October 12, 2021

New International Agreement on Pillars 1 and 2

The OECD/G20 Inclusive Framework Reached a New Global Agreement on Profit Allocation and Minimum Tax

SUMMARY

On October 8, 2021, 136 jurisdictions—almost all of the 140 working members of the OECD/G20 Inclusive Framework on Base Erosion and Profits Shifting (BEPS)—agreed to a statement on international tax reform. It updates the statement released in July and builds upon the Two-Pillar framework for the taxation of large multinational enterprises (MNEs). While many questions remain, key updates include the setting of a 15% global minimum rate and the addition of a new Annex featuring a detailed implementation schedule.

DISCUSSION

A. PILLAR ONE

1. Overview

Pillar One is aimed at addressing the challenges posed by the growth of the digital economy, in which MNEs that are able to access a country's market are currently able to escape taxation by that jurisdiction due to a lack of physical presence. Individual countries have begun to address this by unilaterally enacting digital service taxes (DSTs). Pillar One seeks to coordinate these efforts by providing a global mechanism for partial reallocation of the profits of in-scope MNEs to market jurisdictions. Critical details of the scheme, such as safe harbor rules and formulas to determine profit, remain undeveloped; however, the October 2021 agreement featured key updates, including a revised dispute resolution mechanism and a more comprehensive implementation schedule.

2. Scope

a. Thresholds and exclusions

Pillar One applies to MNEs with over €20 billion in revenues and a profitability margin greater than 10% and excludes from its scope companies in the extractives sector—such as oil, gas, and other mining companies—as well as regulated financial services.

The agreement allows for a reduction of the revenue threshold to €10 billion after a review of seven years after the agreement comes into force. Currently, it is estimated that the €20 billion threshold would render roughly 100 MNEs within its scope.

b. Calculating profitability

The October 2021 update provided a new insight that the 10% profitability margin will be calculated using an averaging mechanism. This mechanism will likely be designed along with other rules in the Multilateral Convention (MLC), described below.

c. Segmentation

Unchanged from the July 2021 statement is a brief note that segmentation of business units will only occur in "exceptional circumstances" where, based on disclosures in an MNE's financial accounts, a segment meets the revenue and profitability thresholds outlined above. Thus, some MNEs may have separate profit allocations for the ultimate parent entity and its largest business units.

3. Amount A

a. Taxable residual profit

Amount A is defined as the portion of an in-scope MNE's residual profit—that is, profits in excess of the 10% threshold margin—which may be reallocated to and subject to tax by market jurisdictions under Pillar One. While the July 2021 agreement set a range between 20% and 30% of residual profit, the October 2021 agreement establishes a 25% rate.

In order to determine the relevant measure of profit or loss, the financial statement income of an in-scope MNE will be subject to various substantive and timing adjustments. Losses will be carried forward.

b. Nexus for market jurisdictions

In order for a jurisdiction to be eligible for an Amount A allocation, the in-scope MNE must derive at least €1 million in revenue from that jurisdiction. The agreements also provide a lower nexus of €250,000 for smaller jurisdictions with GDPs under €40 billion.

Revenues will be sourced to end-market jurisdictions, with detailed sourcing rules for specific categories of transactions. The agreements allude to some flexibility in the application of those rules, indicating that MNEs should use reliable methods tailored to their own facts and circumstances.

c. Revenue allocation

Amount A will be allocated to eligible market jurisdictions using a revenue-based allocation key; further guidance will likely be set forth in the MLC.

d. Safe harbor and double taxation issues

The MLC is also tasked with providing a safe harbor provision for marketing and distribution profits, so that the sum of (i) profits already attributed to marketing and distribution functions located in a given jurisdiction and (ii) excess profit allocated under Amount A would not exceed the portion of the excess profit to be allocated to such jurisdiction under Pillar One.

Similarly, the agreements state that any double taxation of profit allocated to market jurisdictions should be relieved by exemptions or credits.

e. Dispute resolution mechanism

Building on the July 2021 statement, the October 2021 agreement sets forth a mandatory and binding dispute resolution mechanism for all Amount A-related issues and establishes a new elective yet binding dispute resolution mechanism for qualifying developing economies. Both the mandatory and elective mechanisms are reserved for Amount A issues, which could include the correct delineation of business lines, allocation of central costs and tax losses to business lines, the existence of a nexus in a particular jurisdiction, or the identification of the relieving jurisdictions for purposes of eliminating double taxation.

In order to qualify for the elective system, a jurisdiction must have low levels of Mutual Agreement Procedure (MAP) disputes and must be eligible for deferral of BEPS Action 14 peer review (conditions for which are set forth in paragraph 7 of the current Action 14 assessment methodology). In practice, this elective system would involve jurisdictions with low capacity of tax administration. Eligibility will be reviewed regularly and jurisdictions found ineligible for the elective system will remain so permanently.

Although the October 2021 agreement did not elaborate further on the dispute resolution mechanism, the Pillar One Blueprint released in late 2020 outlines a proposed dispute prevention process in which MNE groups may request for tax certainty via a representative panel mechanism:

- There would be an initial review function to ensure that early certainty is achieved, including a review panel and, where necessary, a determination panel.
- Where an MNE accepts the outcomes of the tax certainty process, these outcomes would be binding on the MNE and tax administrations in all jurisdictions affected by the calculation and allocation of Amount A, including jurisdictions that did not participate directly on the relevant panel.
- Where an MNE does not accept the outcomes of this process, an MNE group may withdraw its request for early certainty and may then rely on domestic measures. The report contemplates the possibility that further agreements on Pillar One will impose a condition that cases will only progress to the determination panel stage if an MNE group agrees to be bound by its decision.

Finally, where an MNE does not elect into the early tax certainty process, and disputes arise, the approach will provide enhanced dispute resolution features that remain under development. Given the benefits of early certainty, however, it is expected that most in-scope MNEs will opt in.

f. Compatibility with other domestic tax regimes

A key question left open by the July 2021 agreement concerned Digital Service Taxes (DSTs): despite stating that DSTs would be prohibited and that they would have to be removed by jurisdictions that had already implemented them unilaterally, the July 2021 agreement did not provide information on timing or coordination with the new tax rules.

The October 2021 statement implements a ban on introducing new DSTs or similar measures as of October 8, 2021 until the earlier of December 31, 2023 or the coming into force of the MLC. However, still open is the question of what constitute "similar measures," as well as the timeline for removal of DSTs already in place. Some member countries are already discussing transitional arrangements, with France and the United Kingdom indicating that they will remove their taxes on US technology companies in 2023 once the new tax rules come into effect.

One may also expect that Belgium will make use of this general consensus on the allocation of the excess profits to market jurisdictions to justify their tax ruling policy whereby excess profits of Belgian entities were exempted in Belgium on the basis that they should be allocated to other group entities (cf. ECJ September 16, 2021 C-337/19). Since the arm's length principle is no longer the sole driver of profit allocation under international tax standards, the reference system used by the EU Commission may have to evolve as well.

g. Implementation

The Pillar One measures will be implemented via a Multilateral Convention to be developed by the Task Force on the Digital Economy (TFDE) and set for release in early 2022. The MLC will provide a framework for all jurisdictions that join, regardless of existing tax treaties, and it will contain:

- rules to determine and allocate Amount A and to eliminate double taxation;
- the marketing and distribution profits safe harbor;
- a simplified administration process;
- an exchange of information process;
- a dispute prevention and resolution process;
- a detailed process for the removal of existing DSTs and a definition of "similar measures";
- a supplementary explanatory statement describing the purpose and operation of the MLC rules and processes; and
- rules on how to address inconsistencies between the MLC and existing tax treaties or future tax treaties.

The agreements set forth an ambitious goal of opening the MLC for signature in 2022, with the Amount A regime to come into effect in 2023.

As participating jurisdictions will need to update their own laws to reflect the new tax scheme, the TFDE is also tasked with developing model rules for domestic legislation to give effect to new taxing rights under Amount A by early 2022.

4. Amount B

Amount B, an additional calculation based on an arm's length principle applied to in-country marketing and distribution activities, remained unchanged by the October 2021 agreement. A key purpose of Amount B is to prevent transfer pricing disputes regarding such activities through the use of agreed standardized returns to objectively defined activities, supported by quantitative indicators. The agreement stated that work on streamlining the formula will be completed by the end of 2022.

B. PILLAR TWO

1. Overview

Pillar Two is designed to address MNEs shifting profits to low-tax countries by establishing a global minimum corporate tax scheme consisting of three rules: two domestic rules—together called the Global anti-Base Erosion (GloBE) rules—and a secondary, treaty-based rule: the Subject to Tax Rule (STTR). Key updates from the October 2021 agreement include a more detailed implementation timeline, an additional carveout for companies in the early phases of international expansion, and alterations to certain rates and transition periods from the July 2021 statement.

2. GloBE Rules

a. Structure

The overall design of the GloBE rules remains unchanged from the July 2021 agreement and features two interlocking rules. Together, the GloBE rules have the effect of creating a minimum rate of tax on domestic companies investing abroad and foreign companies investing domestically:

- an Income Inclusion Rule (IIR) imposes a top-up tax on the foreign income of a parent company with subsidiaries located in low-tax jurisdictions (subject to a forthcoming split-ownership rule for shareholdings below 80%). The IIR implements a top-down approach to multi-tiered structures such that income will be allocated to the topmost entity that is resident in a jurisdiction participating in the IIR regime; and
- an Under-Taxed Payments Rule (UTPR) denies a deduction for (or allows a withholding tax on) undertaxed cross-border payments. The establishment of a methodology for the UTPR has been left for future agreement, but it is clear that the tax on a payment will include taxes paid directly by the recipient of the payment as well as by a parent corporation under the IIR regime.

The July 2021 agreement established a minimum rate of "at least" 15%; revisions in the October 2021 statement set the rate squarely at 15%.

b. Scope

The GloBE rules apply to MNEs with annual revenues above €750 million[1]; however, the agreements state that jurisdictions are free to apply the IIR to domestically-headquartered MNEs falling below the revenue threshold.

Exempt from the GloBE rules as Excluded Entities are government entities, international organizations, nonprofits, pension funds, and investment funds that are ultimate parent entities of an MNE group, as well as any holding vehicles used by such entities, organizations, or funds.

The October 2021 agreement also provides a new exemption from the UTPR for companies in the early stages of international activity, so long as they meet three requirements:

- the MNE has a maximum of €50 million in tangible foreign assets (note: "tangible assets" are presently undefined, so it is unclear whether this includes non-depreciable assets such as inventory or land);
- the MNE has operations in no more than five other jurisdictions (note: an MNE is considered to "operate" in a jurisdiction if that MNE has a Constituent Entity, as defined for purposes of the GloBE rules[2]); and
- the MNE has been within the scope of the GloBE rules for under five years (note: for MNEs within the scope of the GloBE rules when they come into effect, the time period starts at the time the UTPR rules come into effect).

c. Calculating the effective tax rate

After the October 2021 agreement, many questions remain on how to calculate an MNE's effective tax rate (ETR) in order to determine whether a top-up tax is warranted. One point, however, is clear: the rate will be calculated on a jurisdictional (i.e., a country-by-country) basis. This will likely require updates to domestic international tax regimes such as GILTI in the US, which currently operates by combining the results of foreign affiliates, although there are proposed US tax law changes that would adopt a country-by-country approach. Specifically with respect to GILTI, however, the agreement provides that "consideration will be given to the conditions under which the US GILTI regime will co-exist with the GloBE rules," to ensure a level playing field, without giving any further guidance.

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1 Revenue figures will be taken from the MNE's Country-by-Country (CbC) report, a template developed by BEPS Acton 13.

2 The Pillar Two Blueprint, released in late 2020, defines the term "Constituent Entity" as: (a) any separate business unit of an MNE Group that is included in the group's financial statements, or would be so included if equity interests of the Ultimate Parent Entity of the MNE Group were traded publicly; (b) any such business unit that is, or would be, excluded from the MNE Group's consolidated financial statements solely on size or materiality grounds; and (c) any permanent establishment of any separate business unit of the MNE Group included in (a) or (b), provided the business unit prepares a separate financial statement for such permanent establishment for financial reporting, regulatory, tax reporting, or internal management control purposes. A Constituent Entity does not include a business unit that is an Excluded Entity.

Remaining elements necessary to the ETR determination—such as a standardized set of adjustments to financial accounting income in order to arrive at a tax base—have been left open for future determination. However, the report on the Pillar One Blueprint released in late 2020 defines "covered taxes" for GloBE purposes as any tax on an entity's income or profits, including any taxes imposed in lieu of a generally applicable income tax as well as taxes on retained earnings and corporate equity.

Finally, the July 2021 agreement provided that there would be no top-up tax liability if earnings are distributed within three to four years and taxed at the minimum rate. The October 2021 statement set the earnings distribution period at four years.

d. Carveout provisions

The October 2021 agreement also provided updates to two key carveout provisions for the GloBE rules: a formulaic substance carveout and a de minimis exclusion.

In the July 2021 agreement, the formulaic substance carveout described a deduction of at least 5% for the carrying value of tangible assets and payroll expenses. These deductions would initially start at 7.5% and be reduced during a five-year transition period. The October 2021 statement provided the following revisions:

- final deduction for both categories was set squarely at 5%
- the transition period was lengthened to ten years
- the initial deduction for tangible assets would start at 8%, with the rate declining by 0.2% for the first five years and then 0.4% for the remainder of the transition period
- the initial deduction for payroll expenses would start at 10%, with the rate declining by 0.2% for the first five years and then 0.8% for the remainder of the transition period

Additionally, the October 2021 agreement developed a de minimis exclusion from the GloBE rules for jurisdictions in which the MNE has revenues under €10 million and profits under €1 million.

e. Implementation

As noted above, much remains to be developed with respect to the mechanics of the GloBE rules. The agreements state that the GloBE rule implementation will be more flexible than Pillar One, adopting a "common approach" status rather than a rigidly standardized scheme.

Although member jurisdictions will not be required to adopt the GloBE rules, they should be consistent with the outcomes provided for under the regime. Similarly, members will be bound to accept the application of GloBE rules applied by other jurisdictions.

The October 2021 agreement provides a new timeline for the development of model rules to give effect to the GloBE rules; this guidance is expected to be completed by the end of November 2021, and is set to include:

- rules for determining effective tax rate on a jurisdictional basis;
- methodologies for relevant exclusions from the effective tax rate;
- administrative provisions (filing obligations, safe harbours);
- transition rules; and
- commentary explaining the purpose and operation of the rules.

Additionally, by the end of 2022, there will be an established framework to facilitate the coordinated implementation of the GloBE rules, including procedures and safe harbors to simplify compliance and administration. The agreement states that member jurisdictions should consider a multilateral convention as a possibility as well.

The stated goal is to have the GloBE rules implemented in 2022 and for the IIR and the UTPR to become effective in 2023 and 2024, respectively.

3. Subject to Tax Rule (STTR)

The third rule of Pillar Two is the Subject to Tax Rule (STTR). The STTR is a treaty-based rule that allows source jurisdictions to impose limited source taxation on certain related party payments subject to tax below a minimum rate in the hands of the recipient. The STTR will be creditable as a covered tax under the GloBE rules. The minimum tax rate set in the October 2021 agreement is 9% (a specific rate as compared with an earlier range of 7.5% to 9%). The taxing right of the source jurisdiction would be limited to the difference between the minimum rate and the tax rate on the payment. Payments of interest, royalties, and a defined set of other payments would be subject to the STTR, but it is still unclear whether payments for services or capital gains will be included under the defined set of other payments.

The October 2021 agreement provides a November 2021 deadline for the development of a model treaty provision to give effect to the STTR, as well as a process to assist in its implementation. A corresponding multilateral instrument is also in the works and is set to be completed by mid-2022. The EU Interest and Royalties Directive will also have to be amended to allow the application of the STTR.

4. Compatibility with Other Domestic Tax Regimes

a. GILTI

The agreements note that consideration will be given to conditions under which the US GILTI regime will coexist with the GloBE rules, indicating that the two schemes will be coordinated to ease compliance. Furthermore, the Biden administration has proposed numerous revisions to GILTI that may be implemented as part of the Congressional budget reconciliation process later this year. As things stand,

however, small distinctions between the proposed GloBE rules and GILTI may raise issues or create opportunities for MNEs within the scope of both regimes.

The jurisdictional calculation provides the greatest challenge. Although the GloBE rules calculate effective rates on a country-by-country basis, GILTI in its current form aggregates foreign income regardless of jurisdiction. It is anticipated, however, that GILTI will be amended to the country-by-country methodology in order to reflect the global agreement and ease compliance with both laws.

The formulaic substance carveout in Pillar Two allowing a deduction for 5% (initially 8%) of tangible assets is similar in design to the QBAI deduction under GILTI; however, the QBAI deduction is limited to "depreciable assets." It is unclear whether "tangible assets" under the formulaic substance carveout will include land and inventory, but if so this would lead to differing tax bases. The Biden administration is proposing to eliminate QBAI altogether as a part of GILTI reform.

As the minimum rate for the GloBE rules will be 15% and GILTI sets a minimum effective rate of 10.5%, MNEs subject to GILTI may not face any additional tax burden. However, if the Biden administration successfully raises the GILTI rate to 21% as proposed, affected companies will be placed at a significant global disadvantage.

b. ATAD

The GloBE IIR will work very differently from the income inclusion provision included in the EU Anti-Tax Avoidance Directive. The ATAD provision is a traditional CFC rule with an anti-abuse rationale; passive income or income arising from non-genuine arrangements is included in the income of the parent entity, with a safe harbour provision for foreign entities carrying on a substantive economic activity. The Pillar Two substance carveout, on the other hand, aims at excluding routine profits, but excess profits of subsidiaries with a genuine activity and substance would be taxed to the parent.

c. Potential responses by low-tax jurisdictions

Some countries with current corporate tax rates below the proposed minimum, such as Ireland and Bermuda, have already announced that their rates are going to increase to 15%. It remains to be seen whether they will implement a similar revenue threshold to Pillar Two—that is, whether the consequences of the rate increase will be borne by groups above €750M of revenues, or whether this will impact all companies because the tax increase in low-tax jurisdictions will apply more generally. Ireland has already indicated that its rate increase would not affect small and medium size companies.

It is expected that the goal of most jurisdictions will be to meet the 15% global minimum but also to alleviate the increase of the global burden on their taxpayers. This could be accomplished by transferring other taxes to corporate tax (e.g., a payroll tax may be converted into corporate tax). An alternate strategy could

be to grant aids and subsidies to taxpayers, to indirectly refund part of the corporate income tax increase, which has thus far not been addressed by the Inclusive Framework.

C. NEXT STEPS

Many technical details remain to be determined in the near term, with the Pillar Two model scheduled for release by the end of November and the Pillar One Multilateral Convention set for release in early 2022. Even once key elements are clarified and agreed upon, signatories must implement domestic legislation to give effect to the new international consensus. At the EU level, the European Commission is prepared to propose a directive on Pillar Two shortly after technical guidance is released to ensure coordinated implementation. The Biden Administration, however, faces an uphill battle in the US Congress both to ratify the Pillar One treaty and to pass GILTI reforms crucial to Pillar Two by year's end. The Inclusive Framework has set the ambitious deadline of implementing international tax reform by 2023.

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