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TAX FLASH NEWS

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OECD releases public consultation document on Global Anti-Base Erosion Proposal – Pillar two

Background

The taxation of enterprises that use digital technology has been high on the international political agenda and is a key topic of focus in the broader context of the fight against Base Erosion and Profit Shifting (BEPS) and the perceived mismatch between taxation and value creation.

In October 2015, OECD released the final report on Action Plan 1, 'Addressing the Tax Challenges of the Digital Economy', together with the final reports on the other 14 elements of the Action Plan on BEPS. The Action Plan 1 provides OECD's observations regarding the digital economy and recommended next steps to address the tax challenges presented by its evolution. It states that special rules designed exclusively for the digital economy would prove unworkable, broadly stating that the digital economy cannot be ringfenced because it is increasingly becoming the economy itself, and summarises key features of evolving digital business models that OECD considers relevant for the overall BEPS analysis. It also considers broader direct and indirect tax challenges raised by the digital economy and evaluates options to address those challenges. However, it does not recommend any of the options analysed and leaves it up to individual countries to introduce any of them as additional safeguards against tax challenges of digitalisation.

In March 2018, OECD released a document 'Tax Challenges Arising from Digitalisation - Interim Report 2018' (the Interim Report) as a follow up to BEPS Action Plan 1. The Interim Report sets out the Inclusive Framework jurisdictions' agreed direction of work on digitalisation and the international tax rules through 2020. The Interim Report does not make any specific recommendations to countries, indicating instead that further work will need to be carried out to understand various business models operated by enterprises offering digital goods and services, as well as digitalisation more broadly. However, despite the technical complexity and the diverse positions, the Inclusive Framework jurisdictions agreed to undertake a coherent and concurrent review of the rules and achieve a consensus-based solution by 2020.

In January 2019, OECD released a Policy Note communicating that the renewed international discussions were going to focus on two central pillars, one pillar addressing the broader challenges of the digitalisation of the economy and focusing on the allocation of taxing rights, and a second pillar addressing remaining BEPS concerns. Following the Policy Note, OECD released, in February 2019, a Public Consultation Document describing the two pillar proposals at a high level, received extensive comments from stakeholders, and held a public consultation in March 2019.

In May 2019 the Inclusive Framework agreed a programme of work for addressing the tax challenges of the digitalisation of the economy. The programme of work is divided into two pillars:

- Pillar One addresses the allocation of taxing rights between jurisdictions and considers various proposals for new profit allocation and nexus rules.
- Pillar Two (Global Anti-Base Erosion (GloBE) proposal) calls for the development of a co-ordinated set of rules to address ongoing risks from structures that allow MNEs to shift profit to jurisdictions where they are subject to no or very low taxation.

On 9 October 2019, OECD released a public consultation document whereby 'Unified Approach' was proposed under Pillar One which is based on the significant commonalities between the various profit allocation and nexus proposals.

On 8 November 2019, OECD has released the Consultation Document seeking comments on the Pillar Two proposals. While the consultation under Pillar One centres on the unified approach, this Consultation Document under Pillar Two focusses on specific technical issues in respect of the GloBE proposal where input from stakeholders would be valuable in progressing the work. The stakeholders are invited to send their comments by 2 December 2019[1].

Key highlights of the GloBE Pillar Two are summarised as follows:

Elements of GloBE Pillar Two

Under Pillar Two, members of the Inclusive Framework agreed to explore issues and design options in connection with development of a co-ordinated set of rules to address ongoing risks from structures that allow MNEs to shift profit to jurisdictions where they are subject to no or very low taxation. The four component parts of the GloBE proposal are:

- ***Income inclusion rule***

  As per this rule, the income of a foreign branch or a controlled entity would be taxed if that income was subject to tax at an effective rate that is below minimum rate.

- ***Undertaxed payment rule***

  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.

- ***Switch over rule***

  It is 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.

- ***Subject to tax rule***

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

The Pillar Two seeks to comprehensively address remaining BEPS challenges by ensuring that the profits of internationally operating businesses are subject to a minimum rate of tax. A minimum tax rate on all income reduces the incentive for taxpayers to engage in profit shifting and establishes a floor for tax competition among jurisdictions. In doing so, the GloBE proposal is intended to address the remaining BEPS challenges linked to the digitalisation of the economy, but it goes even further and addresses these challenges more broadly. The GloBE proposal is expected to affect the behaviour of taxpayers and jurisdictions. It posits that global action is needed to stop a harmful race to the bottom on corporate taxes, which risks shifting the burden of taxes onto less mobile bases and may pose a particular risk for developing countries with small economies.

Depending on its design, the GloBE proposal may shield developing countries from pressure to offer inefficient tax incentives. The GloBE proposal is based on the premise that, in the absence of a co-ordinated and multilateral solution, there is a risk of uncoordinated, unilateral action, both to attract more tax base and to protect existing tax base, with adverse consequences for all jurisdictions. The GloBE proposal should be designed to achieve these objectives consistent with principles of design simplicity that will minimise compliance and administration costs and the risk of double taxation.

The Programme of Work calls for the consideration of simplifications, thresholds, carve-outs, and exclusions from the rules. The Consultation Document describes design issues on which input is sought in three categories:

Tax base determination

Key aspects of the tax base determination are as follows:

- The tax base would be determined by reference to the CFC rules or, in the absence of CFC rules, the domestic CIT rules of the shareholder's jurisdiction. Each subsidiary of an MNE would need to recalculate its income each year in accordance with the tax base calculations in the parent jurisdiction.

- The requirement to recalculate the income of each subsidiary in line with the tax-base in the parent jurisdiction may result in significant compliance costs. In order to improve compliance and administrability and to neutralise the impact of structural differences in the calculation of the tax base, the Programme of Work calls for the exploration of simplifications to help address these issues.

[1] The public consultation meeting on the developments under Pillar Two will be held on 9 December 2019, at the OECD Boulogne in Boulogne-Billancourt

- One simplification identified in the Programme of Work would be to start with relevant financial accounting rules subject to any agreed adjustments as necessary. The income calculated for accounting purposes would then be subject to agreed adjustments in order to align accounting income with a proper measure of taxable income.
- The income so determined would be used in the denominator of the effective tax rate fraction. Then, the numerator of the effective tax rate fraction could be based on the actual tax liability or the tax expense accrued for accounting purposes, which may need to be further adjusted to remove accruals of tax related to a different period
- If financial accounting is to be used as a starting point for determining a common tax base under the GloBE proposal, consideration must be given to the choice of accounting standard to be applied by any particular MNE subject to the GloBE proposal.
- MNE groups that prepare consolidated financial statements compute the income of their subsidiaries using the financial accounting standard applicable to the ultimate parent entity of the group as part of the consolidation process.
- Computing the tax base using the accounting standard used by the ultimate parent entity to prepare its consolidated financial accounts may address the issues. A single accounting standard applied to all subsidiaries would be more transparent and ensure that differences between subsidiary accounting standards do not produce distortions.
- To serve as a starting point for determining the GloBE tax base, however, the ultimate parent entity's financial accounts need to be prepared under an acceptable set of financial accounting standards or generally accepted accounting principles (GAAP).

Adjustments

The most straightforward approach to determining the net amount of low-taxed profits would be to take income and expense figures directly from an entity's financial statements without adjustment. However, relying on the unadjusted figures in the accounts could mean that an entity's net profits for accounting purposes may be overstated or understated when compared to the amount reported for tax purposes.

The accounting profit reflected in an entity's financial statements could be adjusted to take account certain permanent and temporary differences between the income computed under financial accounting standards and under the income tax rules.

Approaches to addressing temporary differences

The consultation document discusses three basic approaches to addressing the problem of temporary differences:

- Carry-forward of excess taxes and tax attributes
- Deferred tax accounting and
- A multi-year average effective tax rate.

These basic approaches could be tailored, and elements of the different approaches could be combined to better or more efficiently address specific problems. The consultation document seeks comments on these three approaches, opportunity for potential abuse in any of the approach, suggestions as to alternative mechanisms for dealing with temporary differences, etc. The consultation document states that there are a number of compliance, administration, and tax policy considerations that would need to be considered in the design of the rules for addressing temporary differences under the GloBE proposal. Some challenges are applicable to all the approaches and some are specific to one or two of the approaches.

Some of the differences, however, may be permanent differences that require further consideration, and some of the timing differences may be so significant that they warrant the same consideration as permanent differences.

Blending

As the GloBE proposal is based on an effective tax rate (ETR) test, it must include rules that stipulate the extent to which the taxpayer can mix low-tax and high-tax income within the same entity or across different entities within the same group. The Programme of Work refers to this mixing of income from different sources as 'blending'. Blending can be done on a narrow or broad basis, from a complete prohibition on blending to full blending of all foreign income. A broad approach to blending that allows an MNE to mix income and tax across different entities and jurisdictions will generally have the effect of reducing an MNE's potential tax liability under the GloBE proposal. The ability to blend low- and high-tax income across a wide range of entities and jurisdictions will allow the MNE to avoid a charge to tax even though a certain portion of that total income may be subject to tax at a low rate. The consultation document discusses three different approaches to blending:

- **Worldwide:** A worldwide blending approach would require the MNE to aggregate its total foreign income and the total foreign tax on that income. An MNE would be subject to tax under the GloBE proposal where the tax on the total

foreign income was below the minimum rate. The MNE's liability for additional tax under the GloBE proposal would be the amount necessary to bring the total amount of tax on that foreign income up to the minimum rate.

- **Jurisdictional:** A jurisdictional blending approach would require the MNE to apportion its foreign income between different taxing jurisdictions. An MNE would be subject to tax where the tax on the income apportioned to that jurisdiction was below the minimum rate. The MNE's liability for additional tax under the GloBE proposal would be the aggregate or sum of the amounts necessary in each jurisdiction to bring the total amount of tax on the income in the jurisdiction up to the minimum rate. One model of such an approach would aggregate the income and tax paid by all the members of the MNE group that were tax resident in the same jurisdiction (together with income of, and tax paid by, any branch established in that jurisdiction) in order to calculate the total income arising in that jurisdiction and the taxes on that income. An MNE would be subject to a top-up tax in respect of the income allocated to each jurisdiction where the tax paid on that income was below the minimum rate.
- **Entity:** An entity blending approach would require the MNE to determine the income and taxes of each entity in the group (as well as the income of domestic entities that was attributable to a foreign branch). An MNE would be subject to tax under the GloBE proposal where the effective tax rate of a foreign entity (or foreign branch) was below the minimum rate.

While each can be said to meet the policy objective of ensuring that all internationally operating businesses pay a minimum level of tax on their foreign income, the jurisdictional and entity approaches are more granular. Under a worldwide blending approach an MNE would be required to pay an average minimum rate of tax on all its foreign income whereas under an entity approach an MNE will pay tax at or above the minimum rate with respect to each group entity.

Finally, under a jurisdictional approach the MNE pays tax at or above the minimum rate in each foreign jurisdiction where it operates. The consultation document seeks comment on assessment of the general compliance costs and economic effects of a GloBE proposal that is based on either an entity, jurisdictional or worldwide blending approach. The consultation document further discusses the implications of the factors on each blending approaches and seeks public comments on it:

- Effect of blending on volatility
- Use of consolidated financial accounting information
- Allocating income between branch and head office
- Allocating income of a tax transparent entity
- Crediting taxes that arise in another jurisdiction
- Treatment of dividends and other distributions

Carve-outs

The Programme of Work calls for the exploration of possible carve-outs as well as thresholds and exclusions to restrict application of the GloBE proposal. Specifically, the Programme of Work calls for the exploration of carve-outs, including for:

- Regimes compliant with the standards of BEPS Action 5 on harmful tax practices, and other substance-based carve-outs, noting however such carve-outs would undermine the policy intent and effectiveness of the proposal.
- A return on tangible assets.
- Controlled corporations with related party transactions below a certain threshold.

The Programme of Work also calls for the exploration of options and issues in connection with the design of thresholds and carve-outs to restrict application of the rules under the GloBE proposal, including:

- Thresholds based on the turnover or other indications of the size of the group.
- De *minimis* thresholds to exclude transactions or entities with small amounts of profit or related party transactions.
- The appropriateness of carve-outs for specific sectors or industries

The decision on carve-outs and thresholds is mainly a policy question involving issues related to tax policy and legal analysis. The existence and design of any carve-outs or thresholds will also impact on the neutrality of the tax system and on activities generating positive or negative externalities. The existence and design of any carve-outs or thresholds will also impact on compliance and administration costs for MNEs and tax administrations. The precise nature of these impacts will depend on the specific design of such carve-outs or thresholds, which can either reduce or increase compliance costs.

A carve-out or exclusion can apply on a qualitative, facts-and-circumstances basis, or an objective, formulaic basis. Those options can be varied and tailored in numerous ways, depending upon the carve-out and what is sought to be achieved. The consultation document seeks comments as to taxpayers' experience in applying carve-outs and thresholds under existing regimes which will be helpful in evaluating design options for the GloBE proposal.

Additionally, the consultation document also gives examples to illustrate the application of the carry-forward of excess taxes and tax attributes and deferred tax accounting.

Our comments

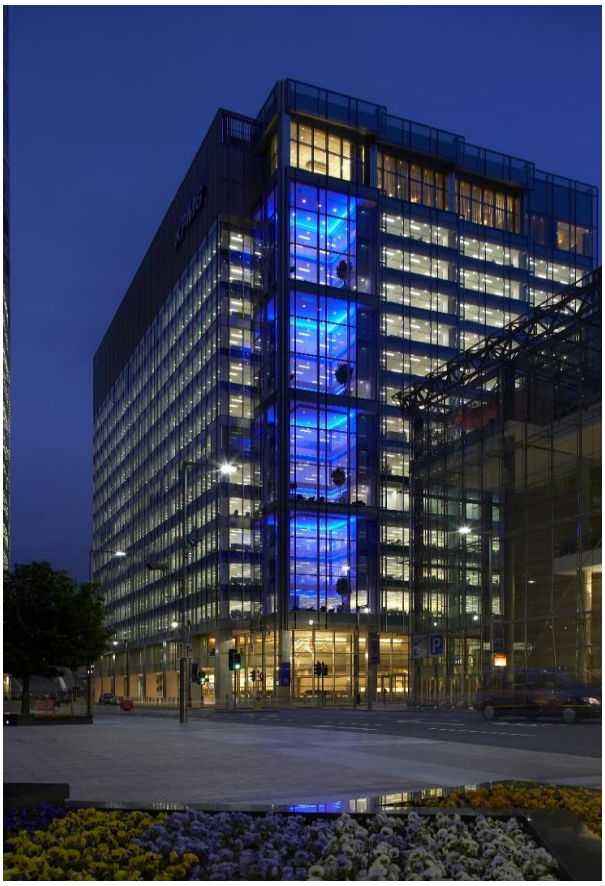
The proposals under Pillar Two represent a substantial change to the tax manner. These proposals could lead to significant changes to the overall international tax rules under which multinational businesses operate.

The OECD should look at an in-depth economic analysis of the proposals under Pillar two especially how the proposals are expected to affect the tax incentive regimes, their impact on investment, innovation and growth.

This document does not address the issue of what this minimum rate of tax will be and focuses instead on various design elements to determine the tax base for such rate including use of financial accounts as a starting point, adjustments needed in cases of blending of high tax and low tax income and necessary carveouts and thresholds. This document throws up several interesting perspectives and nuances that would significantly affect the structure and implementation of the final proposals.

While the design elements are important, it would be critical to watch the rate of tax identified as the 'minimum' for the purposes of these proposals, particularly given that corporate tax cuts are being increasingly used by countries to kick-start their economies.

It is important to track these developments closely to take informed business decisions.



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