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From BEPS To Fair Taxation: Exploring The Two Pillar Solution

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Understanding Two Pillar Solution

In recent years, the rise of the digital economy has posed unique challenges to the international tax system. The traditional rules governing taxation were not designed to adapt to the complexities of the modern global marketplace, leading to concerns over Base Erosion and Profit Shifting (BEPS). To tackle these issues and establish a fair taxation framework in the digital age, the Organisation for Economic Co-operation and Development (OECD) developed the innovative Two Pillar approach. As part of the broader project "Tax Challenges Arising from Digitalisation", the Pillar Two Solution represents a vital step in tackling tax issues faced by multinational enterprises (MNEs).

Both Pillars One and Two fall within the scope of addressing tax challenges arising from digitalization. However, their primary areas of focus differ significantly. Pillar One primarily targets the challenges posed by the digital economy, while Pillar Two is specifically designed to tackle the unintended tax advantages MNEs gain through the arrangement of their intragroup transactions.

Pillar One – The Unified Approach

The proposal under Pillar One focuses on the allocation of taxing rights and aims to modify existing profit allocation and nexus rules. Pillar One proposal seeks to address the challenges the digital economy poses and its impact on international taxation. It proposes a revolutionary approach to taxing large MNEs operating in various jurisdictions, even without a physical presence. The central concept of Pillar One is to reallocate a portion of the MNEs' profits to the jurisdictions where they have a significant consumer or user base.

The application of Pillar One is contingent upon the market jurisdiction in which designated MNEs generate a minimum revenue threshold of 1 million euros (or 0.25 million euros for smaller jurisdictions). This criterion ensures that the framework targets market jurisdictions where MNEs have a significant economic presence and meaningful consumer engagement. By establishing these revenue benchmarks, Pillar One aims to accurately capture and allocate profits in accordance with the economic impact of MNEs in different markets.

By adopting a formulaic approach, Pillar One ensures that MNEs pay taxes in proportion to their economic activities and user engagement in different markets. This novel approach aims to establish a fairer distribution of taxing rights among countries, enabling market jurisdictions to capture a share of the profits generated by digital businesses that previously escaped taxation due to the outdated rules of physical presence.

The Pillar One proposal encompasses several key elements aimed at addressing the challenges posed by the digital economy and ensuring fair taxation. These elements can be grouped into three essential components.

Amount A (Allocating new taxing rights to market jurisdiction)

The concept of Amount A introduces a groundbreaking new taxing right for market countries. It aims to allocate a share of the residual profits of multinational enterprises (MNEs) to jurisdictions where they have a significant consumer or user base, even in the absence of a physical presence. To achieve this, a formulaic approach is employed, considering various factors such as sales, user engagement, and other relevant metrics. This approach ensures that a portion of the MNEs' profits is attributed to the countries where they generate substantial economic activity and derive value from their user base.

Scope: It aims to target the large MNEs – currently those with a turnover exceeding €20 billion and profitability over 10%. Under this rule, these MNEs would allocate 25% of their excess profits (“residual profits”) to the market jurisdiction where they sell their products, regardless of their physical presence. Although only a few MNEs would be affected initially, this marks a radical change.

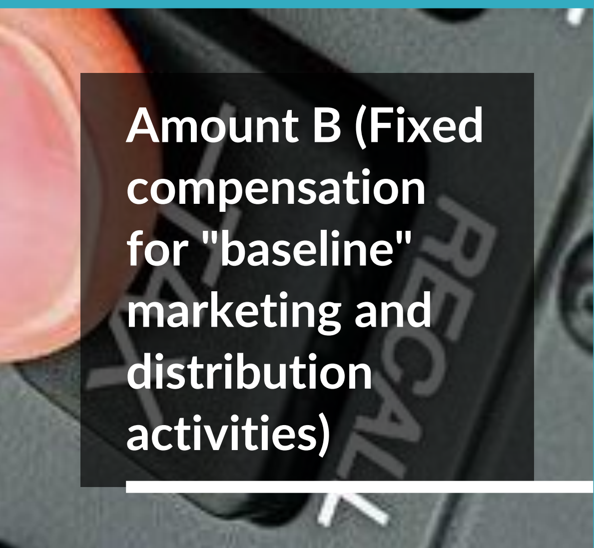
Computation of Taxable Profits under Amount A: The computation of taxable profits under Amount A in Pillar One introduces a multi-step process that ensures accurate and equitable profit allocation in market jurisdictions:

Step 1: Identifying excess profit or residual profits, i.e., actual profits of MNE minus 10% of consolidated revenue.

Step 2: Allocate a portion (25%) of this profit to market jurisdictions; and

Step 3: Distribute this allocated amount among eligible markets based on local revenues.

Amount A = (Total profit - 10% of revenue) * 25%



Amount B (Fixed compensation for "baseline" marketing and distribution activities)

The implementation of Amount B involves the establishment of a fixed "baseline" return for marketing and distribution functions. This baseline return is determined based on the arms' length principle (ALP), which seeks to ensure that transactions between related parties are conducted as if they were between unrelated parties. By applying the ALP, the remuneration for these essential functions is set at a fair and reasonable level, ensuring that businesses receive appropriate compensation for their activities.

Scope: The following types of transactions would be eligible for the application of Amount B under the proposed Pillar One:

1. **Buy-Sell Marketing and Distribution:** This involves transactions where a distributor procures goods from another group entity to distribute wholesale to external parties.

2. **Sales Agency and Commissionaire:** This covers transactions where an entity aids in the wholesale distribution of goods to external parties on behalf of another group entity.

The transactions excluded from the purview of Amount B include those:

1. **Involving distribution of services or Commodities:** Transactions centered around service distribution, or the marketing and trading of commodities, fall outside the scope.

2. **Incorporating Non-Distribution Activities:** The cases where the entity performs non-distribution activities, like manufacturing or research and development alongside distribution activities, are exempt unless the distribution activities can be distinctly assessed and priced apart from the non-distribution activities. This ensures clarity and accuracy in profit allocation.

Tax Certainty

The Pillar One proposal emphasizes the importance of tax certainty for all businesses. It aims to provide effective dispute prevention and resolution mechanisms to ensure a smooth and transparent tax environment. By implementing robust mechanisms for dispute resolution, such as arbitration or advance pricing agreements (APAs), businesses can have greater confidence in their tax positions and avoid prolonged and contentious tax disputes with tax authorities.

Pillar Two – The Global Minimum Tax

Pillar Two complements Pillar One, with the primary goal of setting a minimum effective tax rate (ETR) to prevent harmful international tax competition. The main objective is to ensure that multinational businesses operating worldwide are subject to a minimum ETR of 15%, thereby safeguarding tax revenues and promoting equitable taxation practices across different jurisdictions.

The ETR plays a dual role in the Pillar Two framework. It serves as a trigger to identify "low tax jurisdictions" where an MNE's jurisdictional ETR falls below the agreed minimum rate. Additionally, the ETR functions as a computational tool to determine the amount of income that must be brought back into the tax net to raise the aggregate tax on income in that jurisdiction to the minimum ETR.

Pillar Two presents a robust solution to tackle tax avoidance strategies employed by multinational corporations. Comprising two fundamental components, the Global Anti-Base Erosion (GloBE) Rules and the Subject to Tax Rule (STTR), Pillar Two aims to establish a global minimum tax rate.

The Global Anti-Base Erosion (GLOBE) Rules

The GloBE rules empower jurisdictions to "tax back" when low-tax jurisdictions fail to exercise their primary taxing rights or when payments are subject to a low tax rate. The top-up tax required for an MNE to meet the minimum ETR is collected through the application of the Income Inclusion Rule (IIR) at the parent entity level or through a corresponding adjustment under the Undertaxed Payments Rule (UTPR).

Income Inclusion Rule

The IIR is a framework that operates akin to established Controlled Foreign Corporation (CFC) regimes, discouraging tax planning to exploit low-tax jurisdictions. It triggers the inclusion of income at the shareholder level, either at the Ultimate Parent Entity (UPE) or an intermediate parent entity. This occurs when the income of a controlled foreign entity is taxed below the specified Effective Tax Rate (ETR).

Under the IIR, the UPE is mandated to pay a supplementary tax, known as a top-up tax, on its share of the income earned by any low-taxed Constituent Entity (CE) within the multinational group. This is applicable when the UPE has a direct or indirect ownership stake in the CE. The top-up tax is calculated to bridge the gap between the existing tax rate applied to the income and the 15% Effective Tax Rate (ETR), ensuring that profits are not subjected to unduly low taxation

Any top-up tax payable under the IIR and the Undertaxed Payment Rule (UTPR) is adjusted to account for any Qualified Domestic Minimum Top-Up Tax (QDMTT). This is a minimum tax established in domestic law that aligns with the GloBE rules. This ensures that source countries retain their primary right to tax profits arising within their jurisdiction at the 15% rate if they choose to exercise this right.

The IRR holds the UPE responsible for paying top-up tax on behalf of its group entities or the constituent entities located in low-tax jurisdictions. However, if the UPE is situated in a jurisdiction where the IIR is not applicable, the constituent entity at the highest point in the ownership hierarchy, to which the IIR applies, would then be liable to pay top-up tax under the IIR for the constituent entities.

Switch-Over Rule

The IIR is further enhanced by a tax treaty-based Switch-Over Rule (SOR), which introduces an essential layer of balance and consistency within the framework of the GloBE rules. The SOR would permit treaty exemptions for income derived from Permanent Establishments (PEs) in low-tax jurisdictions to be switched off, allowing such income to be included in the low-tax jurisdiction's income to determine its shortfall from the minimum ETR.

The SOR comes into play in situations where a PE is deemed to be "undertaxed." In such cases, the SOR operates by deactivating a treaty-based exemption that is traditionally applied in the head office jurisdiction. Instead, the SOR introduces a shift to a credit-based method of taxation for the PE's income. This change ensures that the PE's profits are subject to taxation, in alignment with the objective of preventing undue tax advantages stemming from lower-tax scenarios. By replacing the exemption method with a credit-based approach, the SOR maintains consistency in taxation principles and seeks to curb instances of income avoidance and tax discrepancies across jurisdictions.

The Undertaxed Payment Rule

The UTPR acts as a fallback mechanism to the IIR. It comes into play when the IIR isn't sufficient to bring low-tax jurisdictions in line with the 15% minimum ETR. The UTPR allocates the taxing rights over under-taxed income from a low-tax jurisdiction to different jurisdictions apart from the UPE's residence.

The secondary rule under the global minimum tax is proposed to be the UTPR. The UTPR will apply after the IIR and serve as a backstop to the IIR. One scenario in which the UTPR would apply is where the jurisdiction in which a group is headquartered has an effective tax rate below the minimum tax rate. This is because the IIR itself does not apply to the headquarters’ jurisdiction. Any top-up tax then would be collected under the UTPR by the countries where other group companies are located. In such cases, the UTPR restricts deductions or mandates adjustments equivalent to the untaxed portion of the income. This discourages attempts to exploit gaps in tax systems by allowing deductions for income that haven't been adequately taxed.

The IIR takes precedence, and the UTPR functions as a supplementary safeguard to ensure that income escaping the IIR's grasp doesn't lead to unintended tax benefits.

The Subject to Tax Rule (STTR)

The STTR operates as a source-based rule within the Pillar Two framework, empowering the source jurisdiction to exercise certain authority over specific intra-group cross-border payments. These payments may include interest, royalties, or fees between entities within the same multinational group. The key objective of the STTR is to prevent the erosion of the source jurisdiction's tax base and ensure that appropriate taxes are levied on these transactions.

Under the STTR, the source jurisdiction has the right to apply withholding taxes on covered payments or deny treaty benefits if the payment is subjected to a nominal rate of less than 9%. This threshold is crucial in determining whether the source jurisdiction can intervene and impose taxes on the payment to prevent base erosion.

It's important to note that the STTR applies exclusively to "covered payments" made to "connected persons." Covered payments refer to specific types of payments, such as interest, royalties, or fees, falling within the scope of the STTR regulations. On the other hand, "connected persons" are entities that have a special relationship or affiliation within the same multinational group, reflecting the essence of intra-group transactions targeted by the STTR.

The primary aim of the STTR is to restore taxing rights to source states, safeguarding their tax base. When the nominal tax rate in the payee jurisdiction falls below 9%, the payer jurisdiction imposes a withholding tax on such payments to ensure that the top-up tax raises the MNE’s effective tax rate to the agreed minimum.

Scope Inclusion: The GLoBE Rule will apply to MNE group that meet the consolidated group revenue of €750 million or more, as established by the Country-by-Country rules. However, individual implementing countries may choose to use a lower threshold if they deem it appropriate.

Scope exclusion: Entities and structures such as government bodies, international organizations, non-profit organizations, pension funds, and investment funds, whether acting as Ultimate Parent Entities (UPEs) of an MNE Group or as holding vehicles for such entities, are exempt from the GloBE rules.

It is important to note that the impacts of Pillar Two would vary depending on the final details and scope of the agreement. MNEs and various stakeholders are closely monitoring the developments in the negotiations to assess the potential consequences on their business operations and tax planning strategies.

Application Of Globe Rules

The calculation of the Effective Tax Rate (ETR) within the framework of the GloBE rules involves a structured process to ensure accurate assessment

Step 1: Calculation of GLoBE Income/Loss

Firstly, each Constituent Entity (CE) determines its GloBE income or loss, which serves as the starting point and is derived from the CE's income or loss as reported in the UPE's consolidated financial statements (prior to eliminating intragroup transactions).

To refine the calculation, the CE's accounting income or loss is adjusted by removing specific book-to-tax differences. These include items like excluded dividends, equity gains or losses, asymmetric foreign currency gains or losses, prior period errors, and accounting principle changes.

Step 2: Calculation of Adjusted Covered Taxes

The OECD takes a flexible approach in defining covered taxes within the framework of the GloBE rules, aiming to capture a wide spectrum of taxation aspects. It considers any tax levied on an entity's income or profits, encompassing taxes imposed in lieu of a generally applicable income tax. Covered taxes extend to taxes on retained earnings and corporate equity, focusing on the form and intention of the tax, irrespective of its specific name or mechanics. Notably, the definition explicitly excludes Digital Services Taxes (DSTs) due to their nature of supplementing corporate income tax rather than replacing it.

This exclusion helps prevent potential conflicts and double taxation if DSTs proliferate amidst a lack of agreement on Pillar One.

Step 3: Calculation of the Jurisdictional ETR:

The ETR is then determined on a jurisdictional basis. This entails dividing the covered taxes by the net GloBE income relevant to the particular jurisdiction. It's calculated as the GloBE income of all CEs within the jurisdiction minus the GloBE losses of all CEs in the same jurisdiction.

Step 4: Determination of Top up Tax

The process of determining the Top-Up Tax involves calculating the positive percentage point variance between the established minimum Effective Tax Rate (15%) and the Effective Tax Rate (ETR) derived from the computation in Step 3 above. This Top-Up Tax percentage represents the incremental rate required to ensure that the overall tax rate on profits aligns with the stipulated minimum threshold.

Step 5: Determination of Excess Profit

The determination of excess profit within the GloBE framework involves a calculated process that subtracts substance-based income carve-outs from the overall GloBE Income. This step is essential in assessing the portion of income that qualifies as excess profit subject to further taxation under the rules.

Step 6: Calculating Top-Up Tax liability

The calculation of the jurisdictional Top-Up Tax (TUT) liability involves a systematic process that combines various factors to determine the amount of additional tax payable under the GloBE rules for a specific jurisdiction. This calculation takes into account the positive difference between the minimum Effective Tax Rate (ETR) and the calculated Effective Tax Rate for that jurisdiction.

The formula for calculating the TUT liability is as follows:

TUT liability = (TUT % * Excess Profit) + additional current TUT – QDMTT

The Way Forward

The Two-Pillar Solution reflects the collective efforts of the international community to modernize the global tax system and adapt it to the realities of the digital economy. Through enhanced cooperation and effective implementation, the solution seeks to promote a fairer and more stable international tax framework that benefits both nations and businesses alike.

The global tax landscape has witnessed a remarkable shift towards consensus and cooperation, exemplified by the endorsement of BEPS 2.0 proposals by over 139 Inclusive Framework (IF) countries. A pivotal role in shaping this transformative change is being played by the European Union (EU), leading the adoption of the GloBE Rules.

The OECD's roadmap for the implementation of the Pillar Two rules outlines a phased approach, with the rules expected to take effect in 2024, marking a significant shift in global taxation dynamics. Notably, the UTPR, a pivotal aspect of the framework, is recommended to be operational by 2025, reinforcing the comprehensive nature of the regulatory transformation.

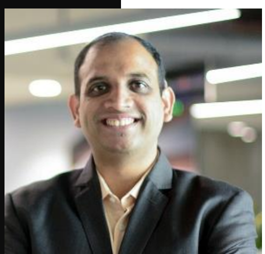
The European Union (EU) Member States have demonstrated proactive commitment by formally adopting the Minimum Tax Directive on December 15, 2022. This directive sets a clear trajectory for action, stipulating that Member States must transpose its provisions into their domestic law by December 31, 2023. The EU's steadfast adoption signifies a significant step towards harmonizing tax practices within the member nations.

Globally, various countries are diligently crafting and fine-tuning their domestic rules to effectively implement the essence of Pillar Two. This concerted effort across nations underscores the recognition of the Pillar Two framework as a critical instrument in recalibrating the global tax landscape.

Notably, countries like Japan, South Korea, the UK, and Switzerland have taken proactive steps by enacting domestic legislation to embrace the GloBE Rules starting from the year 2024. A wave of enthusiasm for this paradigm shift in taxation is sweeping across the globe, with prominent economies like Denmark, New Zealand, Czech Republic, Germany, Netherlands, Luxembourg, Sweden, Australia, and Singapore initiating the process of adopting GloBE Rules through the issuance of draft legislation.

The resolute commitment of KNAV in this dynamic landscape is unwavering. By providing exceptional guidance, we aim to ensure compliance, mitigate risks, and optimize financial outcomes, thereby enabling our clients to traverse this complex realm with confidence and success.

Author



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