Chapter 2.1: Income Inclusion Rule Mechanics

Learning Objective

After completing this chapter, you will be able to determine which entity in an MNE group is liable to apply the Income Inclusion Rule and calculate its Allocable Share of Top-Up Tax.

Introduction

The Income Inclusion Rule represents the linchpin of Pillar Two's enforcement architecture. While Part 1 determined which groups fall within scope, and Part 3-5 will calculate the Top-Up Tax amounts, the IIR answers the critical question: who actually pays? The rule's design reflects a fundamental insight about multinational tax compliance—that parent entities, sitting at the apex of corporate structures with visibility over global operations, are best positioned to ensure minimum taxation throughout their groups. By making the ultimate parent responsible for "topping up" the tax on low-taxed subsidiaries, the IIR aligns economic control with tax responsibility.

1. How the IIR Works

The Income Inclusion Rule (IIR) is the **primary charging mechanism** under GloBE. It requires a parent entity to include its share of Top-Up Tax arising from low-taxed constituent entities in its own tax liability.

The IIR follows a **top-down approach**: the Ultimate Parent Entity (UPE) has first priority to apply the rule. If the UPE's jurisdiction does not have a Qualified IIR, the obligation cascades down to the next parent entity in the ownership chain.

The top-down design serves multiple purposes. It concentrates compliance at the entity with fullest visibility over group-wide operations, avoiding the complexity of multiple entities independently calculating and paying overlapping Top-Up Tax obligations. It also creates a "carrot" for countries to implement Pillar Two: jurisdictions that adopt a Qualified IIR capture the Top-Up Tax revenue that would otherwise flow elsewhere. For multinational groups, this means the UPE's jurisdiction choice—often made decades ago for unrelated reasons—now carries significant Pillar Two implications.

2. Step 1: Identify the Entity That Must Apply the IIR

2.1 Primary Rule: UPE Applies the IIR

If the UPE's jurisdiction has implemented a **Qualified IIR**, the UPE is required to apply the IIR with respect to any Low-Taxed Constituent Entity (LTCE) in which it holds an Ownership Interest *(Article 2.1.1)*.

Key point: The UPE must apply the IIR if it owns an interest in the LTCE "at any time during the Fiscal Year"—the holding period does not matter for determining liability.

2.2 Secondary Rule: IPE Applies the IIR

If the UPE's jurisdiction does **not** have a Qualified IIR, the obligation flows down to the next **Intermediate Parent Entity (IPE)** whose jurisdiction has a Qualified IIR *(Article 2.1.2)*.

The IPE applies the IIR only with respect to LTCEs it directly or indirectly owns—not for entities outside its ownership chain.

2.3 Exception: IPE Excluded When UPE Applies

If the UPE applies a Qualified IIR, lower-tier IPEs are **excluded** from applying the IIR *(Article 2.1.3)*. This prevents double taxation within the same ownership chain.

The cascading mechanism from UPE to IPE reflects a pragmatic recognition that global adoption of Pillar Two will be neither instantaneous nor universal. Some major economies may delay implementation; others may never adopt. Without the IPE fallback, groups headquartered in non-implementing jurisdictions would escape the minimum tax entirely—a gap that would undermine the framework's effectiveness and create competitive distortions. By allowing IPEs in implementing jurisdictions to step into the UPE's shoes, the rules ensure broader coverage while preserving the simplicity of single-point compliance where possible.

3. Decision Flowchart: Which Entity Applies the IIR?

```
                    ┌──────────────────────────────────┐
                    │ Does the UPE's jurisdiction      │
                    │ have a Qualified IIR?            │
                    └────────────────┬─────────────────┘
                                     │
                         ┌───────────┴───────────┐
                         │                       │
                        YES                      NO
                         │                       │
                         ▼                       ▼
              ┌────────────────────┐   ┌─────────────────────────┐
              │ UPE applies IIR    │   │ Move down ownership     │
              │ (Article 2.1.1)    │   │ chain to first IPE with │
              └────────────────────┘   │ Qualified IIR           │
                         │             └───────────┬─────────────┘
                         │                         │
                         ▼                         ▼
              ┌────────────────────┐   ┌───────────────────────────┐
              │ IPEs below UPE     │   │ IPE applies IIR for its   │
              │ are EXCLUDED       │   │ sub-group (Article 2.1.2) │
              │ (Article 2.1.3)    │   └───────────────────────────┘
              └────────────────────┘
```

4. Step 2: Calculate the Allocable Share of Top-Up Tax

Once you identify which entity must apply the IIR, calculate its **Allocable Share** of the Top-Up Tax.

4.1 The Formula

Allocable Share = Top-Up Tax of LTCE × Inclusion Ratio *(Article 2.2.1)*

4.2 Calculating the Inclusion Ratio

The **Inclusion Ratio** represents the parent entity's proportionate interest in the LTCE's GloBE Income *(Article 2.2.2)*.

Inclusion Ratio = (GloBE Income of LTCE − Amount attributable to other owners) ÷ GloBE Income of LTCE

Scenario	Inclusion Ratio
100% ownership	100%
80% ownership (20% minority)	Approximately 80%*
Split ownership through multiple parents	Pro-rata based on each parent's share

*The exact calculation uses GloBE Income allocation, not just ownership percentage. In most cases with straightforward structures, these align closely.

The Allocable Share concept ensures that the IIR charges Top-Up Tax proportionally to economic ownership. A parent owning 60% of a low-taxed subsidiary should bear 60% of the resulting Top-Up Tax—no more, no less. This proportionality prevents the IIR from either under-collecting (leaving minority interests untaxed) or over-collecting (taxing the parent on income economically belonging to others). The use of GloBE Income rather than legal ownership percentages for the Inclusion Ratio adds precision, accommodating structures where profit-sharing differs from capital ownership.

4.3 Worked Example: Simple Ownership

Scenario: Stratos Group plc (UK UPE) owns 100% of SG Singapore Pte Ltd, which has a Top-Up Tax of €500,000.

Item	Value
Top-Up Tax of LTCE	€500,000
Stratos's Inclusion Ratio	100%
Stratos's Allocable Share	**€500,000**

Stratos Group plc pays €500,000 of UK Multinational Top-Up Tax.

5. Step 3: Handle Split Ownership Structures

When an LTCE is owned through multiple ownership chains, each parent entity calculates its own Allocable Share based on its Inclusion Ratio.

5.1 Worked Example: Split Ownership

Scenario: SG Ireland IP Ltd (LTCE) is owned: - 70% by SG Netherlands BV (held by Stratos Group plc) - 30% by an external investor

Data	Value
SG Ireland IP Ltd GloBE Income	€10,000,000
SG Ireland IP Ltd Top-Up Tax	€200,000
GloBE Income attributable to external investor	€3,000,000

Stratos's Inclusion Ratio:

```
Inclusion Ratio = (€10,000,000 − €3,000,000) ÷ €10,000,000
                = €7,000,000 ÷ €10,000,000
                = 70%
```

Stratos's Allocable Share:

```
Allocable Share = €200,000 × 70% = €140,000
```

Stratos Group plc pays €140,000 of Top-Up Tax. The remaining €60,000 is not charged under the IIR (it would be addressed by UTPR or QDMTT depending on the external investor's structure).

6. Partially-Owned Parent Entities (POPEs)

A **Partially-Owned Parent Entity (POPE)** is a Constituent Entity that: 1. Owns an Ownership Interest in another CE, AND 2. Has **more than 20%** of its profits held by third parties *(Article 10.1)*

6.1 Special Rule: POPEs Must Also Apply IIR

Even when a UPE applies the IIR, a POPE must **separately** apply the IIR with respect to LTCEs it owns *(Article 2.1.4)*. This is an exception to the normal top-down exclusion rule.

Why? POPEs have significant third-party ownership, so the UPE cannot fully capture the Top-Up Tax through its own Inclusion Ratio. The POPE must apply the IIR to ensure the third parties' share is taxed.

6.2 Exception: Wholly-Owned POPE Chain

If one POPE is wholly owned by another POPE, only the higher-tier POPE applies the IIR *(Article 2.1.5)*. This prevents multiple POPEs in a chain from each applying the IIR on the same income.

The POPE rules address a structural gap in the standard IIR mechanism. When an intermediate holding company has significant third-party ownership, the UPE's Inclusion Ratio captures only its proportionate share of the low-taxed income—the third parties' share would escape the IIR entirely. By requiring POPEs to apply the IIR separately, the rules ensure that the third parties' economic interest in low-taxed profits is also subject to minimum taxation. This creates complexity—two layers of IIR application require careful coordination—but closes what would otherwise be a significant planning opportunity for groups with listed or joint-venture holding structures.

7. IIR Offset Mechanism

When multiple entities in the ownership chain apply the IIR (e.g., a UPE and a POPE both applying to the same LTCE), the **IIR offset** prevents double taxation *(Article 2.3)*.

7.1 How the Offset Works

The higher-tier parent entity **reduces** its Allocable Share by the amount already charged at the lower-tier entity *(Article 2.3.1 and 2.3.2)*.

7.2 Worked Example: IIR Offset with POPE

Scenario: - Stratos Group plc (UK UPE) owns 60% of SG Holdings BV (Netherlands POPE) - SG Holdings BV owns 100% of SG Singapore Tech Pte Ltd (LTCE) - SG Holdings BV has 40% third-party ownership → qualifies as POPE - Netherlands has a Qualified IIR - SG Singapore Tech Top-Up Tax: €300,000

Step 1: POPE applies IIR

SG Holdings BV (POPE) applies IIR under Article 2.1.4: - Inclusion Ratio: 100% (wholly owns the LTCE) - Allocable Share: €300,000 × 100% = **€300,000**

SG Holdings BV pays €300,000 under Netherlands IIR.

Step 2: UPE calculates Allocable Share before offset

Stratos Group plc calculates its Allocable Share: - Stratos owns 60% of SG Holdings BV - Stratos's indirect Inclusion Ratio in LTCE: 60% - Allocable Share before offset: €300,000 × 60% = €180,000

Step 3: Apply IIR offset

Stratos reduces its Allocable Share by the portion already taxed at POPE level: - Amount charged at POPE: €300,000 - Stratos's share of POPE's tax: 60% × €300,000 = €180,000 - **Offset amount: €180,000**

Stratos's final Allocable Share: €180,000 − €180,000 = €0

The IIR offset eliminates Stratos's Top-Up Tax liability because the full amount has been charged at the POPE level. No double taxation occurs.

The IIR offset mechanism embodies a core principle of the GloBE framework: ensuring the right amount of Top-Up Tax is collected once, and only once. Without this coordination, a UPE with a POPE subsidiary could face Top-Up Tax at both levels on the same underlying low-taxed income—an outcome that would be both unfair and economically inefficient. The offset mechanism traces through the ownership chain to identify where tax has already been paid and reduces the higher-tier charge accordingly. This mechanical elegance comes at the cost of calculation complexity, but it preserves the integrity of the single-tax principle.

8. Multi-Tier Ownership Chains

In complex structures with multiple IPEs, trace the ownership from the UPE down to each LTCE. Each parent in the chain may have different Inclusion Ratios depending on ownership percentages at each level.

8.1 Worked Example: Multi-Tier Chain

Stratos Group Structure:

```
Stratos Group plc (UK UPE) — 100%
    │
    └── SG Holdings Ltd (UK IPE) — 100%
            │
            └── SG Netherlands BV (Netherlands IPE) — 100%
                    │
                    └── SG Singapore Pte Ltd (LTCE)
                        Top-Up Tax: €400,000
```

Analysis:

Level	Entity	Direct Ownership	Cumulative Inclusion Ratio
1	Stratos Group plc	100% of SG Holdings	100%
2	SG Holdings Ltd	100% of SG Netherlands	100%
3	SG Netherlands BV	100% of SG Singapore	100%

Which entity applies IIR?

- UK has a Qualified IIR
- Stratos Group plc (UPE) applies IIR *(Article 2.1.1)*
- SG Holdings Ltd and SG Netherlands BV are **excluded** *(Article 2.1.3)*

Stratos's Allocable Share:

€400,000 × 100% = **€400,000**

All Top-Up Tax is charged at the UK UPE level. Lower-tier IPEs have no IIR liability.

9. Jurisdiction Qualified IIR Status

The IIR application depends on which jurisdictions have implemented a **Qualified IIR**. A jurisdiction's IIR qualifies if it is consistent with the GloBE Model Rules as determined through the OECD Inclusive Framework peer review process.

Major jurisdictions with Qualified IIR (as at 2025):

Jurisdiction	Status
United Kingdom	Qualified IIR effective 2024
EU Member States	Qualified IIR effective 2024

Jurisdiction	Status
Australia	Qualified IIR effective 2024
Japan	Qualified IIR effective 2024
South Korea	Qualified IIR effective 2024
Canada	Qualified IIR effective 2024

Key point: Check the OECD's published list of qualified jurisdictions, as this is updated periodically following peer reviews.

The "Qualified" designation matters critically. A jurisdiction might implement domestic legislation labelled as an IIR, but unless that legislation passes the OECD Inclusive Framework's peer review—confirming consistency with the Model Rules—it does not receive Qualified status. Other jurisdictions would then treat that non-Qualified IIR as if it did not exist, potentially applying their own IIR or UTPR to collect Top-Up Tax on the group's low-taxed entities. The peer review process thus creates both quality assurance and coordination: MNE groups can rely on a single authoritative list rather than analysing each jurisdiction's legislation independently.

10. Stratos Example: Complete IIR Application

Stratos Group Structure (simplified for IIR analysis):

```
Stratos Group plc (UK) — UPE
    |
    ├── SG Holdings Ltd (UK) — 100%
    |       |
    |       └── SG Singapore Pte Ltd (Singapore) — 100%
    |               ETR: 12.3%
    |               Top-Up Tax: €2,100,000
    |
    └── SG Ireland Ltd (Ireland) — 100%
```

```
              ETR: 14.1%
              Top-Up Tax: €800,000
```

IIR Application:

LTCE	Top-Up Tax	UPE Applies IIR?	Allocable Share
SG Singapore Pte Ltd	€2,100,000	Yes (UK has Qualified IIR)	€2,100,000
SG Ireland Ltd	€800,000	Yes (UK has Qualified IIR)	€800,000

Total UK Multinational Top-Up Tax for Stratos: €2,900,000

Note: If Ireland had implemented a QDMTT, the €800,000 would be collected in Ireland first, and Stratos's IIR liability for Ireland would be reduced to zero. See Chapter 5.4 for QDMTT interaction.

11. Common Pitfalls

11.1 Pitfall 1: Assuming IPE Always Applies IIR

If the UPE's jurisdiction has a Qualified IIR, lower-tier IPEs are excluded. Don't calculate separate IIR liability for each entity in the chain.

11.2 Pitfall 2: Forgetting POPE Rules

POPEs must apply the IIR even when the UPE does. Always check whether any intermediate holding company has >20% third-party ownership.

11.3 Pitfall 3: Incorrect Inclusion Ratio

The Inclusion Ratio is based on GloBE Income allocation, not just legal ownership percentage. For complex structures with minority interests at multiple levels, trace the income attribution carefully.

11.4 Pitfall 4: Ignoring the IIR Offset

When both UPE and POPE apply IIR, the offset prevents double taxation. Failing to apply the offset overstates the UPE's liability.

Mastering the IIR requires understanding both its mechanical operation and its underlying logic. The rule is designed to be comprehensive yet avoid double taxation, to function even with imperfect global adoption, and to trace Top-Up Tax responsibility through complex ownership structures to the appropriate parent. Groups with straightforward structures—100% ownership through a single chain from a UPE in an implementing jurisdiction—will find IIR application relatively simple. Those with POPEs, split ownership, or UPEs in non-implementing jurisdictions face greater complexity but can navigate it by systematically working through the decision flowchart and applying the offset mechanisms as designed.