼                 ▼          ▼
             ┌───────────┐    ┌───────────┐    Apply
             │ Apply     │    │ Full      │    Art. 4.3.3
             │ Art. 4.3.3│    │ push-down │    if passive
             │ Limitation│    │ permitted │
             └───────────┘    └───────────┘
```

10. Stratos Worked Example: Multi-Entity Tax Allocation

Scenario: Stratos Group has the following tax allocation requirements for FY 2025:

10.1 Entity Structure

```
Stratos Holdings plc (UK)
├── SG Germany GmbH (100%)
│   └── German Branch in Belgium (PE)
```

```
├── SG Singapore Pte Ltd (100%)
└── SG Ireland Ltd (100%)
    └── Pays dividend to UK parent
```

10.2 Data

Item	Amount (€)	Notes
UK tax on Belgian PE income	180,000	Branch income taxed in UK
UK CFC charge on Singapore	320,000	Passive IP income
WHT on Irish dividend	75,000	15% WHT on €500K dividend
Singapore passive income under CFC	1,800,000	IP royalties
Singapore local tax	150,000	On €4,000,000 GloBE Income

10.3 Allocation Calculations

1. Belgian PE Allocation (Article 4.3.2(a))

```
UK tax on Belgian PE income: €180,000

Allocation:
  Remove from UK Covered Taxes: -€180,000
  Add to Belgian PE Covered Taxes: +€180,000
```

2. Singapore CFC Push-Down (Article 4.3.2(c) with 4.3.3 limitation)

```
Step 1: Singapore pre-push ETR
  Local tax: €150,000
```

```
  GloBE Income: €4,000,000
  ETR = 3.75%

Step 2: Top-Up Tax %
  15% - 3.75% = 11.25%

Step 3: Passive income cap
  €1,800,000 × 11.25% = €202,500

Step 4: Push-down amount
  MIN(€320,000, €202,500) = €202,500

Result:
  Push to Singapore: €202,500
  Remains in UK: €320,000 - €202,500 = €117,500

Singapore post-push ETR:
  (€150,000 + €202,500) ÷ €4,000,000 = 8.8%
```

3. Irish Dividend WHT (Article 4.3.2(e))

```
 WHT paid by UK on Irish dividend: €75,000

Allocation:
  Remove from UK Covered Taxes: -€75,000
  Add to SG Ireland Covered Taxes: +€75,000
```

10.4 Summary Workpaper

Entity	Before Allocation	PE Alloc	CFC Alloc	WHT Alloc	After Allocation
UK Parent	5,000,000	-180,000	-202,500	-75,000	4,542,500
Belgian PE	50,000	+180,000	—	—	230,000

Entity	Before Allocation	PE Alloc	CFC Alloc	WHT Alloc	After Allocation
SG Singapore	150,000	—	+202,500	—	352,500
SG Ireland	800,000	—	—	+75,000	875,000
Group Total	**6,000,000**	**0**	**0**	**0**	**6,000,000**

Note: Total Covered Taxes remain unchanged—allocation only shifts taxes between jurisdictions.

11. Tax Allocation Checklist

11.1 Pre-Allocation

- [ ] Identify all CFC taxes in parent accounts
- [ ] Identify all PE income taxed by main entity
- [ ] Identify all hybrid entity structures
- [ ] Identify all intra-group dividends with WHT
- [ ] Extract passive vs. active income breakdown for CFC

11.2 Allocation Steps

- [ ] Calculate PE tax allocation (no limitation applies)
- [ ] Calculate CFC tax with passive income limitation
- [ ] Calculate hybrid entity allocation with limitation
- [ ] Allocate distribution WHT to distributor
- [ ] Consider deferred tax allocation (or five-year election)

11.3 Post-Allocation

- [ ] Verify group total Covered Taxes unchanged

- [ ] Update each entity's Adjusted Covered Taxes
- [ ] Document allocation methodology
- [ ] Maintain workpapers for each allocation type

12. Common Pitfalls