

Update on October 2021 BEPS agreement on Pillar 1 and Pillar 2

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On Friday 8 October OECD issued update on the major reform of international tax system, the so-called two-pillar solution, which is aimed at fair relocation of profits of certain MNE under taxing right of jurisdictions where such profits are derived irrespective of physical presence of MNE in such jurisdictions, as well as on introducing the global minimum corporate tax rate set at 15%.

Please see below our alert with key outtakes from OECD update.

Inclusive Framework – 8 October 2021 Agreement

On 8 October 2021 the Inclusive Framework (IF) on Base Erosion and Profit Shifting released details of an agreement which refines the statement of 1 July 2021. In terms of consensus, 136 of the 140 Inclusive Framework countries have agreed to this release. The four countries that have not signed up are Kenya, Nigeria, Pakistan and Sri Lanka.

It is titled Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy and is 8 pages in length.

Consistent with the statement of 1 July, **covered previously**, two Pillars are covered. Pillar 1 deals with the reallocation of certain profits from very large Multinational Enterprises (MNEs) to market jurisdictions. Pillar 2 deals with a Global Minimum Tax.

The statement annex includes a detailed implementation plan with timelines for the development of detailed rules, for legislative implementation, and target effective dates.

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Pillar 1: Reallocation of profits

Pillar 1 provides for new profit allocation and nexus rules for MNEs that are in scope. These rules are embodied in “Amount A”. The statement of 8 October confirms that the new rules will apply to MNEs with worldwide revenue greater than €20 billion and profitability above 10%. The 1 July statement indicated that the allocation under Amount A would be between 20% and 30%. The agreement on 8 October states that this amount will be 25%. It is estimated that Pillar 1 will result in the reallocation of USD125 billion of profit.

Amount A requires the development of sourcing rules and a revenue-based allocation key. Details of these rules are not contained in the statement although the statement confirms that jurisdictions from which €1m or

more revenue are earned will receive an allocation. This is reduced to €250,000 for jurisdictions with less than €40 billion in GDP.

Where the residual profits of an in-scope group 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. The details of this cap are yet to be determined.

The statement confirms that jurisdictions will be subject to mandatory binding arbitration with only a limited number of less developed countries permitted to use an elective mechanism.

It also commits that no new Digital Services Taxes or other relevant similar measures will be enacted and imposed on any company from 8 October 2021 and until the earlier of 31 December 2023 or the coming into force of the Multilateral Convention (MLC). The MLC will require all parties to remove all existing Digital Services Taxes and other relevant similar measures with respect to all companies, and to commit not to introduce such measures in the future. The statement provides 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.

Extractive industries and regulated financial services remain outside of Amount A although there is no further

detail of the scope of these exclusions. Nor is there any further detail on the mechanism to reduce double tax and which entities within an MNE group are responsible for payment of any Amount A liability.

The statement commits countries to “use all efforts” to enact legislation and ratify a proposed Multilateral Convention on Amount A in Pillar 1 “within the context of their legislative process”.

Details of a proposal for Amount B which deals with standard remuneration for in-country “baseline” marketing and distribution activities will be developed in 2022, consistent with the statement of 1 July 2021.

Pillar 2: Global Minimum Tax

Minimum rate 15%

Pillar 2 deals with new Global Anti-Base Erosion (or GloBE) or Global Minimum Tax rules. The agreed global minimum tax rate is 15%. The 1 July statement indicated that it would be ‘at least 15%’.

UTPR exclusion for MNEs in their initial phase

There is 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 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.

The rules will provide for an exclusion from the UTPR for MNEs in the initial phase of their international activity. This is defined as those MNEs that have a maximum of EUR 50 million tangible assets abroad and that operate in no more than 5 other jurisdictions. This exclusion is limited to a period of 5 years after the MNE comes into the scope of the GloBE rules for the first time. For MNEs that are in scope of the GloBE rules when they come into effect the period of 5 years will start at the time the UTPR rules come into effect.

Common approach

The 8 October statement continues to describe the GloBE Rules as a “common approach,” meaning that IF member jurisdictions are not required to adopt the GloBE Rules, but they 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 must implement and administer the rules consistently with the agreement reached on Pillar Two.

€750m threshold remains

As envisaged in the 1 July statement, the GloBE Rules will apply to MNEs with revenues exceeding the €750 million threshold as determined under BEPS Action 13 (country by country reporting). Countries remain free to apply the IIR to MNEs headquartered in their countries whose revenue fall below this threshold.

Exclusions

Exclusions are provided from the GloBE Rules for government entities, international organizations, non-profit organizations, pension funds or investment funds that are ultimate parent entities (UPE) of an MNE group or any holding vehicles used by such entities, organizations or funds. International shipping is excluded, but not airlines. This is consistent with the 1 July statement.

Jurisdictional basis for determining effective tax rate

The GloBE Rules are described to impose a top-up tax using an effective tax rate test that is calculated on a jurisdictional basis using 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. There is no discussion on how these timing differences will be determined and treated.

Consistent with the 1 July statement, the new agreement provides that in respect of existing distribution tax systems, there will be no top-up tax liability if earnings are distributed within four years and taxed at or above the minimum level.

Formulaic substance carve-out and de minimis exclusion

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 are initially 8% for tangible assets and 10% for payroll and will taper down over a 10-year period to 5% for both.

The GloBE rules will 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.

The statement confirms that the implementation framework will include safe harbors but does not provide details of these mechanisms.

GILTI Co-existence

Consistent with the July statement, the statement confirms that the US GILTI regime will co-exist with the GloBE Rules, to ensure a level playing field, but does not provide additional details of how this will occur.

Subject to tax rule (STTR)

The statement confirms the importance of the STTR to developing countries and provides that IF member jurisdictions that apply nominal corporate income tax rates below the STTR minimum rate to interest, royalties and a defined set of other payments (subject to further discussion) would incorporate the STTR into their bilateral treaties with developing IF members when requested to do so.

The statement defines 'developing countries' as those with GNI per capital of \$12,535 or less in 2019.

The taxing right under the STTR will be limited to the difference between the minimum rate and the tax rate on the payment, with the minimum rate for the STTR being 9%. This was said to be between 7.5% and 9% in the July statement.

Implementation and timelines

The detailed implementation plan in the annex to the statement sets out key milestones for the finalization of the detailed rules, as well as the target timelines for

legislation/treaties to be implemented/ratified and for the rules to be in effect.

In chronological order:

1. the GloBE model rules and commentary and the STTR model treaty provision and commentary will be developed by the end of November 2021
2. the multilateral convention (MLC) containing the Amount A rules and its explanatory statement, as well as model domestic legislation and commentary, are to be concluded by early 2022
3. the MLC signing ceremony is to be organised by mid-2022
4. the STTR multilateral instrument (MLI) is to be developed by mid-2022
5. the GloBE rules implementation framework will be developed at the latest by the end of 2022 (possibly including a multilateral convention for GloBE)
6. the Amount B deliverables are to be released by end of 2022. While the implementation plan refers to the need for consultation with stakeholders it is not clear whether there will also be public release of the above documents at the times indicated

In terms of roll out timelines, for all elements of the rules (i.e. Amount A, GloBE rules, STTR, Amount B, DST rollback) the implementation plan notes that IF members are fully committed to use all efforts within the context of their legislative process in achieving the timeline goals.

For Amount A it is noted that implementation through the MLC is with a view to allowing it to come into effect in 2023. This is noted to occur once a critical mass of jurisdictions has ratified it, and IF jurisdictions signing the MLC will be expected to ratify it as soon as possible. The critical mass threshold is not yet defined and is to be set out in the MLC in early 2022, so it remains to be seen whether Amount A allocations will start from 2023.

The Pillar Two rules are, per the IF statement, to be brought into law in 2022 to be effective in 2023 (i.e. IIR and STTR) with the UTPR coming into effect in 2024. As noted, it is recognized that countries face limitations in speed of their legislative processes, so it remains to be seen by what stage a significant number of IF members have the rules in place. The timelines for the implementation of Amount B and the rollback of DSTs and other relevant similar measures are not yet clarified.

Open issues

There are a large number of open issues. These include:

For Pillar 1

- definition of MNE group
- foreign de minimis revenue exclusion
- definition of regulated financial services and extractives exclusions (e.g. whether qualifying threshold set for group revenue from excluded activities, and whether need for segmentation for groups that cannot be entirely excluded)
- final design of revenue sourcing rules, design of marketing and distribution safe harbor and double tax relief rules (crucial impact on how much tax revenue countries actually get – includes possible Amount A offset for WHT)

- amount B rules (including status as mandatory or voluntary)
- design of mandatory and binding dispute resolution mechanism

For Pillar 2

- safe harbor design
- scope of STTR and circumstances in which treaty upgrades needed
- technical design features such as losses, deferred tax, UTPR allocation mechanism, Joint Venture rules

Consultation

The statement provides that work will progress in consultation with stakeholders within the constraint of the timeframes for implementation.

US and EU considerations

Additional European considerations

The European Commission has stated that a consistent implementation of Pillar 1 and 2 in all EU Member States, ensuring compatibility with EU law, requires new EU Directives. This EU legislative route could be launched in the first quarter of 2022. Adoption of EU Directives implementing the new global standards would be subject to unanimous agreement among EU Member States, not all of which signed the OECD IF Statement in July 2021.

After intense EU coordination efforts and OECD IF cooperation to find compromise solutions to address the concerns of especially Hungary (substance-based carve-out), Ireland (minimum rate) and Estonia (distribution-based corporate tax), it now seems that all EU Member States could be willing to adopt the new global rules in the form of EU Directives (assuming that Cyprus – not an OECD IF member – is able to join the consensus group in the EU).

Additional US Considerations

Implementation of Pillars 1 and 2 in the US will require legislative action. The current Administration has put forth a budget that includes several proposals to reform current US tax rules in alignment with Pillar 2 of the OECD inclusive framework agreement. The tax writing committees in the US Congress are still debating the contours of a potential tax reform package, but early proposals, while not adopting many of the Administration's budget proposals, also include provisions that appear aligned with the consensus approach to Pillar 2 including raising the GILTI rate to just above 15 percent and adopting a jurisdictional approach.

Subject to the ability to reach a political consensus in the US on a broader tax and infrastructure package, implementing tax legislation could be enacted by the end of this year or beginning of 2022. Thus far, neither the Administration nor Congressional tax writers have put forth legislative language or proposals in connection with Pillar 1. This is likely because several key aspects of Pillar 1 were yet to be agreed. In earlier public statements, Secretary Yellen signaled that implementation of Pillar 1 would be addressed in 2022.

Next steps

The framework for reforms agreed will have a wide-ranging 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:

- **Monitor Developments.** These details will be important to the operation and impact of the new rules.
- The Inclusive Framework will be accepting feedback from stakeholders and tax leaders should consider feeding in issues to the OECD.
- **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.
- **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.

KPMG International Tax group is ready to assist you on the matter and help to assess the potential impact of the implementation of Pillar 1 and Pillar 2 initiatives on your business.

Should you have any questions, please do not hesitate to contact us.

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