Brief Outlook on International Taxation

OECD Pillar Two:

Global Anti-Base Erosion (GLoBE) Proposal

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Timeline

- 2013: OECD issued Action Plan on Base Erosion and Profit Shifting (BEPS)
  - Earlier that year, G20 had approved proposal for OECD to develop plan addressing tax avoidance strategies of multinational corporations
- 2015: OECD issued BEPS Final Report (15 Actions)
  - Action 1: Addressing Tax Challenges of Digital Economy
- 2017: U.S. enacted Tax Cuts and Jobs Act (TCJA)
  - TCJA included new tax on global intangible low-taxed income (GILTI) earned by foreign subsidiaries of U.S. multinational corporations
- 2018: OECD/G20 Inclusive Framework on BEPS (137 countries) issued Interim Report on taxing digital economy
  - Report confirmed need for global solution
- 2019: OECD issued Public Consultation Documents
  - Unified Approach Proposal under Pillar One
  - Global Anti-Base Erosion (GloBE) Proposal under Pillar Two
- 2019-2020: Approximately a dozen countries unilaterally implemented (or proposed) taxes on digital services income
  - In December of 2019, Italy enacted a 3% digital services tax
- 2020: On October 12, the Inclusive Framework released a package consisting of the *Report on the Pillar One Blueprint* and the *Report on the Pillar Two Blueprint*
  - Public comments are invited and public consultation meetings will be held in January 2021, all with a view to bringing the process to a successful conclusion by mid-2021

OECD Pillar Two Blueprint (246 pages!)

Ten Chapters

Overview of GLoBE Rules

- Global Anti-Base Erosion (GLoBE) rules in Pillar Two are designed so that large internationally operating businesses pay a minimum level of tax regardless of where where are headquartered or the jurisdictions they operate in

- Principal mechanism to achieve this outcome is the Income Inclusion Rule (IIR) together with the Undertaxed Payments Rule (UTPR) acting as a backstop
  - IIR and UTPR are new rules that would be implemented through changes to domestic law (model legislation will be developed)

- Operation of the IIR is in many respects based on traditional controlled foreign corporation (CFC) rules
  - Income inclusion triggered at the level of the shareholder where the income of a controlled foreign entity is taxed below the effective minimum tax rate

- UTPR is a secondary rule and applies only where an entity is not already subject to an IIR

Overview of GLoBE Rules

- IIR and UTPR use a common tax base, i.e., determination of the base starts with financial accounts prepared under accounting standard used by parent of MNE group to prepare its consolidated financial statements

- IIR and UTPR use a common definition of taxes, i.e., “covered taxes” is derived from the definition of taxes used for statistical purposes by many international organizations including OECD, EU, IMF, World Bank, and UN

- IIR and UTPR use same rules to determine effective tax rate (ETR)
  - ETR is calculated is by applying the tax base and covered taxes on a jurisdictional basis
  - This requires an assignment of the income and taxes among the jurisdictions in which the MNE operates and to which it pays taxes

- If MNE’s jurisdictional ETR is below the agreed minimum rate, the MNE will be liable for an incremental amount of tax that is sufficient to bring the total amount of tax up to the minimum rate

Overview of GLoBE Rules

- MNE Groups having total consolidated gross revenue below EUR 750 million are excluded from the application of the GLoBE rules
- GLoBE rules include a formulaic carve-out based on expenditures for payroll and tangible assets that is designed to exclude a fixed return for substantive activities within a jurisdiction from the scope of the GloBE rules
  - Excluding a fixed return from substantive activities focuses GloBE on “excess income” (such as intangible-related income) which is most susceptible to BEPS risks
- Excluded entities under the GLoBE rules include parent entities of investment funds, pension funds, sovereign wealth funds, government bodies, international organisations, and non-profit organisations

Income Inclusion Rule (IIR)

- IIR operates by requiring a parent entity – in most cases, the Ultimate Parent Entity – to bring into account its share of the income of each Constituent Entity located in a low-tax jurisdiction and taxes that income up to the minimum tax (a top-up tax), after crediting any covered taxes on that income

- IIR operates in a way that is similar to a controlled foreign corporation (CFC) rule in that it subjects a domestic taxpayer to tax on its share of the foreign income of any controlled subsidiary

- To avoid potential double taxation among Constituent Entities in different jurisdictions, the GLoBE rules apply a top-down approach
  - Ultimate Parent Entity (UPE) of the MNE Group has the first priority to apply an IIR
  - If the UPE does not apply an IIR, then the next Parent down the ownership chain applies the rule (and so on)

- IIR is intended to be implemented consistently in every jurisdiction and operate in a way that produces the same overall result to ensure that an MNE Group is subject to a minimum level taxation in each jurisdiction that it operates without giving rise to the risk of double or over taxation

Undertaxed Payments Rule (UTPR)

- UTPR has the same general purpose as IIR (ensuring a minimum level of taxation), with UTPR principally focused on protecting jurisdictions against base erosion through intra-group payments to low-taxed entities
- While IIR and UTPR have the same general purpose, they have a different function and operate in a different way
  - IIR provides for a mechanism to collect the top-up tax based on a Parent's ownership of the low-tax Constituent Entities
  - UTPR serves as a backstop to IIR and only applies to those Constituent Entities in the MNE Group that are not controlled by an entity further up the chain that applies an IIR
- UTPR requires a UTPR taxpayer that is a member of an MNE Group to make an adjustment in respect of any top-up tax that is allocated to that taxpayer from a low-tax Constituent Entity of the same group
- Under UTPR, top-up tax is allocated among group entities on a proportionate basis using a mechanical rule that is common to each jurisdiction applying the UTPR
  - UTRP is a complex rule to apply and requires a greater amount of coordination between jurisdictions than IIR
  - In practice, scope for application of UTPR is expected to be narrow

Treaty-Related Rules

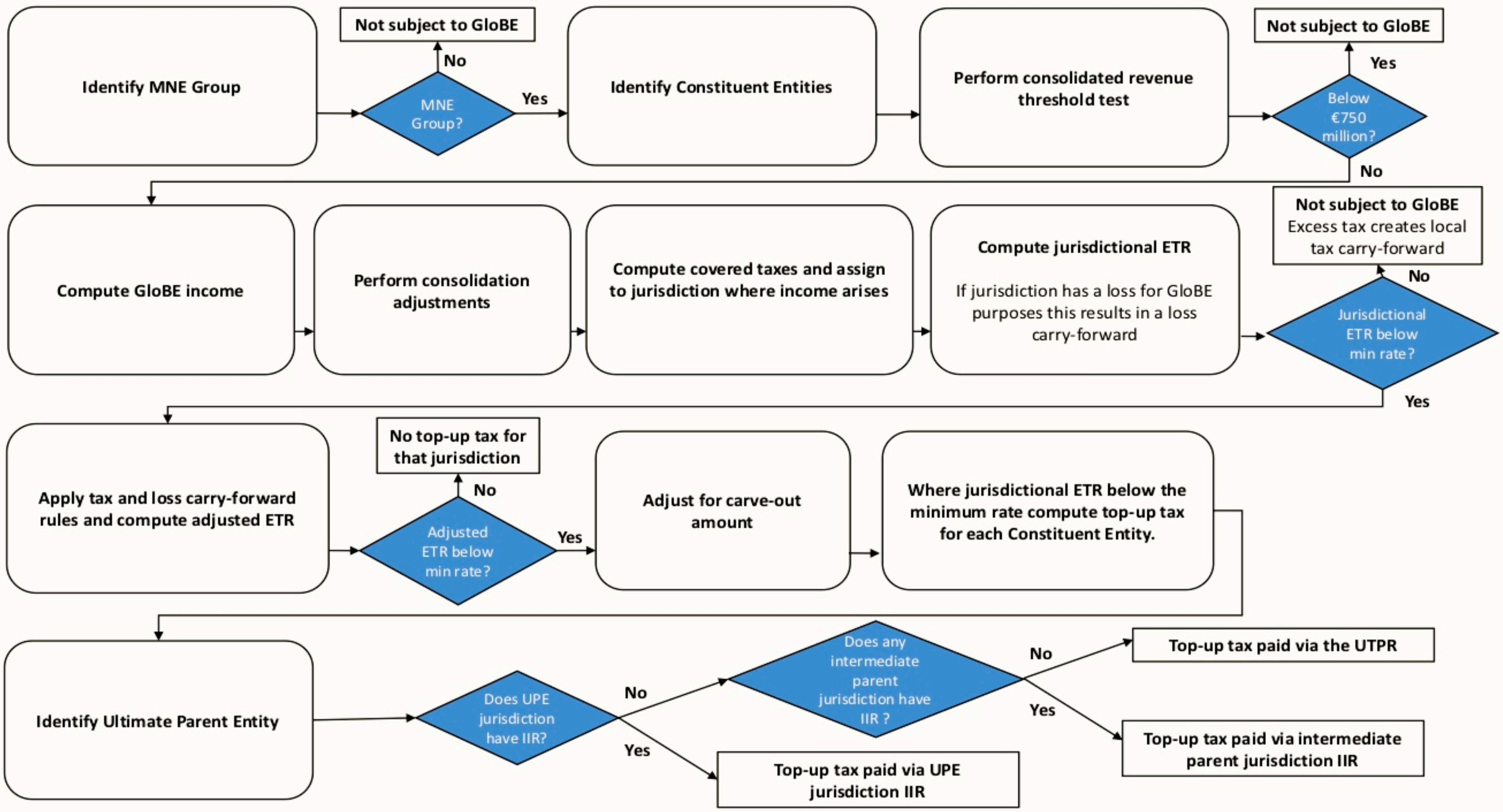
- IIR and UTPR rules are complemented by certain treaty-related rules
  - Switch-Over Rule (SOR) removes treaty obstacles from the application of IIR for certain branch structures where an income tax treaty otherwise obligates a contracting state to use the exemption method, effectively allowing a residence jurisdiction to switch from an exemption to a credit method
  - Subject to Tax Rule (STTR) denies treaty benefits for various deductible intra-group payments by subjecting a payment to withholding or other taxes at source

- SOR and STTR can only be implemented through changes to existing bilateral tax treaties (or via a new multilateral convention)

GLoBE Flow Diagram (on page 22 of Blueprint)

Flow Diagram

40. The flow diagram below is intended to provide a high-level overview of the process steps for applying the GloBE rules to wholly-owned Constituent Entities of an MNE Group.



GLoBE Rules - Interaction with GILTI

- U.S. enacted Global Intangible Low-Taxed Income (GILTI) rules in 2017 TCJA
- GILTI regime provides for minimum level of tax on certain foreign income of MNE group
- While GILTI and GLoBE rules (as described in this Blueprint) have similar purpose and scope, the design of GILTI differs from GLoBE in several important respects
  - GLoBE is generally more permissive than GILTI, including the carry-forward of losses and excess taxes, a broader definition of covered taxes, a carve-out of a broader range of tangible assets, and application with threshold limitations
  - Based on these factors and the pre-existing nature of the GILTI regime, the Blueprint states that "there are reasons for treating GILTI as a qualified income inclusion for purposes of the GLoBE rules provided that the coexistence achieves reasonably equivalent effects"
- Inclusive Framework recognises that an agreement on the coexistence of GILTI and GLoBE would need to be part of the political agreement on Pillar Two

Some final thoughts…

- OECD has said that the Pillar Two minimum tax proposal would contribute the bulk of the new revenue raised worldwide under its digital tax plan
- Negotiators must still land on a minimum tax rate under Pillar Two
- Agreement must also be reached on how the U.S. GILTI version of a minimum tax regime would harmonize with the OECD version
- Target date for Inclusive Framework's "consensus-based solution" – previously set for the end of 2020 – has now slipped to mid-2021
- EU has said that it will move forward with its own digital tax plans if OECD does not reach a deal by the end of 2020, and a number of countries have said that they are considering unilateral measures if agreement cannot be reached