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Tax Insights

Pillar Two blueprint on a global minimum tax issued

Snapshot

On 12 October 2020, the G20/OECD inclusive framework on BEPS ("inclusive framework") released two detailed "blueprints" in relation to its ongoing work to address the tax challenges arising from the digitalisation of the economy. The Pillar Two blueprint proposes a set of interlocking international tax rules designed to ensure that large multinational businesses pay a minimum level of tax on all profits in all countries. Comments on the blueprint are invited by 14 December 2020 and a virtual public consultation meeting will be held in January 2021.

Work to address the political and remaining technical issues will continue after the blueprints have been presented to the G20 finance ministers on 14 October 2020. The OECD's aim is to bring the process to a conclusion by mid-2021.

The Pillar Two blueprint sets out proposals that do not yet have the political agreement of the inclusive framework countries, including the following key elements:

- **The income inclusion rule and the undertaxed payments rule (GloBE)**: Connected rules that are intended to ensure large multinational groups pay tax at a minimum level in each country in which they operate. These share common rules for scope, and for calculating effective tax rates and top-up amounts:
    - The principal rule is the income inclusion rule, which will trigger additional "top-up tax" payable in a group's parent company country where the profits of group companies in any one country are taxed at an effective tax rate below a minimum tax rate;
    - A switch-over rule will apply similarly to exempt branches; and
    - An undertaxed payments rule acts as a backstop for low-taxed group companies not controlled by a parent company subject to the income inclusion rule.
- **The subject to tax rule**: A separate rule that applies in priority to the income inclusion and undertaxed payments rule. Paying (source) countries will be able to charge a top-up tax in respect of specific types of intra-group payments made to other group companies, where the recipient country has a nominal tax rate less than a minimum tax rate. The rule is applied on a payment-by-payment basis, but may be calculated and administered by way of an annual return.

Income inclusion rule and undertaxed payments rule

Scope

Multinational groups with consolidated group revenue below EUR 750 million (or equivalent) in the preceding fiscal year will be excluded from the scope of the income inclusion and undertaxed payment rules.

Investment funds, pension funds, governmental entities, international organisations, non-profit entities, and entities subject to tax neutrality regimes may be excluded from scope. The rules can apply instead to subgroups controlled by such excluded entities. Further work will be required on whether, and to what extent, the rules will apply to the international shipping industry due to the global prevalence of tonnage tax regimes that are not based on profits.

Operation of the income inclusion rule

The income inclusion rule applies on a **top-down basis** such that any tax due is calculated and paid by the ultimate parent company to the tax authority in its country. The tax due is the "top-up" amount required to bring the overall tax on the profits in each country where the group operates up to the minimum effective tax rate.

If the ultimate parent company is located in a country that has not implemented the income inclusion rule, the next intermediate holding company in the ownership chain calculates and pays top-up taxes in respect of their low-taxed subsidiaries. Specific "split-ownership" rules apply where a significant portion of the shares in a subsidiary are held outside the group.

A treaty-based switch-over rule will be designed to allow for the parent country to top-up the tax on the income of overseas permanent establishments to the minimum rate.

Operation of the undertaxed payments rule

The undertaxed payments rule applies as a **secondary rule** in cases where the effective tax rate in a country is below the minimum rate, but the income inclusion rule has **not** been applied by the ultimate or intermediate holding companies in respect of a group company in that jurisdiction.

The required top-up tax is allocated to other companies in the group on an annual basis based on a formulaic approach. The primary allocation key will be the amount of deductible payments made by each of the other group companies to the low-taxed company.

No tax will be allocated to countries with an effective tax rate below the minimum rate, and any amounts will be capped at the domestic tax rates applicable multiplied by the deductible intragroup payments made.

Calculating the effective tax rate

The rules will apply on a **jurisdictional-blending basis**. The annual effective tax rate calculation required for each country will take into account the total covered taxes, profits, and losses attributable to all of the group companies in that country.

Covered taxes (the numerator) are taxes on a group company's income or profits. Both domestic and foreign taxes imposed on the company's profits are included, e.g., taxes paid under controlled foreign company rules further up the ownership chain are taken into account when determining the covered taxes for the group company's country. Sales taxes, VAT, excise taxes, digital services taxes, stamp taxes, employment taxes, and property taxes are not covered taxes.

The starting point for the tax base (the denominator) is the accounting profit (or loss) before tax of each group company, as used in the preparation of the parent company's consolidated financial statements (prepared under an acceptable accounting standard) subject to a small number of adjustments. The allocation of profits of a permanent establishment is determined in accordance with the tax rules applicable in the permanent establishment country.

A limited number of adjustments for permanent items are required to determine the tax base from the profit before tax. Items for which adjustments are proposed include dividends, gains or losses from the disposal of shares, and share-based compensation expenses. A mechanism will be developed to mirror any local tax deferrals applying to intragroup transfers of assets made in connection with a reorganisation. Adjustments to the tax base and covered taxes may also be required to properly reflect Pillar One outcomes. While temporary differences are not generally adjusted in calculating the tax base, specific adjustment rules will be developed where immediate expensing and accelerated tax depreciation of business assets is available for local tax purposes. Additional rules are also set out for the treatment of government grants and tax credits.

Carryforwards

To reduce the effects of temporary differences on the volatility of effective tax rates:

- Losses arising in a country can be carried forward indefinitely, to be offset against profits arising in the same country in future periods; and
- In years where the effective tax rate for a country exceeds the minimum rate, the excess tax is computed. If income inclusion rule tax has been paid in respect of the same country in preceding years, the excess tax can generate an income inclusion rule tax credit which can reduce current or future income inclusion rule tax (or potentially other taxes) otherwise payable by the group. Otherwise, excess tax creates a local tax carry-forward, to be taken into account in future effective tax rate calculations for the same country. The maximum number of years for the lookback period and for the local tax carry forward are to be determined. Seven years is suggested, with further consideration of extended time limits for industries with long economic cycles.

Further work will also be performed to examine possible transitional rules to account for losses or timing differences arising in periods prior to the application of the rules.

Formulaic substance-based carve-out

In countries where the effective tax rate is below the minimum rate, a formulaic carve-out will exclude an amount of profit from the calculation of additional top-up taxes due, intended to represent a fixed return for substantive activities less susceptible to BEPS risks.

The carve-out will have two components:

- A payroll component equal to a fixed percentage mark-up on payroll costs (including bonuses, benefits and employer social security contributions) of eligible employees (including independent contractors) performing activities in the country; and
- A tangible asset component equal to a fixed percentage mark-up applied to, *inter alia*, depreciation of property, plant and equipment and deemed depreciation of land and natural resources.

The carve-out is subject to further work, including agreeing each of the fixed percentage mark-up rates.

Simplifications

Additional simplification measures will be explored to reduce the number of countries for which detailed annual effective tax rate calculations are required. No decision has been taken on which countries, if any, will be included, and this will be an area for public consultation.

Simplifications under consideration include a safe-harbour based on effective tax rate calculations derived from country-by-country reports, a *de minimis* profit exclusion, the ability for calculations to cover several years and administrative guidance (e.g., tax administrations working together to identify "low-risk" countries in respect of which effective tax rate calculation obligations would be reduced).

Associates and joint ventures

A simplified income inclusion rule is proposed for associates and joint ventures in which a group has a direct ownership interest, but which are not controlled group companies (i.e. because their results are not fully consolidated on a line-by-line basis in the consolidated accounts).

Special rules may also apply to companies ("orphan entities") that are controlled by the same common shareholders (e.g., a fund, foundation or group of connected individuals) that also control an in-scope group, potentially bringing them within the scope of the undertaxed payments rule.

Subject to tax rule

The subject to tax rule operates separately, and in priority to, the other Pillar Two rules. It allows for source country taxation where a payment is undertaxed in the country of the recipient:

- The rule will apply to individual payments between connected persons, with a definition-based on existing tests of common control; and
- The rule will be applicable when the adjusted nominal tax rate applicable to the company receiving the payment is below an agreed minimum rate. The nominal statutory rate will be adjusted for features of the local tax system applicable to the recipient, e.g., preferential tax rates. The minimum rate for the subject to tax rule may be different from, and could be lower than, the effective minimum rate applied under the income inclusion and undertaxed payments rules.

- The rule will apply to defined categories of payments, considered to be high-risk from a base erosion perspective. These are:
    - Interest;
    - Royalties; and
    - Other payments, including franchise fees or other payments for the use of intangibles in combination with services, insurance and reinsurance premiums, guarantee, brokerage, or financing fees, rent or payments for the use of moveable property, and consideration for the supply of marketing, procurement, agency or other intermediary services. Payments generating a low profit margin will be excluded.
- Payments made to or by individuals are not within scope. Consistent with the other Pillar Two rules, investment funds, pension funds, governmental entities, international organisations, non-profit organisations, and entities subject to tax neutrality regimes may also be excluded from scope;
- Materiality thresholds: Further work will be undertaken on the design of thresholds that may be based on a combination of the size of the group, tiered thresholds based on the value of covered payments, with tiers based on the GDP of the source country, and/or ratios of covered payments to total expenditure; and
- A top-up approach will apply, bringing the tax on the gross payment up to the minimum rate. Further work will be required to manage the interaction with double tax relief provisions in treaties.

Further technical work will be undertaken to explore various administrative approaches to apply the rule. This will include exploring administering the top-up tax as a charge assessed annually post year-end, a certification system providing for reduced rates of withholding tax, and/or interim contingent withholding taxes set at a lower level combined with an annual balancing payment.

Implementation

Model legislation and guidance will be developed to set out the detailed rules for the income inclusion and undertaxed payments rules to promote consistent implementation in domestic legislation. Both the subject to tax rule and the switch-over rule will require changes to existing tax treaties, possibly through the BEPS Multilateral Instrument or a new multilateral convention. A new multilateral convention could also be used to coordinate the application and operation of the income inclusion and undertaxed payments rules in a legally binding form.

Comments

The blueprint does not have the political agreement that the G20 had originally hoped for when setting the ambitious target of completing work on the tax challenges of the digitalised economy by the end of 2020.

No agreement has yet been reached on the key issue of setting the minimum effective tax rate. Rates of 10%-12.5% are used for illustrative purposes across the blueprint and associated economic impact analysis.

The blueprint sets out the technical design components of the global minimum tax proposals and the further technical work required prior to finalisation. There are a number of political and technical issues where differences of views remain to be bridged. For example, it is recognised that political agreement needs to be reached on the coexistence of the existing US global intangible low-taxed income (GILTI) regime alongside the proposed income inclusion rule. Further technical work is being undertaken on coordination, such as how the GILTI regime would apply to US holding companies within non-US groups that apply the income inclusion rule at the parent company level. In addition, the blueprint "strongly encourages" the US to limit the operation of

the base erosion and anti-abuse tax (BEAT) in respect of payments to entities that are subject to the income inclusion rules.

A formulaic substance based carve-out based on payroll costs and tangible assets is under consideration to represent a modest fixed return for substantive activities considered to be less susceptible to BEPS risks. No further carve outs are outlined, including for regimes that are considered compliant under BEPS action 5 rules on harmful tax practices.

The blueprint gives priority to the subject to tax rule, which is applied by source countries on intragroup payments where the receipt is not subject to a minimum level of tax based on an adjusted nominal rate. Applying this rule on a payment-by-payment basis is likely to be problematic from a practical perspective, and applying an appropriate minimum tax rate to gross payments is likely to be challenging where the gross amount is not reflective of the net profit arising in the low tax country. Businesses will also wish to ensure that profits are taxed only once and that there is effective and timely resolution of disputes between countries on the application of the subject to tax rule.

Implementing the Pillar Two rules on a global basis in a manner that is not distortive and that does not require disproportionate efforts in terms of compliance and administration remains a concern. A number of areas have been identified, particularly in respect of implementation and simplification, for further work.

The amount of tax expected to be raised by Pillar Two is expected to be considerably more than for Pillar One, with estimates (excluding modelling of the subject to tax rule and US GILTI revenues) of USD 42 billion-USD 70 billion annually.

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