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OECD's proposal for 'Global Anti-Base Erosion' under Pillar Two, released for public consultation

OECD's 'Global Anti-Base Erosion' under Pillar Two to address tax challenges of digitalisation of the economy released, for public consultation

Background

- Under the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS), over 130 countries are collaborating and implementing 15 Action Plans to put an end to tax avoidance strategies that exploit gaps and mismatches in tax rules to avoid paying tax, improve the coherence of international tax rules and ensure a more transparent tax environment.
- Action 1 Tax Challenges Arising from Digitalisation - Addressing tax challenges that have cropped up due to digitalisation, is currently top priority for the OECD/G20 Inclusive Framework, and has also been a key area of focus of the BEPS Project since its inception.
- In May 2019, the OECD/G20 Inclusive Framework on BEPS (Inclusive Framework) Action 1 agreed on a Programme of Work (POW) for addressing tax challenges arising from digitalisation of the economy. The POW is divided into two pillars:
  - Pillar One addresses the allocation of taxing rights among jurisdictions and considers various proposals for new profit allocation and nexus rules;
  - Pillar Two (also referred to as the 'GloBE' proposal) seeks to develop rules that would provide jurisdictions with a right to 'tax back' where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.
- To progress towards a consensus solution to Pillar Two issues, the OECD Secretariat on 8 November 2019 released a public consultation document. Comments have been invited from interested parties by 2 December 2019 18:00 (CET).
- On 9 October 2019 the OECD Secretariat released a public consultation document on the "Unified Approach" under Pillar One.

GLoBE Proposal

- The GloBE proposal is based on the premise that, in the absence of a co-ordinated and multilateral solution, there is a risk of uncoordinated, unilateral action- both to broaden the tax base and to protect the existing tax base - with adverse consequences for all jurisdictions.
- The GloBE proposal should be designed to achieve the objective of taxing cross border income at minimum tax rates, consistent with principles of design simplicity to minimise compliance and administration costs and the risk of double taxation.
- The four parts of the GloBE proposal are:
  1. an **income inclusion rule** that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate.

2. an **undertaxed payments rule** that would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at or above a minimum rate.
3. a **switch-over rule** to be introduced into tax treaties that would permit a residence jurisdiction to switch from an exemption to a credit method where the profits attributable to a permanent establishment (PE) or derived from immovable property (which is not part of a PE) are subject to an effective rate below the minimum rate; and
4. a **subject to tax rule** that would complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source and adjusting eligibility for treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate.

- These rules would be implemented by way of changes to domestic law and tax treaties and would incorporate a co-ordination or ordering rule to avoid the risk of double taxation arising where more than one jurisdiction seeks to apply these rules to the same structure or arrangement.
- The consultation document[1] focuses on specific technical issues in respect of the GloBE proposal and comments have been sought on all aspects of the Programme of Work on Pillar Two, but specifically on three technical design aspects of the GloBE proposal, as elaborated below:

1. The use of financial accounts as a starting point for determining the tax base and mechanisms to address timing differences

i) Importance of a consistent tax base

- As per the approach followed by the POW, the tax base would be determined by reference to the CFC rules or, in its absence, under the domestic corporate income tax (CIT) rules of the shareholder's jurisdiction. This would require yearly recalculation of income of each subsidiary of an multinational enterprise (MNE) in accordance with the tax base calculations in the parent jurisdiction.
- This may significantly increase compliance cost as well as administrative burden and may give a distorted picture of the effective tax rate (ETR) of the subsidiary due to technical and structural differences in calculation of tax base in the parent and subsidiary jurisdiction.

ii) Use of financial accounts to determine income

- One simplification measure would be that the income calculated for accounting purposes would be subject to agreed adjustments in order to align accounting income with a proper measure of taxable income.
- The income so determined would be used in the denominator of the ETR fraction. The numerator of the ETR fraction could be based on the actual tax liability or the tax expense accrued for accounting purposes, which may need to be further adjusted to remove accruals of tax related to a different period.
- The accounting standard used by the ultimate parent entity applied to all subsidiaries would be more transparent and would ensure that differences between subsidiary accounting standards do not produce distortions and reduce compliance costs. For this purpose, the financial accounts of the ultimate parent entity need to be prepared

[1] http://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf

under an acceptable set of financial accounting standards or generally accepted accounting standards (GAAP).

- It will be necessary to consider various approaches of MNEs that are not listed who may have no legal obligation to prepare consolidated financial statements under any financial accounting standard.
- Allowing the use of various financial accounting standards under the GloBE proposal may lead to different results when the ultimate parent entities of different MNE groups are resident in different jurisdictions. Most of the differences among accounting standards will be timing differences, or permanent differences that require further consideration, or some significant timing differences which warrant the same consideration as permanent differences.

iii) Adjustments

The accounting profit reflected in an entity's financial statements could be adjusted to take into account certain permanent and temporary differences between the income computed under financial accounting standards, and as under the income tax rules.

- **Permanent differences** - Permanent differences are differences in the annual income computation under financial accounting and tax rules that will not reverse in the future. Financial accounts include all income and expense. Thus, in the design of the GloBE tax base, adjustments for permanent differences will involve exclusion of categories of income or expense from the financial accounts. Excluding categories of income will narrow the tax base and excluding categories of expense will expand the tax base. Permanent differences arise for a variety of reasons. For example, difference between the treatment of corporate acquisitions under financial accounting and tax rules, income exclusions or disallowance of certain expenses due to domestic policy requirements, etc, may trigger permanent differences.
- **Temporary differences** - Temporary differences are differences in the time for taking into account income and expense that are expected to reverse in the future. Assuming there are no changes to the local tax law, these temporary differences will not affect the total amount of local taxes the entity will be required to pay over its lifetime. Examples of temporary differences include differences in depreciation methods, deductions for reserves, the allowance of loss carry-forwards, etc.

  There are three basic approaches to addressing the problem of temporary differences –

  - carry-forward of excess taxes and tax attributes –
    - Under the first rule, taxes paid by a subsidiary to a jurisdiction in excess of the minimum tax rate in a year would be carried forward and treated as tax paid in a subsequent year in which the local tax paid by the subsidiary falls below the minimum tax rate
    - The second rule would allow the tax paid by a parent corporation under the income inclusion rule with respect to a subsidiary's income to be refunded or credited against another tax liability of the parent corporation when local tax paid by the subsidiary is in excess of the minimum tax rate
    - Under the third rule, operating losses of a subsidiary corporation determined under financial accounting would be carried forward and used to reduce the financial accounting income of the subsidiary

  - All three carry-forwards would be tracked through memorandum accounts maintained by the parent corporation
  - The loss carry-forward rule would prevent taxation under the GloBE proposal in excess of economic income
  - The carry-forward rule would iron out book/tax differences in the timing in the recognition of income and expense.
- deferred tax accounting
  - When the actual tax due is less than the tax expense on the financial income (because taxable income is deferred), deferred tax accounting accrues the full tax expense and creates a deferred tax liability that is extinguished later when the tax on the tax deferred income becomes due, to the tax authority
  - When the actual tax due exceeds the tax expense on the financial income (because the taxable income is accelerated), deferred tax accounting excludes the additional tax paid with respect to the accelerated income from the tax expense and creates a deferred tax asset that is eliminated when the financial tax expense arises
  - Large MNEs preparing financial statements pursuant to IFRS and other commonly used financial accounting standards are already computing financial income and tax expense on an entity-by-entity basis for accounting purposes. Thus computing the ETR based on deferred tax accounting, reduces the additional compliance burden on those MNEs.
- a multi-year average effective tax rate
  - Computing the annual ETR based on the total taxes paid and total income of the relevant subsidiaries over a multi-year period that includes the current year and a specified number of preceding years.
  - A multi-year averaging approach has the benefit of simplicity as it would not necessarily require the development of separate rules for the carry forward of losses, excess taxes and other tax attributes.

These basic approaches could be tailored and elements of the different approaches could be combined to better or more efficiently address specific problems.

There are a number of compliance, administration, and tax policy considerations that would need to be considered in the design of the rules for addressing temporary differences under the GloBE proposal. All three approaches described above entail some degree of record-keeping burden.

2. Blending

"Blending" under the GloBE proposal refers to mixing low-tax and high-tax income within the same entity or across different entities within the same group.

There are three blending approaches being explored:

i) A worldwide blending approach

This would require the MNE to aggregate its total foreign income and the total foreign tax on that income. An MNE would be subject to tax where the tax on the total foreign income was below the minimum rate. The MNE's liability for additional tax under the

GloBE proposal would be the amount necessary to bring the total amount of tax on that foreign income up to the minimum rate.

ii) A jurisdictional blending approach

This would require the MNE to apportion its foreign income between different taxing jurisdictions. An MNE would be subject to tax where the tax on the income apportioned to that jurisdiction is below the minimum rate. The MNE's liability for additional tax would be the aggregate of the amounts necessary in each jurisdiction to bring the total amount of tax on the income in the jurisdiction, up to the minimum rate.

One model of such an approach would be to aggregate the income and tax paid by all the members of the MNE group that were tax resident in the same jurisdiction (together with income of, and tax paid by, any branch established in that jurisdiction) in order to calculate the total income arising in that jurisdiction and the taxes on that income. An MNE would be subject to a top-up tax in respect of the income allocated to each jurisdiction where the tax paid on that income was below the minimum rate.

iii) An entity blending approach

This would require the MNE to determine the income and taxes of each entity in the group (as well as the income of domestic entities that was attributable to a foreign branch). An MNE would be subject to tax where the ETR of a foreign entity (or foreign branch) was below the minimum rate.

All three different approaches to blending raise different challenges, as further explained below.

i) Effect of blending on volatility

- A worldwide blending approach does not directly address temporary differences or volatility year-on-year. It simply allows the MNE to smooth over some of the volatility resulting from these timing differences by allowing the offset of profits and losses and allowing surplus tax arising in a high-tax jurisdiction in one reporting period, to be credited against low-tax income arising in another jurisdiction in the same period, but not in future periods.
- The worldwide blending approach will tend to provide more benefits to larger MNEs with significant and diversified operations across a number of low and high-tax environments.

ii) Use of consolidated financial accounting information

- A global blending approach would require the income determined by reference to the consolidated financial statement of the ultimate parent entity as discussed under "use of financial accounts" referred to above, to be separated between the MNE's domestic and foreign operations, whereas a jurisdictional or entity blending approach would require this income to be further broken down to ultimately show a jurisdictional or entity level view.
- The different approaches may have different compliance cost implications.

iii) Allocating income between branch and head office

- Where a group entity is only subject to tax in a jurisdiction on its branch income, it will typically be required, under the laws of that jurisdiction, to prepare accounts for tax purposes showing how much of the entity's income is subject to tax in that jurisdiction.

- The principles that inform this allocation could also be applied to apportion a corresponding amount of income under the GloBE proposal. Once the income has been apportioned it may be necessary to attribute the tax paid in the head office to the branch jurisdiction in line with the CFC crediting mechanism thereby treating the tax paid in the head office in respect of the branch income, as tax paid in the branch jurisdiction.
- The key difference between an entity or jurisdictional approach and a worldwide approach is that in the latter case, branch income allocation would need to be done only for the domestic to foreign context and not also for the foreign-to-foreign context. Thus, these adjustments may be less onerous than those required under the jurisdictional and entity blending approach.

iv) Allocating income of a tax transparent entity

- Each blending approach would need to incorporate a mechanism recognising the impact of fiscal transparency on the taxation of group members.
- Principles similar to that used for apportioning income between the branch and head office could also be used to apportion the income of partnerships and other fiscally transparent entities.

v) Crediting taxes that arise in another jurisdiction

- Worldwide blending could allow the MNE to treat any tax imposed by a foreign jurisdiction on any item of foreign income as "creditable", no matter which jurisdiction imposes the tax or where that income arose.
- In each case, the tax paid on that income could be creditable under the GloBE proposal, whether that tax was paid at the level of the branch, head office or under the CFC rules of an intermediary jurisdiction.
- Under a jurisdictional or entity approach however, the tax paid under a CFC rule in a foreign jurisdiction, for example, is tax paid on income that arises in another jurisdiction. A failure to align the income and tax paid on that income could be seen as understating the effective tax rate for the jurisdiction or entity in which the underlying income arises and overstating the taxes paid, and effective tax rate, on income in the other jurisdiction or entity.
- One way of achieving an alignment could be to treat the tax paid under the CFC rule as paid in the jurisdiction or entity where the income is treated as arising. This credit-transfer mechanism for determining the MNE's tax liability in a given foreign jurisdiction could be applied to any situation where income arising in one jurisdiction or entity is taxed in another jurisdiction.

vi) Treatment of dividends and other distributions

- Dividends and other distributions could be excluded from the determination of income under a jurisdictional or entity approach on the assumption that the underlying earnings of the distributing entity will already have been subject to tax at the minimum rate. Similarly, it may be appropriate to exclude any source country withholding taxes on those dividends from being treated as creditable taxes of the distributing entity's owner under the GloBE proposal. In order to avoid such taxes not being creditable in any jurisdiction, such taxes could, however, be treated as an additional tax on the earnings of the distributing entity.
- Alternatively the dividends could be included in income (together with any withholding taxes on those dividends) in those cases where the dividend is included in income by the payee. There may be further options for the treatment of both intra-group and portfolio dividends based on the way they are treated under local law. These options may include treating the withholding tax as a tax on the payee in line with the legal incidence of taxation.

3. **Carve-outs**
    - The POW calls for the exploration of possible carve-outs as well as thresholds and exclusions to restrict application of the GloBE proposal.
    - A carve-out or exclusion can apply on a qualitative, facts-and-circumstances basis, or on an objective, formulaic basis.
    - Carve-outs and exclusions based on facts and circumstances analysis may generate uncertainty for taxpayers and be more difficult for tax administrations to administer.
    - Carve-outs based on objective criteria are simpler to apply and administer than carve-outs that depend on a facts and circumstances analysis. However, a carve-out based on specific identifiable criteria (such as asset values) may pose additional compliance costs if the taxpayer is required to produce and maintain documentation to prove they qualify for the exclusion.
    - The mechanical, formulaic nature of these types of carve-outs also means that they may be over- or under-inclusive. They may be more easily subject to manipulation and may need to be accompanied by anti-abuse rules, which may be a facts and circumstances test.
    - Thresholds that are based on broad criteria, such as total revenue or profit, may be easier from an administration and compliance perspective than a specific carve-out tied to a particular feature of a particular taxpayer. Thresholds can, however, create volatility for taxpayers who operate near the envelope set by the threshold.
    - The experience of taxpayers in applying carve-outs and thresholds under existing regimes will be instructive in evaluating design options for the GloBE proposal.

Observation

Like Pillar One, the GloBE proposal under Pillar Two represents a substantial change to the international tax architecture. This Pillar seeks to comprehensively address remaining BEPS challenges by ensuring that the profits of internationally operating businesses are subject to a minimum rate of tax. A minimum tax rate on all income reduces the incentive for taxpayers to engage in profit shifting and establishes a floor for tax competition among jurisdictions. In doing so, the GloBE proposal is intended to not only address the remaining BEPS challenges linked to the digitalisation of the economy, but goes even further and addresses these challenges more broadly. The GloBE proposal is expected to stop the harmful race to the bottom on corporate taxes, which risks shifting the burden of taxes onto less mobile bases and may pose a particular risk for developing countries with small economies.

The timeline agreed in the G20 is to develop a **consensus-based solution by the end of 2020**. There are several questions for consultation raised in the report for each aspect of the GloBe tool.

Pillar 2 - Global anti-base erosion mechanism explores the design of a system to ensure that multinational enterprises – in the digital economy and beyond – pay a minimum level of tax. This pillar is intended to provide countries with new tools to protect their tax base from profit shifting to jurisdictions, which tax these profits at below the minimum rate. Pillar 2 should help reduce not only non-taxation but also double taxation of cross border income of MNEs.

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