KPMG

TaxNewsFlash

Transfer Pricing

No. 2019-093
November 13, 2019

KPMG report: OECD proposal under Pillar Two; addressing tax challenges of digitization of the economy

The Organisation for Economic Cooperation and Development (OECD) on November 8, 2019, released its public consultation document concerning the global anti-base erosion (GloBE) proposal (Pillar Two) as part of its work to address the tax challenges of digitalisation of the economy.

Read the OECD's **public consultation document**

The following discussion provides initial impressions about the proposals in Pillar Two approach.

Background

As first described in the "policy note" released by the OECD on January 30, 2019, the members of the Inclusive Framework agreed to examine proposals relating to its work to address the tax challenges of digitalisation of the economy under two "pillars"—one focusing on the allocation of taxing rights between jurisdictions and a second addressing remaining base erosion and profit shifting (BEPS) issues.

On February 13, 2019, the OECD and the Inclusive Framework issued a public consultation document on the specific proposals being examined under Pillars One and Two. With respect to Pillar Two, the consultation document described two proposals—an income inclusion rule and a tax on base eroding payments, both of which would operate broadly, but with coordination rules aimed at reducing the risk of double taxation.

Following this consultation, the OECD and Inclusive Framework released a Programme of Work on May 31, 2019, describing in more detail the proposals being considered under both Pillars One and Two. Under Pillar Two, the members of the Inclusive Framework agreed to explore an approach that leaves jurisdictions free to choose their own tax system (i.e., whether they have a corporate income tax) and set their own tax rates, but considers the right of other jurisdictions to apply, when income is

taxed at an effective rate below a minimum rate, various rules including an income inclusion rule, an undertaxed payment rule, a switch over rule, and a subject to tax rule.

Overview of public consultation document

In this latest public consultation document, the OECD elaborates on those various rules and seeks comments on specific technical issues. The consultation document describes the four rules under the Pillar Two or GloBE proposal as follows:

- An income inclusion rule that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate;

- An undertaxed payments rule that would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at or above a minimum rate;

- A switch-over rule to be introduced into tax treaties that would permit a residence jurisdiction to switch from an exemption to a credit method where the profits attributable to a permanent establishment (PE) or derived from immovable property (which is not part of a PE) are subject to an effective rate below the minimum rate; and

- A subject to tax rule that would complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source and adjusting eligibility for treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate.

The consultation document states that the operative minimum rate under those rules will be discussed and decided after other key design elements of the overall proposal are fully developed.

Key design issues that need to be addressed in the context of the GloBE proposal include determination of the tax base, the extent to which the rules will permit blending of low- and high-tax income, and the need for (and design of) carve-outs and thresholds. In addition, the mechanics and operation of the undertaxed payment rule and the nature and scope of the subject to tax rule need to be further developed and likely could benefit from further public consultation at a future point in time. Further, the Inclusive Framework must consider issues relating to rule coordination and the interaction of the GloBE proposal with other international and domestic tax rules in order to ensure that the proposal avoids the risk of double taxation, minimises compliance and administration costs, and that the rules are targeted and proportionate.

KPMG observation

The GloBE proposal clearly needs to be coordinated with the already adopted provisions of BEPS, such as those adopted in accordance with the OECD's Action 2 anti-hybrid recommendations, which are arguably just a special case of the undertaxed payments rule. There is also potential for overlap between the various elements of the GloBE proposal that will need to be resolved. For example, there appears to be the potential for overlap between the undertaxed payments rule and the subject to tax rule in the case of deductible payments, such as a royalties, that might be treated as both not subject to tax and undertaxed. In that case, would a country deny a deduction, apply a withholding tax, or do both? In this regard, it is important to note that the denial of a deduction is a tax on the payor, whereas a withholding tax is a tax on the payee.

Although the consultation document does not recommend a specific minimum rate, it is interesting to note that the examples included in the document apply a rate of 15%, which is above the effective foreign-derived intangible income (FDII) rate of 13.125%.

Comments requested

Comments are requested by December 2, 2019, and are welcome on all aspects of the work on Pillar Two, but are specifically requested on three technical design aspects of the GloBE proposal:

- The use of financial accounts as a starting point for determining the tax base, as well as different mechanisms to address timing differences;

- The extent to which a multinational enterprise (MNE) can combine high-tax and low-tax income from different sources in determining the effective (blended) tax rate on such income; and

- Stakeholders' experience with, and views on, carve-outs and thresholds that may be considered as part of the GloBE proposal.

Determining the tax base

With respect to tax base determination issue, the consultation document notes that the Programme of Work suggests starting with relevant accounting rules, subject to any agreed adjustments to align accounting income with a proper measure of taxable income, as a means of improving compliance and administrability and neutralising the impact of structural differences in the calculation of the tax base. However, when the entities in a MNE use different accounting standards, potentially for different purposes, it must be determined which accounting standard should be used. The consultation document notes that the use of different accounting standards may significantly increase compliance and administration burdens and creates the possibility of distortions arising from transactions between MNE entities. Accordingly, the consultation document concludes that computing the tax base using the accounting standard used by the ultimate parent entity to prepare its consolidated financial accounts would address some of these issues, so long as the ultimate parent entity's financial accounts are be prepared under an acceptable set of financial accounting standards or generally accepted accounting principles, which will not always be the case.

In addition, it is unclear what adjustments should be made to appropriately align accounting income with the concept of taxable income. Adjustments for permanent differences will involve exclusion of categories of income or expense from the financial accounts, and excluding categories of income will narrow the tax base while excluding categories of expense will expand the tax base. Comments are requested on what common and material permanent differences between financial accounting income and taxable income could be removed from the tax base without undermining the policy intent of the GloBE proposal. With respect to adjustments for temporary differences, the consultation document outline three basic approaches—(1) carry-forward of excess taxes and tax attributes, (2) deferred tax accounting, and (3) a multi-year average effective tax rate. The consultation document discusses the compliance, administration, and tax policy considerations of each approach and notes that the approaches could be tailored and elements of the different approaches could be combined to better or more efficiently address specific problems. Comments are then requested with respect to adoption of the various approaches. The consultation document also includes an Appendix with examples illustrating the application of the carry-forward of excess taxes and tax attributes (Examples 1 and 2) and the application of deferred tax accounting (Examples 3-5).

KPMG observation

Adopting a global definition of the tax base for purposes of the GloBE proposal would be a significant departure from the approach used by many countries in existing controlled foreign corporation (CFC) regimes. For example, current U.S. rules determine the tax base of a CFC applying U.S. income tax principles. Converting to a global financial statement standard for purposes of the GloBE proposal thus would appear to create a global common corporate tax base, at least as to extra-territorial income, which would represent a major change in the international tax system. Further, based on similar

questions put forward by the OECD on possible adjustments to financial statement income for purposes of Pillar One, it is possible that the OECD may extend the concept of the Pillar Two tax base to also serve as the tax base for determining Amount A under the Pillar One Unified Approach.[1]

Determining the tax rate – blending options

For purposes of determining effective tax rate, the consultation document notes that the Programme of Work describes different tax rate blending options ranging from blending at the entity level, the jurisdictional level, and the global group level. Entity, jurisdictional, and worldwide blending represent different policy choices. The consultation document observes that while worldwide blending may result in lower overall compliance costs, it may be less effective in creating a floor for tax competition. The different blending approaches also may have varying impacts on the existence of temporary differences between accounting income and taxable income, discussed above.

In addition, the consultation document notes that each blending approach potentially raises unique challenges. For example, an entity-blending approach may need to consider how to deal with the effect of tax grouping or consolidation regimes that apply to the subsidiary under local law. Under any of the blending approaches, it will be necessary to develop an agreed approach for allocating income between the branch and head office jurisdictions and allocating income of a tax transparent entity. Comments are requested with respect to all of these issues, as well as how to deal with taxes arising in a third jurisdiction and the treatment of dividends and other distributions.

KPMG observation

With the adoption of the global intangible low-taxed income (GILTI) regime, the United States is ahead of the game on these policy choices. GILTI employs worldwide blending; has also set the top-off rate (as a range between 10.5% and 13.125%); and addressed the question of how to deal with both permanent and temporary differences in taxable income vs. financial statement income—by largely ignoring them (e.g., realizing the benefits of deferred tax assets, such as NOL carryforwards, can trigger a GILTI "top-off" tax). One critical question is whether the U.S. GILTI regime will protect the CFCs of U.S. MNEs from anti-base erosion taxes if the consensus solution requires blending on a jurisdictional basis, sets the top-off rate at a rate less than 10.5%, or requires a country's CFC minimum tax regime to account for temporary differences. Any difference in these policy choices, could expose U.S. MNEs to an increased tax burden or put pressure on the U.S. government to amend its GILTI rules.

Carve-outs and thresholds

Finally, the consultation document discusses the possibility of carve-outs and other thresholds or exclusions from application of the GloBE proposal. The Programme of Work suggests consideration of certain carve-outs, including for: (1) regimes compliant with the standards of BEPS Action 5 on harmful tax practices, and other substance-based carve-outs (noting that such carve-outs would undermine the policy intent and effectiveness of the proposal); (2) a return on tangible assets; (3) controlled corporations with related-party transactions below a certain threshold.

Such carve-outs also could be subject to certain limitation such as: (1) thresholds based on the turnover or other indications of the size of the group; (2) de minimis thresholds to exclude transactions or entities with small amounts of profit or related party transactions; and (3) applicability to only specific sectors or industries.

---

[1] Unified Approach Consult Paper, Para 53.

The consultation document states that the decision on carve-outs and thresholds is mainly a policy question. The existence and design of any carve-outs or thresholds will also affect the neutrality of the tax system and on activities generating positive or negative externalities. The consultation document notes that carve-outs based on facts and circumstances can be more targeted and more resistant to abuse than carve-outs based on objective tests, but they are more difficult to design and increase complexity and compliance and administration costs. Such carve-outs also may create uncertainty for taxpayers. By comparison, carve-outs based on objective criteria are simpler to apply and administer, but they may be over- or under-inclusive and more easily subject to manipulation. Comments are requested with respect to what carve-outs should be made available, and how such carve-outs should be designed, taking into account factors such as simplicity, compliance costs, certainty, incentives and behavioural impacts.

KPMG observation

The consultation document does not provide sufficient detail about the potential design of an income inclusion rule, undertaxed payments rule or subject to tax rule. Absent additional work on design, it is difficult to discuss how a particular design should be adapted to a specific industry or whether specific carve-outs should be included.

For more information, contact a tax professional with KPMG LLP in the United States:

Manal Corwin | +1 (202) 533-3127 | mcorwin@kpmg.com

Seth Green | +1 (202) 533-3022 | sethgreen@kpmg.com

Brett Weaver | +1 (206) 913-6697 | baweaver@kpmg.com

Jesse Eggert | +1 (202) 533-5512 | jeggert@kpmg.com

Danielle Rolfes | +1 (202) 533-3378 | drolfes@kpmg.com

Mark Martin | +1 (713) 319-3976 | mrmartin@kpmg.com