

Engineering and construction multinational enterprises:

The future of taxation under the OECD's Pillars One and Two

The international tax landscape will change dramatically in the near future. The Organization for Economic Co-operation and Development (OECD) G20 Inclusive Framework (IF) on Base erosion and profit shifting (BEPS), formed by over 135 countries, is currently agreeing on how taxing rights on income generated from cross-border activities in the digital age should be allocated among jurisdictions¹. Measures to be agreed upon by the IF will represent a substantial renovation of key international tax rules, such as the physical nexus concept, which were designed more than a century ago. The new international tax rules will impact most economic sectors, including to a certain extent, engineering and construction multinational enterprises (E&C MNEs), affecting not only highly digitalized businesses.

1. OECD, "Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy", January 29-30, 2020, <https://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf>, accessed June 1, 2020.

New international tax rules under the OECD's Pillars One and Two

The IF grouped the proposals to address the allocation of taxing rights among jurisdictions into two pillars:

• **Pillar One** aims to reallocate taxing rights in favor of the "market country", introducing new tax nexus and profit allocation rules under a three-tier mechanism:

01. A "new taxing right" (Amount A) that allocates a share of the large (EUR€750 million consolidated revenue, approximately USD\$816 million) multinational enterprise's (MNE) residual profit to the "market country" using a formulaic approach. Amount A applies only to in-scope businesses that can participate in a sustained and significant manner in the economic life of a "market country" with or without local physical operations, namely automated digital services (i.e., online search engines, social media platforms, online marketplaces, etc.) and consumer-facing businesses (i.e., the sale of goods and services of a type commonly sold to final consumers).

02. A fixed remuneration based on the Arm's Length Principle (ALP) for baseline distribution and marketing functions that take place in the market jurisdiction (Amount B).

03. Additional profit calculated under the ALP where in-country functions exceed the baseline activity compensated under Amount B (Amount C).

• **Pillar Two** (also referred to as the GloBE proposal) intends to ensure a minimum level of global taxation. The GloBE proposal includes a set of intertwined income inclusion and tax on base-eroding payments rules. The income inclusion rule would act as a top-up tax to an agreed minimum rate calculated as a fixed percentage (pending agreement by the IF).

Impact of the new international tax rules on E&C MNEs

Based on the OECD's economic analysis and impact assessment, the combined effect of Pillars One and Two would lead to a significant increase in global taxation - around USD\$100 billion annually². However, the increase in taxation would not affect all industries equally. In particular, E&C MNEs operating under a traditional model should not be significantly affected by the upcoming new set of international tax rules for a number of reasons:

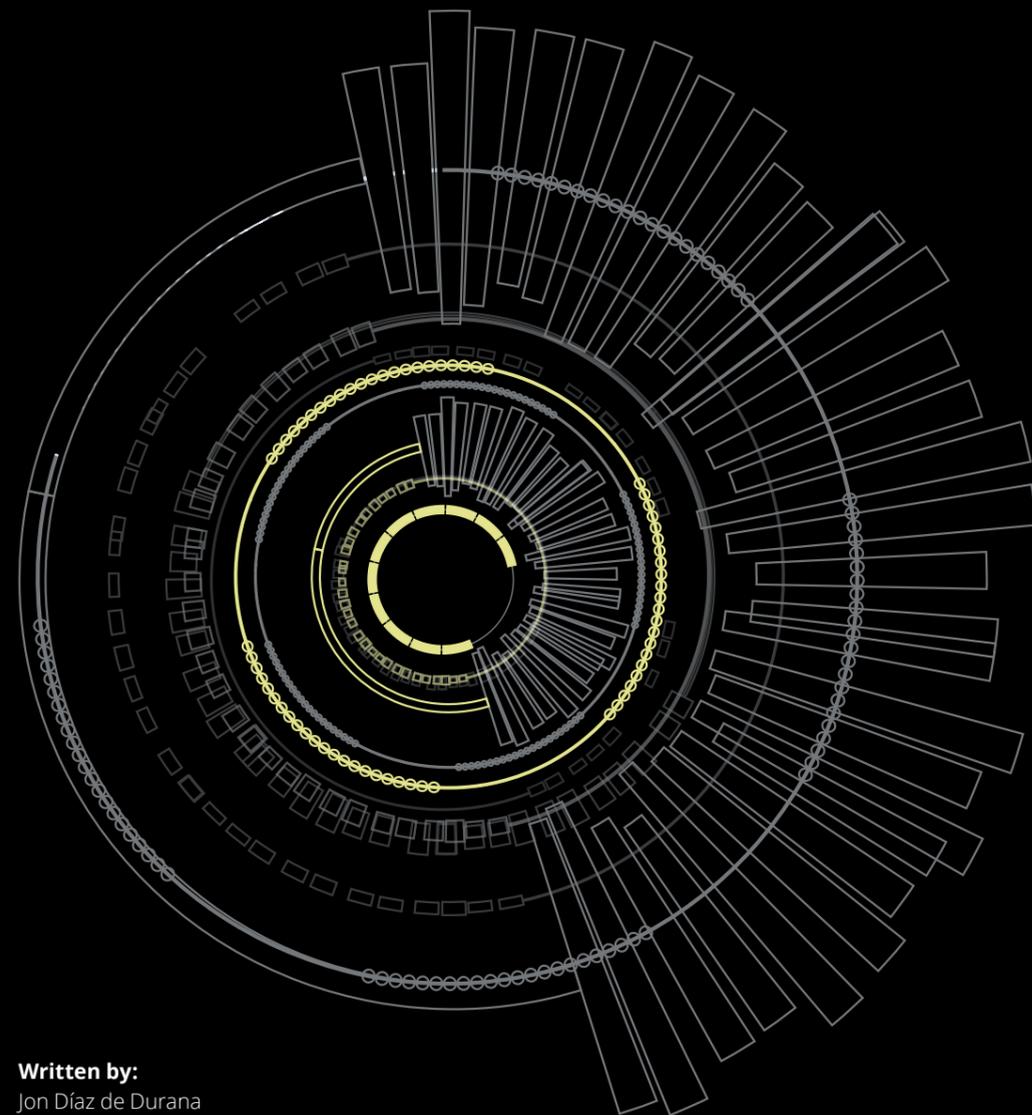
- Traditional E&C MNEs engaged in large infrastructure construction projects may not fall within the scope of Amount A of Pillar One, since they primarily operate under business to business (B2B) models (not consumer-facing) and do not provide automated

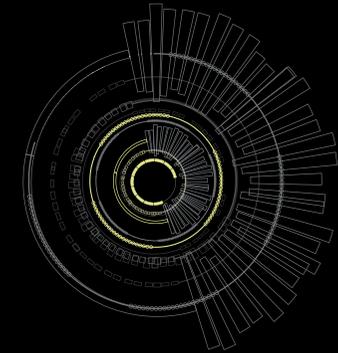
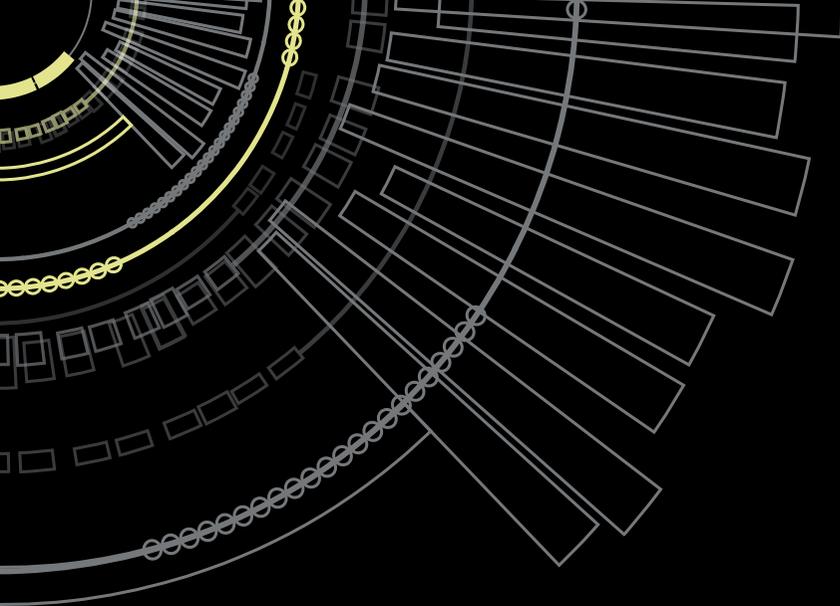
digital services. Even if the E&C activities ultimately qualified for the application of Amount A, which is unlikely, the "new taxing right" applies only to the portion of profit exceeding a certain level of profitability (yet to be determined); E&C profit margins are not high (due to a highly competitive environment, etc.) and therefore, the redistribution of the residual profit to the market jurisdictions, if any, are not expected to be significant. In addition, E&C MNEs have a predominantly physical presence (i.e., construction projects) in the jurisdictions where they generate revenue and, accordingly, are already taxed in these jurisdictions under the existing international tax rules.

- E&C MNEs with headquarters, operating hubs and offshore construction yards located in low corporate tax rate jurisdictions may be affected by the income inclusion rules of the GloBE proposal. However, E&C MNEs are often headquartered and operate in regions with medium-to-high corporate tax rates, such as Latin America, Australia, the US and Canada and, therefore, the impact of this proposal in terms of the global minimum tax should be limited

In any case, digitalization (i.e., 3D printing, advanced robotics, automation, artificial intelligence (AI) and analytics, cloud, Internet of Things (IoT), etc.) is reshaping traditional E&C businesses and the impact of these measures could increase with the introduction of new models; consequently, the changes in international tax rules must be closely monitored by E&C MNEs to accurately determine their future impact.

2. OECD, "Tax Challenges Arising From The Digitalisation Of The Economy, Update On The Economic Analysis & Impact Assessment", February 13, 2020, <https://www.oecd.org/tax/beps/presentation-economic-analysis-impact-assessment-webcast-february-2020.pdf>, accessed June 1, 2020.





How to be prepared for the future of taxation

A case-by-case analysis is required. Anticipating the impact analysis and modelling the different scenarios before the new international tax rules enter into force is critical. Anticipation would allow an E&C MNE to implement measures to mitigate any potential negative impact (double taxation, for instance), in all possible situations (traditional vs. digitalized business models, potential future changes in operating structure, etc.). Adapting the systems to the new tax requirements is also key to correctly and efficiently managing and monitoring new tax filings worldwide.

Latest news

In spite of the coronavirus (COVID-19) emergency, the OECD has announced that teams in charge of Pillars One and Two are working virtually to meet the agreed deadlines, i.e., reaching a political decision on the key components of a multilateral consensus-based solution at the G20/OECD Inclusive Framework on BEPS plenary meeting scheduled for 1-2 July 2020 in Berlin, Germany.

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