Back to basics

BEPS 2.0: the two-pillar approach

Speed read

The OECD's two-pillar corporate tax reform plan is due to come into effect in 2023. Pillar one includes a rule to reallocate profits of the largest groups in the world to market jurisdictions. Pillar two consists of global anti-base erosion (GloBE) rules and the subject to tax rule (STTR). The GloBE rules impose a minimum corporate tax rate, to be effected by top-up taxes. The STTR allows jurisdictions to impose source taxation (for example, withholding taxes) on certain related party payments. Further detail is expected next month.

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With the arrival of the Biden administration in the US, the OECD has finally made political progress with its two pillar corporate tax reform plan. Agreement was reached amongst the G7 in June 2021 and, on 1 July, the OECD /G20 Inclusive Framework on Base Erosion and Profit Shifting published a statement (the 'July statement') setting out the key components of each pillar.

The July statement envisages both pillars coming into effect in 2023, which, given the size and complexity of the reforms, is an ambitious timetable.

Although the July statement only provides the bare bones of the new regimes, much of it looks consistent with the chunky reports on the pillar one and pillar two blueprints ('the blueprints') published by the OECD in October 2020, and so the authors expect a lot of the detail set out there to be relevant. We should know more next month (October), when a detailed implementation plan is expected to be finalised.

Pillar one

Pillar one will reallocate a portion of the profits of a multinational enterprise (MNE) to market jurisdictions where the MNE has a substantial engagement in that market, regardless of whether or not they have a physical presence there. This is likely to result in a greater proportion of profits being subject to corporate taxes on income in the countries in which their customers are located.

Originally aimed at digital business models (automated digital services and consumer facing businesses), the measure has been refocused on the largest businesses in the world, whatever their activity. It will apply to MNEs with annual global turnover above €20bn (reducing to €10bn in no earlier than seven years) that have a profitability threshold above 10%. There will be exclusions for regulated financial services and extractives; the detail of these exclusions is yet to be published. Segments of an MNE may be within the rules in exceptional circumstances where they satisfy the scope criteria. The €20bn threshold means that only a small number of MNEs will be in scope. Econpol (the European Network for Economic and Fiscal Policy Research) estimates that just 78 MNEs will be within the pillar one rules.

Substantial engagement in a market jurisdiction is measured by a new 'nexus test' which will be met if the MNE generates €1m of income in a year from a jurisdiction. The threshold is reduced to €250,000 for small countries (countries with GDP below €40bn). Detailed revenue sourcing rules will need to be applied to determine the jurisdiction in which revenue is derived.

Amount A

The profits reallocated to countries meeting the nexus test are known as Amount A. There is a three-step process to calculate Amount A:

1. Deduct 10% of the MNE's global *revenue* from its *profit before tax* to arrive at 'residual profits'.
2. Deduct 70%–80% of residual profits (the percentage is yet to be finalised) to leave the 'allocable tax base'.
3. Split the allocable tax base between countries meeting the nexus test in proportion to the revenue generated in each country. (See the figure above right.)

The deduction of 10% of revenue and restriction of Amount A to 20%–30% of the residual profits means that only a relatively small proportion of the MNE's profits will be reallocated to market jurisdictions.

A marketing and distribution safe harbour will prevent profits from being taxed twice in the same market jurisdiction. This will operate by capping the profit allocation to a jurisdiction where residual profits (profits in excess of a fixed return for routine marketing and distribution activities) have already been allocated to that jurisdiction under existing tax rules.

Additional double taxation rules will prevent reallocated profits from being taxed twice across the MNE group (once in the market jurisdiction and once in the jurisdiction where they are currently located under existing tax rules). These rules will identify 'paying entities'; broadly, these are entities which have a connection to the reallocated profits and can absorb the Amount A tax liability. The jurisdiction in which the paying entity is resident will be required to either exempt from tax the profits reallocated away from its jurisdiction under pillar one, or give credit for market jurisdiction taxes on such profits.

The effect of pillar one is that profits from jurisdictions where IP, risk and capital are located will be shifted, for tax purposes, to jurisdictions where end-users are located.

In exchange for this new taxing right, countries will be required to give up any unilateral taxes on digital businesses. For example, the UK will have to repeal its 2% digital services tax.

Pillar one also contains rules to simplify the arm's length principle for related party distributors and mechanisms to provide tax certainty.

Pillar two

Pillar two consists of two elements: the global anti-base erosion (GloBE) rules and the subject to tax rule (STTR). The GloBE rules seek to impose a global minimum corporate tax rate (at least 15%) for in-scope entities. This is effected by

top-up taxes in other (higher tax) jurisdictions. The STTR allows jurisdictions to impose limited source taxation on certain related party payments that are subject to tax below a minimum rate (7.5% to 9%).

GloBE: scope

The size threshold for the GloBE rules is significantly lower than that for pillar one. The rules will apply to MNEs that meet the €750m turnover threshold as determined under the BEPS country by country reporting rules.

There will be more exclusions than for pillar one. Government entities, international organisations, non-profit organisations, pension funds and investment funds that are ultimate parent entities (UPEs) of an MNE group and any holding vehicles used by such entities, organisations or funds will be out of scope. There will also be an exclusion for international shipping income and a *de minimis* exclusion. An exclusion for MNEs in the initial phase of their international activities is being explored.

The blueprint contains a fairly tightly-drawn exemption for income of a UPE that is subject to a tax neutrality regime which, broadly, requires investors to be subject to immediate taxation on their share of the entity's income at a rate at least equal to the minimum one. It is not expressly mentioned in the July statement, so it is unclear whether this has been dropped.

GloBE: ETR calculation

The GloBE rules impose a top-up tax where the effective tax rate (ETR) of constituent entities of an MNE group in a jurisdiction is below the minimum rate. Permanent establishments (PEs) are generally treated as separate entities. The calculation is complicated but, broadly, the tax base is determined by reference to financial accounting income, subject to various adjustments. There is a formulaic substance carve out to exclude an amount of income that is at least 5% (at least 7.5% for a five year transition period) of the carrying value of tangible assets and payroll.

For the purposes of the ETR calculation, the taxes covered are, broadly, those on income and profits (or imposed in lieu of a generally applicable income tax).

GloBE: top-up tax

The primary top-up tax method is the income inclusion rule (IIR). This is similar to a CFC charge, and taxes a parent entity on its proportionate share of a low-taxed constituent entity's income. This will often (but not always) be the UPE. To allow the IIR to apply to the profits of a low-taxed PE, it is expected that a 'switch-over rule' will apply to turn off provisions in a double tax treaty (DTT) that allocate taxing rights solely to the PE's jurisdiction.

Where there is top-up tax but the IIR does not apply (for example because the only parent is located in a low tax jurisdiction), the undertaxed payment rule (UTPR) will apply. The UTPR allocates top-up tax to constituent entities of the MNE group located in jurisdictions that have implemented the rule ('UTPR taxpayers'). It does so in a two-step process:

- first, by reference to the UTPR taxpayer's proportionate share of deductible payments made to the low-taxed entity by all UTPR taxpayers; and
- second (if there is remaining unallocated tax), by reference to its share of net intra-group expenditure of all UTPR taxpayers,

in each case, subject to various caps.

STTR

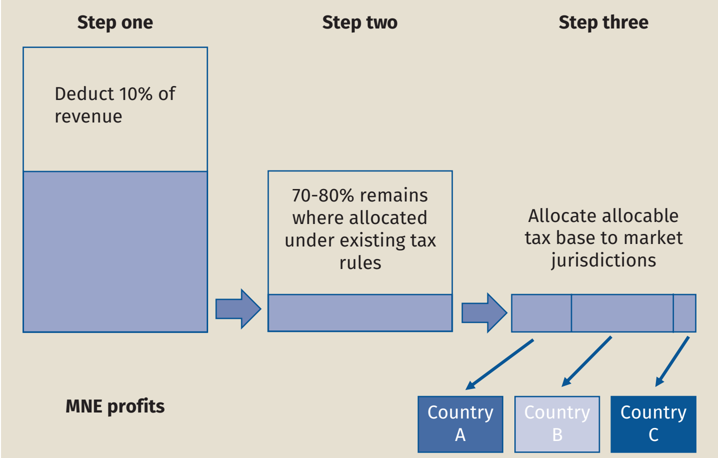
The STTR applies separately from the GloBE rules. Where a source jurisdiction has ceded its taxing rights under a DTT in relation to certain payments made between related parties, the STTR allows it to tax those payments. It applies where the tax rate in the payee jurisdiction is below a minimum rate and is limited to the difference between the two rates. The relevant tax rate is the nominal tax rate in the payee jurisdiction (after certain adjustments). The July statement envisages it being used by developing countries but it is not clear whether it is to be limited to them.

A wide range of payments are within scope, including interest, royalties, franchise fees, insurance premiums, rent for moveable property and consideration for intermediary services. The source jurisdiction can decide the form of the tax, but given its simplicity, a withholding tax may be most common.

Materiality thresholds and exclusions for the STTR have not yet been confirmed.

The implementation plan due next month is to include an STTR model provision for DTTs together with a multilateral instrument to facilitate its adoption. ■

The three-step process for calculating Amount A



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