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INTERNATIONAL TAX

OECD Inclusive Framework reaches agreement on taxing the digitalized economy and a global minimum rate

Tax Alert

Overview

On October 8, 2021 the OECD/G20 Inclusive Framework (IF) on BEPS issued a statement and an implementation plan agreed by 136 of the 140 members of the IF outlining the political agreement with respect to the two-pillar approach to address the tax challenges of the digitalization of the economy. The two-pillar solution will be delivered to the G20 Finance Ministers meeting in Washington on October 13, then to the G20 Leaders' Summit in Rome at the end of the month.

On October 8, 2021 the OECD/G20 Inclusive Framework on base erosion and profit shifting (BEPS) issued a statement and an implementation plan (together, "the statement") agreed by 136 of the 140 members of the IF outlining the political agreement with respect to the two pillar approach to address the tax challenges of the digitalization of the economy. Pillar One, Amount A, would reallocate profits of the largest and most profitable multinational enterprises (MNEs) to market jurisdictions; Pillar Two would impose a minimum tax on MNEs with gross revenues in excess of EUR 750 million and would require certain jurisdictions to agree to a subject to tax rule (STTR) in their treaties. A preliminary agreement had previously been announced in July. The two-pillar solution will be delivered to the G20 Finance Ministers meeting in Washington on October 13, then to the G20 Leaders' Summit in Rome at the end of the month.

According to the OECD, under Pillar One taxing rights on more than USD 125 billion of profit are expected to be reallocated to market jurisdictions each year, whereas the OECD estimates that Pillar Two will generate approximately USD 150 billion in additional global tax revenues annually.

The statement outlines the agreed components of each of the two pillars, but most noteworthy is the agreement with respect to certain important details. Specifically, the IF has now agreed that (a) 25% of profit in excess of 10% of revenue will be allocated to market jurisdictions for MNEs in scope of Pillar

One, Amount A, (b) the agreed minimum tax rate for Pillar Two's Global anti-Base Erosion (GloBE) rules will be 15%, and (c) the minimum rate for the STTR will be 9%. The implementation plan retains the same ambitious timeline for bringing this into force that the July document set forth: 2023 for both Pillars One and Two, with the exception that the undertaxed payment rule of Pillar Two would come into effect in 2024.

It is noteworthy that three EU member states (Ireland, Hungary, and Estonia) that did not sign on to the July 2021 statement have signed on to this one, perhaps making it easier for the EU to adopt the Pillar Two minimum tax through an EU directive.

Pillar One highlights

Amount A

Scope. Companies within scope of Pillar One, Amount A would be multinational enterprises with global turnover above EUR 20 billion and profitability (i.e., profit before tax/revenue) above 10%, calculated using an averaging mechanism with the turnover threshold to be reduced to EUR 10 billion eight years after the agreement comes into force, contingent on successful implementation, including with respect to tax certainty on Amount A.

Nexus. Amount A would be allocated to a market jurisdiction when the in-scope MNE derives at least EUR 1 million in revenue from that jurisdiction, with a lower threshold of EUR 250,000 for jurisdictions with GDP lower than EUR 40 billion.

Amount A calculation. 25% of profit in excess of 10% of revenue will be allocated to market jurisdictions.

Marketing and distribution safe harbor. Where the residual profits of an in-scope MNE are already taxed in a market jurisdiction, a marketing and distribution profits safe harbor will cap the residual profits allocated to the market jurisdiction through Amount A.

Elimination of double taxation. Double taxation of profit allocated to market jurisdictions will be relieved using either the exemption or credit method. The entity (or entities) that will bear the tax liability will be drawn from those that earn residual profit.

Carve-outs. Extractives and regulated financial services are excluded, although the statement contains no detail as to the scope of these exclusions.

Tax certainty. In-scope MNEs will benefit from mandatory and binding dispute prevention and resolution mechanisms that will avoid double taxation for Amount A, including all issues related to Amount A (transfer pricing and business profits disputes). An elective mechanism will be available for certain developing economies.

Technical details. The statement contains no agreement with respect to technical details, such as revenue sourcing for purposes of determining which markets will receive Amount A, the marketing and distribution safe harbor, the countries that will be relieved of taxing rights in favor of the market countries, or the manner in which tax certainty will be achieved. We cannot assume that technical details that were contained in the October 2020 Blueprint with respect to Pillar One will ultimately be agreed by the IF.

Unilateral measures

The MLC will require all parties to remove all Digital Services Taxes (DSTs) and other relevant similar measures with respect to all companies (not just those within scope of Amount A), and to commit not to introduce such measures in

the future. No newly enacted DSTs or other relevant similar measures will be imposed on any company from October 8, 2021 and until the earlier of December 31, 2023 or the coming into force of the MLC.

Implementation of Amount A and removal of DSTs

Amount A and the removal of DSTs will be implemented through a multilateral convention (MLC). The IF has mandated the Task Force on the Digital Economy (TFDE) to define and clarify the features of Amount A (e.g., elimination of double taxation, marketing and distribution profits safe harbor, revenue sourcing, etc.), develop the MLC and negotiate its content with IF members. The TFDE will seek to conclude the text of the MLC and an accompanying explanatory statement by early 2022, "so that the MLC is open to signature and a high-level signing ceremony can be organized by mid-2022." The TFDE has also been tasked with drafting model rules for domestic legislation necessary to implement Amount A by early 2022. The statement explains that Amount A will come into effect in 2023.

As noted above, the MLC will require all parties to remove all DSTs and other relevant similar measure with respect to all companies (not just those in scope of Amount A) and to commit not to introduce such measures in the future. However, the statement does not define "digital services tax" or specifically provide that the definition will be provided in the MLC. This is perhaps an oversight. The statement notes that a detailed definition of what constitutes relevant similar measures will be finalized as part of the adoption of the MLC and its explanatory statement; one may assume that this will include a definition of a digital services tax.

Amount B

The application of the arm's length principle to in-country baseline marketing and distribution activities will be simplified and streamlined, with a particular focus on the needs of low-capacity countries. The statement explains that this work will be completed by the end of 2022.

Pillar Two highlights

Pillar Two consists of two interlocking domestic rules, an income inclusion rule and an undertaxed payment rule (together the Global anti-Base Erosion (GloBE) rules), as well a treaty-based rule for the benefit of developing countries, the Subject to Tax Rule (STTR).

The GloBE

The income inclusion rule (IIR) imposes a top-up tax on a parent entity in respect of the low-tax income of a constituent entity on a jurisdiction-by-jurisdiction basis. The Undertaxed Payment Rule (UTPR) denies deductions or requires an equivalent adjustment to the extent the low-tax income of a constituent entity is not subject to tax under an IIR.

Scope. The GloBE rules will apply to MNEs that meet the EUR 750 million threshold as determined under BEPS Action 13 (country-by-country reporting). Countries are free to apply the IIR to MNEs headquartered in their country even if they do not meet the threshold. Government entities, international organizations, non-profit organizations, pension funds or investments funds that are Ultimate Parent Entities (UPE) of an MNE group, or any holding vehicles used by such entities, are not subject to the GloBE rules.

The GloBE rules have the status of a "common approach," meaning that countries are not required to adopt the GloBE rules, but if they do so they should adopt them in a manner consistent with the outcomes provided for under Pillar Two, and accept the application of the GloBE rules applied by other

IF members. The practical consequence is that MNEs headquartered in countries that do not adopt the GloBE rules will nonetheless be subject to the UTPR.

Rule design. The UTPR allocates top-up tax from low-tax constituent entities, including those located in the jurisdiction of the ultimate parent entity (UPE). However, the rules will provide for an exclusion from the UTPR for certain MNEs in the initial phase of international activity.

ETR calculation. In order to determine the effective rate of tax in a jurisdiction, the GloBE rules will use a common definition of covered taxes and a tax base determined by reference to financial accounting income with agreed adjustments consistent with the tax policy objectives of Pillar Two and mechanisms to address timing differences. The statement does not identify those mechanisms.

Minimum rate. The minimum tax rate used for purposes of the IIR and the UTPR will be 15%.

GILTI co-existence. US GILTI is not calculated in the same manner as the IIR. For example, under current law GILTI is not determined on a jurisdiction-by-jurisdiction basis. As another example, US tax principles (as opposed to financial accounting rules) apply for purposes of determining the US GILTI tax. If, under Pillar Two, the US GILTI is respected as a compliant IIR, then under the terms of GILTI co-existence, the UTPR would not apply to subsidiaries of US MNEs that are subject to the GILTI regime. The UTPR, however, would continue to apply to low-taxed income in the US (as determined under the GloBE rules). If US GILTI is not amended to apply on a country-by-country basis, it is not clear whether other IF members will agree to GILTI co-existence. There is no political agreement on GILTI co-existence. Rather the statement simply explains that "consideration will be given to the conditions under which the US GILTI regime will co-exist with the GloBE rules, to ensure a level playing field."

Carve-outs. The GloBE will provide for a formulaic substance carve-out similar to the QBAI carve-out in GILTI. Specifically, after a 10-year transition period, GloBE will exclude an amount of income that is 5% of the carrying value of tangible assets and payroll. During a 10-year transition period, the exclusion will be 8% of carrying value of tangible assets and 10% of payroll in the first year, which percentages will decline pursuant to a formula over the 10-year period.

- The GloBE rules also provide for a de minimis exclusion for those jurisdictions where the MNE has revenues of less than EUR 10 million and profits of less than EUR 1 million in a jurisdiction.
- The GloBe rules also provide for an exclusion of international shipping income using the definition of such income under the OECD Model Tax Convention.

Subject to tax rule

The minimum rate for the STTR will be 9%. IF members that apply nominal corporate income tax rates below 9% to interest, royalties and a to-be defined set of other payments would implement the STTR into their bilateral treaties with developing IF members when requested to do so. The taxing right will be limited to the difference between the minimum rate and the tax rate on the payment.

Pillar Two implementation

Unlike Pillar One, it is not currently contemplated that the GloBE will be implemented through a multilateral convention. Rather, model rules that would serve as the basis for domestic legislation will be developed by the end

of November 2021. The statement does not explain when and whether these rules will be made public. An "implementation framework" will be developed by the end of 2022. The implementation framework will cover agreed administrative procedures (e.g., detailed filing obligations and multilateral review processes) and safe harbors to facilitate compliance by MNEs and administration by tax authorities. As part of the development of this framework, IF members will consider the merits and possible content of a multilateral convention to ensure the coordinated and consistent implementation of the GloBE.

A model treaty provision to give effect to the STTR will be developed by the end of November 2021, and a multilateral instrument for the implementation of the STTR will be developed by the IF by mid-2022.

Deloitte observations

The statement represents the culmination of the "political" phase of the Pillar One and Pillar Two projects, and all eyes now turn to implementation. While the statement explains that this work will continue to progress in consultation with stakeholders, it also explains that this will need to occur "[w]ithin the constraints of the timeline set forth in the implementation plan." Taxpayers may be concerned that these constraints leave very little time for meaningful consultation.

The implementation phase requires the completion of a substantial amount of technical work to draft the instruments that will need to be enacted by IF member governments to implement Pillars One and Two. Taxpayers and governments will be keenly interested in how long this important follow-on work will take and whether governments will ultimately deliver on the commitments made in the statement by adopting the relevant provisions in their domestic law and relevant treaties.

Specifically with respect to the US, the statement is not binding on the US Congress. The US Congress is currently considering changes to US GILTI to make it apply on a jurisdiction-by-jurisdiction basis, as advocated by the Biden Administration. Congress is not currently considering changes to US law or treaties that would bring Pillar One into force since the MLC with respect to Pillar One is not scheduled to be drafted until early 2022, which is widely acknowledged as an ambitious and challenging timeline given the amount of technical detail to be agreed. Congressional consideration of the MLC – whether as a treaty subject to a two-thirds vote in the Senate or by some other means – will be an important element in the next chapter of the Pillar One and Pillar Two journey.

Get in touch

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