US International Tax Alert

OECD/G20 Inclusive Framework issues Pillar One and Pillar Two Blueprints for public consultation

Overview

The OECD/G20 Inclusive Framework on BEPS (IF) , which groups 137 countries and jurisdictions for multilateral negotiation of international tax rules, agreed during its October 8-9 meeting that the two-pillar approach they have been developing since 2019 provides a solid foundation for a future agreement.

Participants approved for public consultation a new Blueprint for Pillar One of the project, which would establish new rules on where tax should be paid ("nexus" rules) and a fundamentally new way of sharing taxing rights between countries. According to the IF, the aim is to ensure that digitally intensive or consumer-facing Multinational Enterprises (MNEs) pay taxes where they conduct sustained and significant business, even when they do not have a physical presence, as is currently required under existing tax rules. Participants also approved for public consultation a new Blueprint for Pillar Two of the project, which would introduce a global minimum tax that would, according to the IF, help countries around the world address remaining issues linked to base erosion and profit shifting.

The following documents were released on October 12, 2020:

- *Cover Statement by the Inclusive Framework on the Reports on the Blueprints of Pillar One and Pillar Two*;
- *Addressing the Tax Challenges Arising from the Digitalisation of the Economy HIGHLIGHTS*;

- *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint*;
- *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint*;
- *Tax Challenges Arising from Digitalisation – Economic Impact Assessment*;
- *Public Consultation on the Reports on the Pillar One and Pillar Two Blueprints*; and
- *Tax Challenges Arising from Digitalisation – Top 10 Frequently Asked Questions*.

The documents will serve as the basis for upcoming public consultations, with written comments on the Blueprints due on December 14, 2020, and a virtual public consultation to be held in January 2021.

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The Cover Statement acknowledges that "no agreement has been reached," but asserts that "the Blueprint nevertheless provides a solid foundation for a future agreement that would adhere to the concept of net taxation of income, avoid double taxation and be as simple and administrable as possible." It establishes a new goal of "bringing the process to a successful conclusion by mid-2021," while acknowledging further work "to resolve technical issues, develop model draft legislation, guidelines and international rules and processes as necessary to enable jurisdictions to implement a consensus-based solution." In light of the fact that no agreement has been reached to date, please note that any or all of the detail discussed below could change as the process moves forward.

The Economic Impact Assessment estimates that Pillar One and Two could increase global corporate income tax revenues by approximately USD 47-81 billion annually (between 1.9% and 3.2% of corporate income tax revenues, with the bulk of the gains coming from Pillar Two (USD 42-70 billion)). For both pillars, investment hubs have the most revenues to lose, whereas high, middle, and low-income countries all stand to benefit. Finally, the OECD highlights that a consensus-based solution should only have minimal negative impact on MNE investment activity: less than 0.1% of global GDP in the mid to long term, whereas the lack of consensus could cause global GDP to decrease by more than 1%, especially if unilateral DSTs are broadly implemented.

Pillar One Blueprint

Pillar One sets out a unified approach to addressing nexus and profit allocation challenges arising from digitalization. The most critical features of Pillar One are Amount A, new taxing rights in market jurisdictions that go beyond current permanent establishment and transfer pricing rules; Amount B, setting agreed margins for baseline activities of distributors; and dispute prevention and resolution mechanisms.

While the Blueprint is rich in technical detail, it leaves open most of the difficult political decisions needed to bring this work to fruition. Examples of open issues include:

- The dollar threshold for Amount A. Consideration is being given to the phasing in of the Amount A rules starting with the very largest multinationals to make the new rules manageable for tax administrations and businesses;
- Whether Amount A would first be implemented for automated digital services and later consumer-facing businesses;
- The quantum of profit reallocation for Amount A, including whether there will be more profit reallocated for digital companies or lower dollar thresholds for digital businesses (so-called “digital differentiation”);
- Which aspects of the pharmaceutical industry are in-scope (over-the-counter v. prescription drugs);
- The measure of distributor profit for purposes of Amount B;
- The degree to which any mandatory, binding dispute resolution provisions will apply beyond Amount A; and
- The definition of “relevant unilateral measures” that countries would agree to withdraw as part of an agreement.

Amount A

Scope: Amount A continues to scope in automated digital services (ADS) and consumer-facing businesses (CFB), with the Blueprint providing much more detail around the contours of each.

- For ADS, if an activity is on a positive list of nine activities described in some detail in the text of the Blueprint, it is considered ADS; whereas if it is on a negative list of five activities, it is not considered ADS. If an activity is not on either list, a taxpayer then refers to a general definition to determine whether an MNE or a business segment is in scope. The positive/negative lists and general definition for ADS are listed in the table below:

Positive List	Negative List	General Definition
Online advertising services; sale of user data; online search engines; social media platforms; online intermediation platforms; digital content services; online gaming; standardized online teaching services; and cloud computing services	Customized professional services; customized online teaching services; online sale of goods or services other than automated digital services; revenue from the sale of physical goods; and services providing access to the internet or other electronic network	• Automated, i.e. once the system is set up the provision of the service to a particular user requires minimal human involvement on the part of the service provider; and • Digital, i.e. provided over the Internet or an electronic network

- Consumer-facing businesses are defined as "businesses that generate revenue from the sale of goods and services of a type commonly sold to consumers, including those selling indirectly through intermediaries and by way of franchising and licensing." The Blueprint further clarifies that the good or service would be regularly, repeatedly, or ordinarily supplied to an individual for personal purposes, and that "sold to" includes the sale, lease, license, rent or delivery, whether directly or indirectly.
- Exclusions currently contemplated are certain natural resources; certain financial services; construction, sale and leasing of residential property; and international air and shipping business.
- The Blueprint discusses the factors that might influence a decision to use higher or lower thresholds, provides a chart estimating the number of MNE groups globally above certain thresholds , and suggests, in addition, a carve-out for in-scope businesses with only a minimal amount of foreign in-scope revenue.

Nexus: In-scope MNEs are subject to new nexus rules that are based on indicators of a significant and sustained engagement with market jurisdictions.

- For ADS, exceeding a market revenue threshold could be the only test to establish nexus.
- For CFB, a revenue threshold and a plus factor could be required. The plus factor could be a subsidiary or a traditional PE. It could also be based on an Amount-A-specific PE test to be developed by the Inclusive Framework. Also under consideration, however, is whether revenues in excess of a certain (undecided) dollar threshold would be sufficient to bring a CFB in scope.

- Lower nexus thresholds may be set for small, developing economies.

Revenue sourcing rules: The revenue sourcing rules determine the revenue that should be treated as deriving from a particular market jurisdiction.

- A sourcing principle is identified for each type of in-scope revenue, accompanied by a list of the acceptable indicators an MNE will use to apply the principle and locate the jurisdiction of source.
- MNEs should use the indicator that is first in the hierarchy, but they may use the next indicator down the list if they can justify that the first indicator either was not reasonably available or was unreliable, and so on with the remaining indicators.
- MNEs will be required to maintain documentation explaining the functioning of its internal control framework related to revenue sourcing, as well as detailing why an indicator was used and the results of applying such indicator for each type of revenue.

Tax base determination: The tax base for Amount A will be quantified using an adjusted profit before tax (PBT) measure that will be derived from the consolidated financial accounts of in-scope MNEs.

- Limited book-to-tax adjustments will apply, including: exclusion of income tax expenses, exclusion of dividend income and gains or losses in connection with shares, and expenses not deductible for CIT purposes. Further work will be undertaken to evaluate whether additional book-to-tax adjustments (e.g., profit/loss derived from JVs using the equity method of accounting, interest expenses, gain/loss from exceptional and non-recurring items) need to be made.
- **Segmentation:** The Blueprint sets forth an elaborate framework for the circumstances in which segmentation will be required and/or respected by the tax authorities. It also describes how to allocate expenses across segments if an MNE is not relying on operating segment data used for financial reporting purposes, though it indicates that such scenario will be the exception rather than the norm.
- **Loss carry-forward regime:** Any losses arising from a taxable period would be preserved and carried forward to subsequent years through an earn-out mechanism, pursuant to which no Amount A would be owed until profits exceed prior losses and require the payment to markets of an Amount A. A transitional regime would allow certain pre-regime losses to be preserved and deducted against Amount A. There are also discussions of whether profit shortfalls should also be carried forward to offset years in which profits exceed the profit shortfalls, and the impact of business reorganizations on historical losses. To utilize the loss carry-forward regime, in-scope MNEs may need to compute their Amount A tax base annually, including in periods where they may not foresee significant profits.

Profit reallocation: The formula for determining the quantum of Amount A remains essentially unchanged from prior discussions:

- **Step 1: Profitability threshold:** Determine the residual profit of the group in excess of an agreed profitability threshold (i.e. a percentage of the ratio of profit before tax to revenue).
- **Step 2: Reallocation percentage:** An agreed fixed percentage of the residual profit can be allocated to the market jurisdiction (the remaining residual profits are assumed to be attributable to activities not targeted by the new taxing right).
- **Step 3: Allocate the relevant portion of residual profit to market countries** based on locally sourced in-scope revenues.

The Blueprint introduces two potential safe harbor/exemption mechanisms:

- **Marketing and distribution profits safe harbor:** A company would not owe an Amount A or would owe less Amount A to a market jurisdiction if the residual profit of the MNE is already taxed in that jurisdiction as a result of the application of the existing profit allocation rules.
- **Domestic business exemption:** Profits derived in a market jurisdiction by a unit of business that acts autonomously from the rest of the group (e.g., developing, manufacturing and selling goods all in one jurisdiction) may be exempt from Amount A.

Elimination of double taxation: Amount A is an overlay to the system of allocating profits based on the arm's length principle. The new taxing right and existing profit allocation rules will be reconciled by identifying the relevant jurisdictions where double taxation arising from Amount A should be relieved.

The Amount A liability will be allocated between 'paying entities' in the following steps:

- **Step 1:** A qualitative activities test to identify group entities that make "material and sustained contributions" to a group's residual profits (based largely on existing transfer pricing functional analyses);
- **Step 2:** A quantitative profitability test to ensure that the potential paying entity has the capacity to bear the Amount A tax liability;
- **Step 3:** As a priority, the Amount A tax liability will be allocated to paying entities that have a market connection;
- Step 4: Any remaining Amount A tax liability will be apportioned between other entities in the group (or segment) on a formulaic pro-rata basis.

The Amount A liability allocated to paying entities will be relieved via either exemption or credit to the paying entity.

Administration: The OECD aims to mitigate the compliance burden for Amount A by developing a simplified and centralized compliance framework, including standardized filing requirements, where one entity in the group would be responsible for administration and compliance with Amount A.

Amount B

Amount B aims to standardize the remuneration of related party distributors that perform baseline marketing and distribution activities in a manner that is intended to approximate results determined in accordance with the arm's length principle.

- Unlike Amount A, all companies are potentially in scope for Amount B.
- Distribution and marketing activities would be identified as in-scope based on a narrow scope of baseline activities, set by reference to a defined positive list and negative list of functions, risks, and assets that should and should not be performed/assumed/employed to be considered as in-scope. Quantitative indicators would then be applied to further support and validate the identification of in-scope distributors.
- Baseline returns could vary by industry and geographic region based on transactional net margin method benchmarking.
- A new addition to previous discussion is that an entity can rebut the application of Amount B by providing evidence that another transfer pricing method would be most appropriate to use under the arm's length principle (for example, a sufficiently reliable comparable uncontrolled price).
- Amount B would not supersede previously agreed advanced pricing agreements (APAs) or MAP settlements.
- While commissionaires, sales agents, and sales and marketing service providers that do not distribute product are not currently considered, further work is being conducted to see whether they could be brought into scope and whether any functional intensity adjustments are required.
- Some IF members expressed an interest to see Amount B first delivered in a pilot program.
- Some IF members would like to broaden Amount B beyond the identified baseline activities.

Tax certainty

The Blueprint breaks down the tax certainty dimension of Pillar One into two distinct segments: dispute prevention and resolution for Amount A, and dispute prevention and resolution beyond Amount A.

For Amount A:

- A standardized Amount A self-assessment covering all elements of the Amount A determination will be submitted generally to the parent entity's home country, which will then be shared with other countries where the relevant market and paying entities are located.
- There will be a dispute prevention process to provide MNEs early certainty of their compliance with Amount A before tax adjustments are made. In this process, multi-country panels would carry on a review function, which, if necessary, could be supplemented by a determination panel in the case of stalemate in the review panel. The outcome of this process is binding on the MNE and tax administrations in all jurisdictions if accepted by the MNE.
- If an MNE does not elect into this process, and disputes arise, an MNE group may seek to address this through domestic processes or may seek to rely on mutual agreement procedure (MAP) if available. However, the Blueprint notes, given the likely complexity of a MAP involving potentially all jurisdictions where an MNE group has constituent entities or a market, it may be preferable from a tax administration perspective to rely on a panel process.

The Blueprint calls for mandatory dispute resolution for determining whether a taxpayer falls within the definition of baseline marketing and distribution activities with respect to Amount B. However, the Blueprint notes that this would only be available as a last resort and after exhausting all other dispute prevention and resolution tools.

Inclusive Framework members are of differing views on the scope of application of a new mandatory and binding dispute resolution beyond Amount A. Nonetheless, new mechanisms are contemplated to become part of the MAP process even if not mandatory or binding.

Implementation and administration

- The implementation of Pillar One will require action across three different dimensions: (i) domestic law, (ii) public international law, and (iii) guidance to supplement (i) and (ii).
- A new multilateral convention is contemplated that would remove existing barriers in tax treaties to the application of Amount A, and it would set forth the new simplified administration process and the processes for dispute prevention and resolution with respect to Amount A.
- It is expected that any consensus-based agreement must include a commitment by members of the Inclusive Framework to implement the agreement and at the same time to withdraw "relevant" unilateral actions (still undefined) and not adopt such unilateral actions in the future.

Pillar Two Blueprint

The Pillar Two project is intended to address BEPS-type challenges and ensure that multinational enterprises pay a minimum amount of tax with respect to their global profits. The “GloBE” rules contemplated by the Pillar Two Blueprint adopt a two-pronged approach to accomplish this minimum level of taxation.

Key components

A primary Income Inclusion Rule (IIR) that functions as a top-up tax to the extent the covered taxes with respect to income of an MNE in a jurisdiction do not meet a certain threshold.

The IIR is supported by two treaty-based rules:

1. A subject-to-tax rule (STTR) that imposes source-based taxation on certain payments to the extent the nominal rate imposed on those payments in the recipient jurisdiction does not meet the threshold level; and
2. A switch-over rule (SOR) that removes treaty-based restrictions on taxes imposed on a permanent establishment.

The IIR is backed up by an Undertaxed Payment Rule (UTPR) that applies where income is not subject to an IIR.

Other important highlights

- Both the IIR and the UTPR utilize the same tax base and definition of “covered taxes” in determining whether income has been subject to the minimum amount of tax.
- The income base used by the GloBE rules is determined using financial accounting standards with limited adjustments.
- Similarly, the rules use the accounting definition of a consolidated group with certain limited adjustments.

The Pillar Two Blueprint describes in detail the technical aspects currently under consideration in developing the GloBE rules. Set forth below are important highlights from each of the chapters.

Chapter 1 – Executive Summary

The Pillar Two Blueprint for the first time addresses the interaction of the proposed GloBE rules with the US GILTI regime but this issue remains subject to future political developments.

- GILTI may be treated as a qualified income inclusion rule under the GloBE rules ("GILTI Grandfather"), subject to reconsideration if changes in US law or regulations materially narrow the GILTI base or reduce the effective rate of tax.
- Inclusion of the GILTI Grandfather must be part of the political agreement on Pillar Two.
- Technical aspects of interaction between GILTI and GloBE rules are yet to be determined. The Inclusive Framework also encourages the United States to limit the application of BEAT where payments are made to entities subject to the IIR.

Chapter 2 – Scope of the GloBE rules

Identifying constituent entities of the MNE group: In line with the requirements for country-by-country reporting (CbCR), an MNE group will generally consist of those enterprises that are required to consolidate their accounts with those of the ultimate parent entity (UPE).

A constituent entity consists of a separate business unit that is (or would have been) included in the consolidated financial statements of the MNE Group.

Excluded entities: The GloBE rules are not intended to apply to certain ultimate parent entities such as investment and pension funds, governmental entities such as sovereign wealth funds, and international and non-profit bodies, which typically benefit from an exclusion or an exemption from tax under the laws of the jurisdiction where they are incorporated.

A carveout for international shipping is also under consideration.

Consolidated revenue threshold: As with CbCR, the application of the GloBE rules is confined to MNE groups that have total consolidated revenue above EUR 750 million or equivalent in the immediately preceding fiscal year.

Chapter 3 – Calculating the top-up tax under the GloBE rules

Basics of the top-up tax: A central feature of the Pillar Two proposal is a top-up tax at the level of the UPE.

- The IIR applies by determining the ETR on a jurisdictional basis.
- The top-up tax in the UPE jurisdiction will apply if the ETR of a constituent entity in a jurisdiction is less than a rate to be determined (perhaps 12.5%).
- The ETR is the amount of "covered taxes" divided by the amount of income in the jurisdiction determined under special GloBE rules.

- The top-up tax owed by the UPE is the difference between the ETR in a jurisdiction and the agreed minimum rate and is determined without reference to any other tax attributes of the UPE (losses, etc.).
    - Since the top-up tax is the difference between the ETR in the local jurisdiction and the GloBE minimum tax, no foreign tax credits are needed to offset this tax at the UPE level.

Allocation of income and taxes: Income of PEs and constituent entities with tax jurisdiction of residence are assigned to PE location or entity residence. Income of flow-through entities with no tax residence (stateless entities) are assigned to their owner if transparent to owner or assigned to "stateless" category otherwise.

Covered taxes follow related income (assigned to same jurisdiction).

Covered taxes: "Covered taxes" means any tax on an entity's income or profits (including a tax on distributed profits), and includes any taxes imposed in lieu of a generally applicable income tax. Covered taxes also include taxes on retained earnings and corporate equity.

- **CFC taxes** are considered covered taxes in the jurisdiction in which the relevant income is earned.
- Digital services taxes (DSTs) are not considered "income" or "in lieu of" taxes for this purpose and so likely *will not be considered covered taxes*.

Tax base: The starting point for determining the GloBE tax base is the profit (or loss) before income tax as determined using the relevant financial accounting standard (typically that of the UPE). Certain items of income are removed and certain items of expense are added back to arrive at the GloBE tax base.

- Entity-level financial information that is used in preparing the parent's consolidated financial accounts can be used, even if such financial information is not prepared in strict accordance with the parent's financial accounting standard where (a) it is reasonable to do so, (b) the information is reliable, and (c) the use of such information does not result in material permanent differences from the accounting standard of the parent.
- Special rules are described for the treatment of a series of situations that will, in effect, require entities subject to the GloBE to keep an entirely separate set of "books." Adjustments to the financial accounting rules include (among others) intercompany items (including those within the same jurisdiction), dividends and dispositions of stock, stock-based compensation, covered taxes, and adjustments for Pillar One outcomes.

Accelerated depreciation and immediate expensing: Accelerated depreciation can have the effect of making the ETR in a jurisdiction fall below the minimum GloBE threshold. A deferred tax accounting rule or utilization of tax depreciation schedules in determining the tax base may be adopted to avoid this result.

Chapter 4 – Carry-forwards and carve-outs

Mechanisms to address temporary book differences: Rather than relying on deferred tax assets and liabilities as determined for book purposes (with the possible exception noted above with respect to accelerated depreciation and immediate expensing), the GloBE opts for a series of loss carry-forwards and credits, and special rules for the treatment of depreciation.

Loss carry-forward: Losses in a jurisdiction (including some pre-regime losses) may be carried forward indefinitely and allowed as a deduction in the computation of the GloBE tax base in the subsequent year, thereby reducing the GloBE tax base in that year or increasing the loss carry-forward arising in that year. A loss carry-forward is only used to reduce the GloBE tax base if the entity in that jurisdiction has an ETR below the minimum tax rate determined without regard to the loss carry-forward.

Losses are defined as the excess of expenses over income included in the GloBE tax base of the jurisdiction.

Excess taxes carry-forward: Excess taxes in a jurisdiction for a year may create an IIR tax credit, a local tax carry-forward, or both.

- Excess taxes are defined as the amount of covered taxes due and payable in the tax returns of constituent entities for the year in excess of the minimum GloBE tax.
- Ordering rules for excess taxes:
    - Excess taxes in a jurisdiction create an IIR credit to the extent the UPE paid an IIR tax with respect to that jurisdiction in previous years (which tax has not already given rise to an IIR credit). The IIR credit can be used to reduce the UPE's IIR tax liability for *any jurisdiction* in the year the IIR credit arose or any subsequent year.
    - Excess taxes that do not create an IIR credit under the prior rule are carried forward and treated as a tax expense for that jurisdiction in a subsequent year in which the local ETR falls below the minimum GloBE rate.

Substance-based carve-outs: The GloBE rules reduce the taxable income base for a jurisdiction by an amount equal to a *percentage of payroll* and a *percentage of tangible assets* located within the jurisdiction.

Computation of ETR and top-up Tax

- ETR for a jurisdiction = adjusted covered taxes/adjusted GloBE income
- Top-up tax for an entity = adjusted GloBE income of the entity x (GloBE minimum ETR – actual ETR)

Chapter 5 – Simplification options

The Blueprint identifies several simplification options:

1. CbC Report ETR safe harbor,
2. *De minimis* profit exclusion,
3. Single jurisdictional ETR calculation to cover several years, and
4. Tax administrative guidance.

Chapter 6 – Income inclusion and switch-over rules

Overview: The IIR applies at the level of the parent jurisdiction and levies top-up tax on the low-tax income of those foreign constituent entities that are directly or indirectly controlled by the parent entity.

Income inclusion rule: A UPE that owns (directly or indirectly) an equity interest in a foreign low-taxed constituent entity at the end of a reporting period shall be subject to a top-up tax under the IIR in respect of its proportionate share of the income of that constituent entity for that period.

Switch-over rule: This rule would effectively allow the IIR to apply to a PE of a constituent entity as if the PE were a separate corporation, notwithstanding any applicable treaties.

Chapter 7 – Undertaxed payment rule

Undertaxed payment rule (UTPR): The IIR is the primary rule, backstopped by UTPR. The UTPR allocates the top-up tax amount between constituent entities in situations where the owner of the constituent entity is not subject to the IIR, either at the ultimate or intermediate parent level. For this reason, the IF expects the UTPR to apply only in limited circumstances.

- **No overlap** between the IIR and UTPR within groups where the IIR is applied at the intermediate level; binary application of one rule or the other.
- **Application to the UPE jurisdiction:** Profits earned in the UPE jurisdiction will not be subject to the IIR because income in that jurisdiction is outside the scope of the IIR. As a result, income earned in the UPE jurisdiction could be subject to the UTPR in subsidiary jurisdictions if the UPE income is taxed below the minimum ETR.

Mechanics: The UTPR utilizes the same general principles of the IIR, including the determination of "covered taxes" and carve-outs and other exemptions. The UTPR also calculates the top-up tax in the same way as the IIR; however, the top-up tax amount is allocated among constituent entities that are subject to the UTPR using a *two-step allocation method*:

- For UTPR entities that make deductible payments to the low-tax entity, the top-up tax is allocated under the following formula:
    - Payments made by the UTPR entity to the low-tax entity / All intragroup payments from UTPR entities to the low-tax entity
- For any remaining unallocated top-up tax, the remainder is allocated among UTPR entities that have net intragroup expenditure under the following formula:
    - Net intragroup expenditure of UTPR entity divided by total related party expenditure of all UTPR entities.
    - For these purposes, only payments/expenditures made by UTPR entities and who are not low-taxed are taken into account.
    - Definition of intragroup payments and expenditures: The definition of "payment" is intended to be broad and includes all current expenditures and receipts, as well as inventory costs.
        - Payments that generally are not deductible in a given jurisdiction are disregarded.
        - Deductions that are limited under specific rules or anti-abuse provisions (e.g. anti-hybrid rules, interest limitations) are still taken into account.
- Caps on top-up tax allocation: The sum of the top-up tax allocated under the UTPR among constituent entities will not exceed the total amount of the top-up tax. The draft provides several formulas for imposing a cap on amounts allocated under the UTPR to achieve this result.

Implementation: The draft does not address how the amount of the UTPR adjustment allocated to a constituent entity is to be taken into account under local law, deferring instead to each jurisdiction that adopts the UTPR regime to implement its own mechanism for doing so.

Chapter 8 – Special rules for associates, JVs, and orphan entities

This section provides rules for special entities. The first rule applies a simplified IIR to the income of an MNE group attributable to ownership interests in entities or arrangements that are reported under the equity method but excluded from the GloBE tax base as a permanent difference. The second rule extends the application of the UTPR to "orphan" entities.

Chapter 9 – Subject-to-tax rule

- The STTR is a treaty-based rule that applies at the source country where payments are not subject to a sufficient nominal tax rate at the payee. The STTR is a standalone rule that applies on a payment-by-payment basis to payments between connected persons (based on definition in OECD and UN Model Treaties).
- The STTR applies to specific categories of payments that present the greatest risk of base-stripping, such as interest, royalties, and "high-risk" service payments.
- Excluded entities are consistent with IIR/UTPR scope.
- Consideration is given for various materiality thresholds, based on:
    - Total amount of "covered payments" for the year
    - Size/revenue of MNE (may not be the same as for IIR/UTPR)
    - Ratio of covered payments made to connected person in other jurisdictions
- *The top-up approach* imposes additional withholding tax to bring adjusted *nominal rate* to the minimum level set under the STTR.

Chapter 10 – Implementation and rule coordination

Ordering: The STTR applies before the IIR/UTPR, and the tax imposed on a payment under the STTR is allocated to the associated income for purposes of determining the ETR on that income for IIR/UTPR purposes.

- The IIR then applies, with the UTPR serving as the final backstop.
- The IIR applies using a "top-down" approach, beginning at the UPE and moving down the chain of ownership. In split ownership structures, the IIR applies at the partially owned "intermediate parent."

Implementation: The IIR and UTPR are expected to be enacted under each jurisdiction's domestic law, and specific details will be laid out there. However, the STTR and switch-over rule require changes to bilateral tax treaties in order to implement.

- The IIR and UTPR are not expected to violate existing treaties (such as non-discrimination provisions), and no treaty changes are anticipated for these rules to apply.
- Model legislation and treaty language may be released in the future.

Dispute resolution: Because the IIR is applied at the ultimate parent level, it is not anticipated that there will be significant disputes between taxing jurisdictions. The UTPR is not expected to apply often, and so the opportunities for disputes there are also limited; however, in the event that disputes arise, they could be resolved through:

- Convention on Mutual Administrative Assistance in Tax Matters;
- New multilateral conventions for GloBE matters; and/or
- Engagement in simultaneous tax examinations.

Because the STTR and SOR will need to be added to existing treaties, it is expected that those treaties' current dispute resolution mechanisms will apply.

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