



# Inclusive Framework BEPS Agreement

## Initial resp-level agreement on Pillar 1 and Pillar 2

Policy Perspectives update – New Zealand country view



## KPMG Global Release: OECD/G20 Inclusive Framework Agreement on BEPS 2.0

On 1 July 2021, in an historic agreement, 130 countries approved a statement providing a framework for reform of the international tax rules. These countries are members of the OECD/G20 Inclusive Framework on BEPS (“IF”), comprising 139 countries. The statement sets forth the key terms for an agreement of a two-pillar approach to reforms and calls for a comprehensive agreement by the October 2021 G20 Finance Ministers and Central Bank Governors meeting, with changes coming into effect in 2023. Pillar One of the agreement is a significant departure from the standard international tax rules of the last 100 years, which largely require a physical presence in a country before that country has a right to tax. Pillar Two secures an unprecedented agreement on a global minimum level of taxation which has the effect of stipulating a floor for tax competition amongst jurisdictions.

The five-page statement reflects high-level agreement on key political questions and design features of Pillars One and Two following a two-day meeting of the IF. Of the 139 members of the IF, 130 had signed onto the statement as of its release. IF members that have not joined in the statement are: Barbados, Estonia, Hungary, Ireland, Kenya, Nigeria, Peru, St. Vincent and the Grenadines, and Sri Lanka. Several of these members (including Ireland and Hungary) had expressed concerns in the weeks leading up to the IF meeting.

The statement diverges in important respects from the Pillar One and Pillar Two Blueprints, released by the IF in October 2020. However, in a number of respects the statement builds on the Blueprints and resolves some of the key open items from the Blueprints. For prior coverage of the Blueprints, refer to our reports for Pillar One and Pillar Two.

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## Pillar 1:

### Reallocation of profits for large companies to market countries

Pillar One's Amount A would provide a new taxing right to market jurisdictions, allocating a portion of residual profit based on a formulary approach. The statement reflects important developments with respect to the scope and computation of Amount A. The statement reaffirms that Amount B is intended to streamline the application of the arm's length standard to routine marketing and distribution activities, but does not substantively address Amount B, which is on a separate track for completion.

#### Scope

According to the statement, Pillar One will apply to multinational groups that have more than EUR 20 billion of global turnover and profitability above 10 percent (measured as profits before tax divided by revenue on a book basis). This threshold would be reduced to EUR 10 billion 7 years after Pillar One enters into force contingent on successful implementation.

**KPMG Observation:** The agreed scope is a dramatic departure from the Pillar One Blueprint, which had focused on businesses engaged in "automated digital services" and "consumer facing businesses." Based on the defined scope, it appears that Amount A is likely to initially apply to approximately 100 companies.

The statement provides that segmentation would only be required in exceptional circumstances in which, based on the segments disclosed in the financial accounts, a segment meets the scope thresholds.

**KPMG Observation:** Based on the language in the statement, segmentation would apply if a multinational enterprise ("MNE") did not meet the profitability threshold on a consolidated basis, and a segment of that MNE (as reported for financial statement purposes) exceeded both the turnover and profitability thresholds. It is not clear whether segmentation would also apply if an MNE did meet the profitability threshold on an overall basis and also had one or more disclosed segments that meet the thresholds.

The statement provides that extractives and regulated financial services will be excluded from Amount A.

**KPMG Observation:** It is unclear whether the scope of the exclusions for extractives and regulated financial services will be the same as that described in the Pillar One Blueprint.

#### Calculation of New Taxing Right

The statement provides that for in-scope MNEs, between 20 and 30 percent of residual profit (defined as profit in excess of 10 percent of revenue) will be allocated to market jurisdictions with nexus using a revenue-based allocation key.

**KPMG Observation:** The statement's allocation of "between 20-30%" of residual profit differs from the "at least 20%" language from the G7 Finance Ministers and Central Bank Governors Communique by capping Amount A to 30 percent.

As described in the statement, nexus for Amount A will be based solely on an MNE's sales in a market jurisdiction. For this purpose, a bifurcated threshold applies. For most jurisdictions, nexus will only exist if the in-scope MNE derives at least EUR 1 million in revenue from the jurisdiction. For smaller jurisdictions with gross domestic product ("GDP") less than EUR 40 billion, the nexus threshold is reduced to EUR 250,000 in revenue. The statement notes that compliance costs, such as those associated with tracing small amounts of sales, will be "limited to a minimum."

**KPMG Observation:** The lower threshold for small jurisdictions would only cover a small portion of overall economic activity. Based on data from the World Bank, it appears that jurisdictions that fall below the EUR 40 billion GDP threshold comprise less than 2% of total global GDP.

## Tax Certainty

The statement commits to making mandatory binding dispute prevention and resolution mechanisms available for in-scope MNEs. These mechanisms would cover all issues related to Amount A, including transfer pricing and business profits (e.g., permanent establishment) disputes. While the dispute prevention and resolution mechanisms would generally be mandatory, the statement notes that consideration will be given to making them elective for certain developing countries (i.e., those that have few or no mutual agreement procedure cases and are eligible for deferral of their BEPS Action 14 peer reviews).

## Implementation and Unilateral Measures

The statement provides that Amount A will be implemented through a multilateral instrument, which will be opened for signature in 2022. Amount A is anticipated to take effect beginning in 2023. The final agreement on Amount A will provide for the removal of all digital service taxes and “other relevant similar measures” for “all companies.”

**KPMG Observation:** The language of the statement suggests that digital service taxes and other unilateral measures will be eliminated for all companies, not just for MNEs within the scope of Amount A. The statement does not provide detail on how relevant measures will be identified, or on the timing for their removal.

## New Zealand considerations for Pillar 1

### Inbound sales – “Amount A”

The expected 100 MNEs subject to the Amount A calculation are unlikely to raise significant amounts of tax for New Zealand. New Zealand is a small proportion of the global consumer market, so New Zealand’s share of “excess profits” to be taxed is likely to be small.

The justification for implementing Pillar 1 will therefore be a “common good” / “global citizenship” argument used for previous international tax changes. The hope/expectation is that the tax effects will become less of a driver for the way that business is done in New Zealand.

### Impact on New Zealand MNEs

New Zealand MNEs are unlikely to be affected by Amount A, at least in the first seven years of operation until the global turnover threshold is lowered. As noted, there is very little announced progress on Amount B. The final design of Amount B should remain a key focus for New Zealand MNEs.

### Taxpayer certainty

For the agreement to be worthwhile, and to ensure that trade is facilitated, a clear set of rules which are applied by all is necessary. Although progress has been made on how Amount A disputes will be resolved and enforced between Revenue Authorities, it is unclear whether these broader rules will also apply to Amount B and other international tax issues. This should also be a key area of focus for New Zealand MNEs.

## Pillar 2:

### Global Minimum Tax

#### Overall design

The statement describes Pillar Two as:

- two interlocking domestic rules (Global anti-Base Erosion (GloBE) Rules): (i) an Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity in respect of low taxed income of constituent entities within an MNE group, and (ii) a supporting Undertaxed Payment Rule (UTPR) which denies tax 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; and
- a treaty-based Subject to Tax Rule (STTR), which allows limited source taxation at a rate of 7.5% to 9% on interest, royalties, and certain other related party payments that are subject to tax below a minimum rate. Any tax paid under the STTR is creditable under the GloBE Rules.

The statement notes that the IIR and UTPR 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. Special ETR calculation rules are provided for jurisdictions with distribution tax systems.

**KPMG Observation:** The language included in the statement makes no reference to the specific approach for managing timing difference. While the Pillar Two Blueprint contained a detailed carry-forward approach, the statement seems to leave open the possibility of alternative approaches, such as deferred tax accounting.

The statement notes that the IIR allocates top-up tax based on a top-down approach in which the application of the IIR by the jurisdiction at or near the top of the ownership chain of the MNE group takes priority, subject to a split-ownership rule for shareholdings below 80%. It further states that the UTPR allocates top-up tax from low-tax constituent entities including those located in the UPE jurisdiction under a methodology to be agreed.

**KPMG Observation:** Significantly, the UTPR design in the Pillar Two Blueprint had a special capping mechanism that limited the application of the UTPR to the UPE. The language in the IF statement - "including those located in the UPE jurisdiction" - seems to call into question whether such a cap is still being contemplated.

The statement describes the GloBE Rules as a "common approach," meaning that IF member jurisdictions are not required to adopt the GloBE rules, but must accept their application by other IF members (including the specified rule order and the application of any agreed safe harbors). IF members that adopt the GloBE rules would agree to implement and administer the rules consistently with the agreement reached on Pillar Two.

**KPMG Observation:** While the GloBE rules are presented as a common approach, the statement provides that IF members applying nominal rates below the STTR rate to covered payments would agree to incorporate the STTR into their bilateral treaties with developing IF members when requested to do so, indicating that the STTR would be more akin to a minimum standard.

#### Scope

The statement provides that the GloBE rules will apply to MNEs with revenues exceeding the €750m threshold as determined under BEPS Action 13 (country by country reporting). Countries are, however, noted to be free to apply the IIR to MNEs headquartered in their countries whose revenue fall below this threshold.

Exclusions are provided from the GloBE rules for government entities, international organisations, non-profit organisations, pension funds or investment funds that are ultimate parent entities (UPE) of an MNE group or any holding vehicles used by such entities, organisations or funds.

**KPMG Observation:** Under this approach, the UTPR would still be limited in application to MNEs above the €750m revenue threshold. While not explicit, it appears that the threshold would still apply to the application of the IIR to MNE subgroups (i.e. where a jurisdiction other than the residence of the UPE applies the IIR).

International shipping income is also excluded from the GloBE rules using the definition of such income under the OECD Model Tax Convention.

In addition, while not directly positioned as an “exclusion”, the statement notes that the IF is exploring excluding MNEs in the initial phase of their international activity.

### Minimum tax rate

The statement provides for a minimum tax rate of at least 15% for purposes of the GloBE Rules.

**KPMG Observation:** The failure to indicate a specific rate indicates that further negotiation of the rate will be required.

### Carve-out

A formulaic substance carve-out is provided that would exclude an amount of income from the GloBE rules, determined as a mark-up on the carrying value of tangible assets and payroll. The mark-ups would be at least 7.5% for the first 5 years in which the rules are in effect and at least 5% after that.

The IF statement also provides for a de minimis exclusion.

**KPMG Observation:** The statement explicitly links the discussion of the minimum tax rate to the availability of carveouts. While the statement does not indicate an intent to apply favorable rules with respect to existing tax incentives, the carve outs, the possible exclusion for MNEs starting to expand overseas, and the deferred implementation of the UTPR may combine to preserve the value of some incentives otherwise impacted by Pillar Two.

### Implementation

The statement provides that the Pillar Two rules are anticipated to be brought into law in IF member jurisdictions in 2022, and made effective beginning in 2023.

It is noted that IF member jurisdictions will finalise remaining issues and release a detailed implementation plan by October 2021. The implementation plan will include (i) GloBE model rules with proper mechanism to facilitate over time the coordination of the GloBE rules that have been implemented by IF members, including the possible development of a multilateral instrument, (ii) an STTR model provision together with a multilateral instrument to facilitate its adoption, and (iii) transitional rules, including the possibility of a deferred implementation of the UTPR.

**KPMG Observation:** A 2023 effective date for the Pillar Two rules seems to assume prompt resolution of all remaining open issues, and swift implementation. It seems particularly challenging for the STTR to be effective by 2023 since its widespread adoption would require a multilateral instrument.

### Open issues

While the statement represents very significant progress, many key political and technical issues remain open, including:

#### **GloBE rules:**

- The precise minimum rate to be applied
- Mechanism for managing timing differences for the ETR calculation
- Precise mark-up percentages on the carrying value of tangible assets and payroll
- Design of the “de minimis exclusion” carve-out
- Design of exclusion for MNEs in the “the initial phase of their international activity”
- Design of elements to ensure “limited impact on MNEs carrying out real economic activities with substance”
- Transitional related issues including the treatment of pre-existing losses
- Design of the UTPR generally
- The scope of simplification measures, including “safe harbors and/or other mechanisms”

#### **STTR:**

- Precise minimum rate
- Scope of “other payments”
- Rules for determining the tax rate on specific payments

## New Zealand considerations for Pillar 2

Pillar 2 is likely to raise the more complex issues for New Zealand MNEs and foreign MNEs operating in New Zealand.

Although New Zealand MNEs are not expected to be subject to Pillar 2 in countries in which they operate because the New Zealand corporate tax rate is above the likely minimum, New Zealand MNEs may need to be in a position to show an overseas revenue authority that is the case.

Pillar 2 is likely to affect foreign MNEs more as there will be a variety of regimes and tax rates applying in the countries they operate in.

From a New Zealand perspective, based on our experience with the design and implementation of the anti-hybrid mismatch tax rules, the key issues are:

- Ignoring tax timing differences except at the extreme. The hybrid mismatch tax rules require consideration not only of the current tax treatment but also the future treatment. If taxation occurs too far in the future, deductions are denied. A simple determination of foreign countries' tax rules, without having to consider the timing element, will make Pillar 2 easier to apply.
- The interaction of the UTPR and STTR is unclear. It appears, as with the hybrid mismatch tax rules, that a New Zealand deduction can be denied for an item while higher rates of New Zealand withholding tax can still apply to the same amount. This double taxes the item.

For completeness:

- Interest appears to be included in the Pillar 2 rules. This raises the question of the status of Approved Issuer Levy ("AIL"). In principle, interest subject to AIL should not be included as AIL only applies if interest is paid to a non-associated non-resident lender.
- Dividends should not be included as they do not give a deduction to the New Zealand payer.
- Pillar 2 envisages that removal of all unilateral measures, such as Digital Services Taxes, will accompany implementation. This may also act to deter countries introducing new unilateral measures in the interim.

## Implementation & Timelines

### Timeline

Agreement	Adoption into Law	Implementation	Review
<p><b>1 July 2021</b> – Agreement by 130 countries in the IF to a new international tax framework</p> <p><b>October 2021</b> – Detailed implementation plan for both pillars and resolution of remaining issues including the detailed mechanics for the operation of both pillars.</p> <p><b>2022</b> – Additional details on Amount B in Pillar One</p>	<p><b>2022</b> – A multilateral instrument (that will have to be ratified domestically) is contemplated for Pillar One and the STTR rule in Pillar Two. Other components might need to be adopted through domestic legislation.</p>	<p><b>2023</b> – Effective date for implementation for both Pillar One and Pillar Two (with a possible deferred implantation of the UTPR)</p>	<p><b>c. 2030</b> – Review of Pillar One including potential reduction of the scope threshold from EUR 20 billion to EUR 10 billion</p>

### New Zealand considerations on timelines

The proposed timeline seems to us to be ambitious, if not aspirational. It envisages that much of the detailed design can be concluded in calendar 2021 to facilitate implementation into law (domestically and/or in New Zealand tax treaties) by 2022, for application in 2023. As noted above, significant gaps remain (particularly with regards to the implementation and design of Pillar 2). This will make the timelines challenging.

Further, our experience with the BEPS 1.0 process suggests that high-level agreement may not always translate to detailed commitments and actions, particularly once domestic considerations are overlaid. Even if New Zealand is ready, many others will not be.

From a New Zealand Generic Tax Policy (Development) Process perspective, this means a very much truncated process will be required. An implementing Tax Bill would likely need to be introduced by March 2022 so there is legislation by December 2022. With design details not finalised until October, any New Zealand specific consultation is likely to be short. This means that the final OECD design will, practically, be the basis of consultation in a small window prior to Christmas 2021.

## What tax leaders can do

The framework for reforms agreed by the 130 members of the IF will have a wide reaching effect on many MNEs. Given the ambitious timeline for implementation, it is important that potentially impacted businesses understand what is coming and prepare for the resulting changes. Tracking the timeline for further developments provided below, MNEs should:

1. **Monitor Developments.** Between now and October, the members of the IF and the OECD secretariat will be working to fill out the details and finish the design of the rules necessary to implement various aspects of Pillar One and Two. These details will be important to the operation and impact of the new rules.
2. **Consider Engagement.** As the OECD works towards finalising rules, there may be formal and informal opportunities for engagement both at the OECD or with implementing jurisdictions. The OECD and participating members have welcomed engagement by the business community in completing the work and understanding practical considerations including administrability.
3. **Model and Assess Impact.** The reforms being considered are complex and potentially will intersect with existing domestic rules. It will be important for MNEs to use appropriate assessment tools to model impacts, evaluate interdependencies and prevent double taxation or other inadvertent impacts.
4. **Track Implementation:** Implementation of agreed reforms requires legislative adoption and, where relevant, ratification of a signed multilateral instrument. Given the variations in legislative and parliamentary processes across jurisdictions, MNEs will need to understand the timelines and relevant requirements of the various processes and track when laws in different jurisdictions come into effect.

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