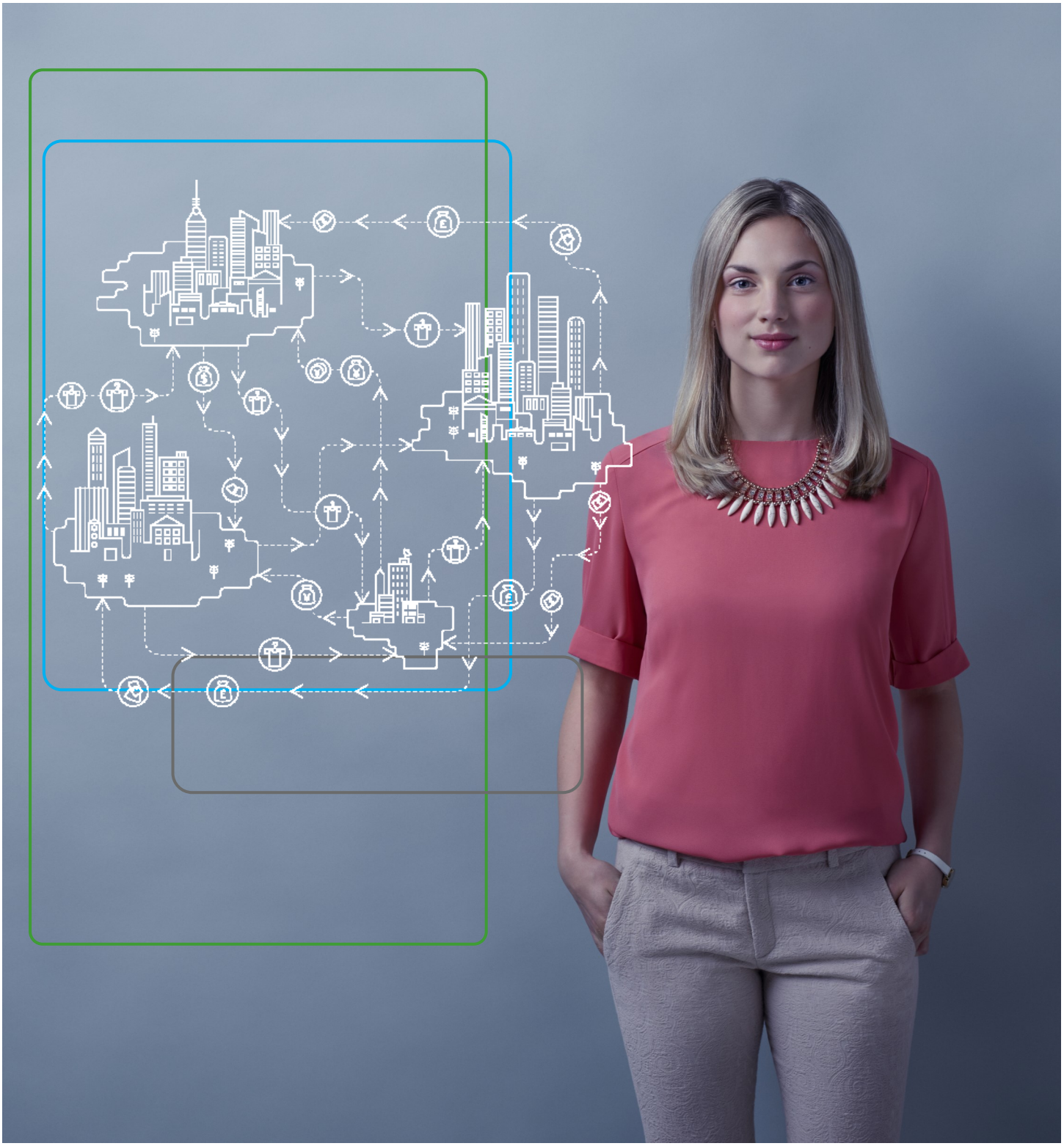

Newsflash:

OECD Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy

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Newsflash

OECD Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy

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1.0 BACKGROUND:

1.1 The practice of shifting legal form or Intellectual Properties by multinational enterprises (MNEs) to low tax jurisdictions or so called "tax havens" has been one of the major economic challenges before governments of various countries in last five decades. Recent years have seen numerous attempts to mitigate such challenges undertaken through multilateral forums through international measures like global standardization and exchange of MNE information, multilayer transfer pricing filings, signing of multilateral instruments, imposing unilateral digital service taxes on digital organizations, etc. Similarly, world economic think tanks like Organization for Economic Co-operation and Development ('OECD'), United Nations (UN), G7 Countries, the European Union etc. over the period have had a special focus on taxing digital technology companies and through various committees, there is continuous research carried out to avoid tax leakage, tax digital income and provide a fair share to respective jurisdictions. The OECD being an institution ascribed by maximum number of tax jurisdictions and having global acceptance has been a flag bearer in steering international tax reforms in the past few decades. OECD considers the shifting of tax base by MNEs and taxation of digital companies as among the major challenges of modern times and over the period has taken many initiatives to attempt to provide a solution to it.

1.2 The key milestones of work done by OECD to address the above issues are as under:

Period	Detail of Events
1996	G7 makes the problems of tax evasion and avoidance a priority
1998	OECD report: Harmful Tax Competition: An Emerging Global Issue
2000-2007	Development of international standards on tax transparency and securing commitments to a global level playing field
2008-2009	Global Financial Crisis – G20 pledge to end bank secrecy and establish the Global Forum on Transparency and Exchange of Information for Tax Purposes
July 2013	G20 identifies tax avoidance as a priority
October 2015	Adoption of the Base Erosion and Profit Shifting (BEPS) package of 15 Action Plans to counter tax avoidance – Action Plan 1 dealt with the tax challenges arising out of the digitalisation of the economy

Period	Detail of Events
June 2016	Establishment of the OECD/G20 Inclusive Framework (IF) on BEPS
2017-2020	Active discussions in the IF on how to address the tax challenges of the digitalisation of the economy culminating with the release of "blueprints" for a two-pillar solution in October 2020.
July 2021	Over 130 countries and jurisdictions join a new two-pillar plan to reform international taxation rules.
October 2021	Further report to the G20 Finance Ministers on the finalisation of the agreement and resolution of technical details.

1.3 On October 8, 2021, there was a further agreement on the outline for the new digital tax rules. Global political consensus was broadly achieved as out of the 140 countries of the IF engaged in negotiations, 136 signed on to the Two-Pillar proposal. Notably, Ireland, Estonia, and Hungary gave their approval after initially staying out of the agreement in July, however Kenya, Nigeria, Pakistan, and Sri Lanka in the end decided not to opt for the measure.

1.4 The proposal follows a general outline that has been under discussion since 2019. There are two "pillars" of the reform: Pillar 1 is focused on enlarging as well as replacing the traditional rule of "nexus" as widely recognized and followed in international tax practice, thereby enabling a jurisdiction to levy income tax on a foreign enterprise dealing with its economy, beyond physical presence; Pillar 2 includes a global minimum tax, with the aim of addressing the remainder of the BEPS challenges. The agreed components of each Pillar are described in the following paragraphs.

2.0 PILLAR ONE:

The design of Pillar One is split into two sections — Amounts A and B. Amount A reallocates a fraction of in-scope residual profit of multinationals toward market jurisdictions. Whereas, Amount B provides an arms-length principle for marketing and distribution function.

2.1 Amount A

- Pillar 1 contains "Amount A" which would apply to companies (referred as 'in scope companies' or 'in scope MNEs') with more than €20 billion in revenues and a profitability above 10%. For such companies, a portion of their profits would be taxed in jurisdictions where they have sales- i.e., 25% of profits above 10% of revenue. After a review period of seven years, the €20 billion threshold may fall to €10 billion.
- Companies in the extractives sector and regulated financial services companies would be excluded. In effect, under Pillar 1, the scope is large enough that encompasses tech/ digital company to conventional brick mortar businesses as well.

2.2 Nexus

A new special-purpose nexus rule will be introduced to permit the allocation of a share of the residual profit i.e., Amount A, to market jurisdictions where an in-scope MNE derives at least €1 million in revenue. In the case of smaller jurisdictions with GDP lower than €40 billion, the nexus threshold will be €250,000.

2.3 Revenue sourcing

Revenue will be sourced to the end market jurisdictions where goods or services are used or consumed. Depending upon the class of transaction detailed source rules will be developed.

2.4 Tax base

The relevant measure of profit or loss of the in-scope MNE will be determined by reference to financial accounting income, with a small number of adjustments. It is also provided that losses will be carried forward.

2.5 Segmentation

Segmentation will occur in exceptional circumstances where, based on the segments disclosed in the financial accounts, a segment meets the scope rules.

2.6 Marketing and distribution profits safe harbor

Where the residual profits of an in-scope MNE are already taxed in a market jurisdiction, a marketing and distribution profits safe harbour will cap the residual profits allocated to the market jurisdiction through Amount A.

2.7 Elimination of double taxation

Double taxation of profit allocated to market jurisdictions will be relieved using either the exemption or credit method

2.8 Tax Certainty

- Statement provides for mandatory and binding dispute prevention and resolution mechanism for 'in scope' companies under Amount A. Disputes from other issues related to Amount A like transfer pricing, business profit arising due to creation of Permanent Establishment (PE) in source jurisdiction are also contemplated to be resolved.
- It also provides elective binding dispute resolution mechanism for jurisdictions with low level MAP cases deferred from MAP peer review.

2.9 Amount B

Pillar 1 also suggests "Amount B" which would provide a simplified mechanism for application of arms-length principle for in country baseline marketing and distribution function.

2.10 Other clarifications

- It is stated that in scope MNEs will be allowed to manage the process through a single entity for Amount B.
- Existing Digital Service Taxes (DST)/ other similar measures would be removed in due course and no such new measures to be introduced further. Further rules to be agreed in this regard.

3.0 PILLAR TWO:

Pillar 2 ensures a global minimum tax rate of 15% on corporate income. It includes two interlocking domestic rules [together known as Global anti-Base Erosion Rules (GloBE) rules] and then a third rule i.e., Subject to Tax rules for tax treaties. The overall design of rules is as under:

Interlocking Domestic Rules / GLoBE Rules	Treaty based Subject to Tax Rule (STTR)
Income Inclusion Rule (IIR) A top-up tax in the hands of parent entity in respect of low taxed income of constituent entity	Source jurisdiction is allowed to impose limited source taxation (withholding tax) at the rate of 9% in relation to certain related party payments[1]
Undertaxed Payment Rule (UTPR) If any constituent entity is not subject to IIR, then UTPR will deny deductions or makes an equivalent adjustment on low taxed Income	

3.1 Minimum Tax Rate

The Minimum tax rate for IIR and UTPR is 15% and for STTR its 9%.

3.2 Scope of Pillar two

- The GloBE rules will apply to MNEs that meet the €750 million annual revenue threshold as determined under BEPS Action Plan 13 (country by country reporting). Countries are free to apply the IIR to MNEs headquartered in their country even if they do not meet the threshold.
- Government entities, international organisations, non-profit organisations, pension funds or investment funds that are Ultimate Parent Entities (UPE) of an MNE Group or any holding vehicles used by such entities, organisations or funds are not subject to the GloBE rules.
- It is pertinent to note that the Statement does not mention about applicability of STTR rules. Further, STTR is not based on effective tax rate of overall entity and same is applicable on transaction level. Accordingly, this may be applicable to all MNEs.

[1] Intragroup payments in the nature of interest, royalties, franchise fees, fees for use of intangibles in combination with services, insurance or reinsurance premiums, guarantee, brokerage or financing fees, rent or other payments for use of movable property and payments for supply of marketing, procurement, agency or other intermediary services may be

3.3 Rule status of GLoBE

The GloBE rules will have the status of a common approach. This means that IF members:

- are not required to adopt the GloBE rules, but, if they choose to do so, they will implement and administer in consistent with the outcomes provided under Pillar Two;
- accept the application of the GloBE rules applied by other IF members

3.4 Carve Out and Exclusions

The GLoBE Rules are subject to below carve out and exclusions

- GLoBE Rules provide for exclusion of an amount of income that is 5% of carrying value of tangible assets and payroll[2].
- GLoBE rule provides exclusion of jurisdictions where MNEs has revenue of less that €10 million and profit of €1 million.
- GLoBE rules will not apply in case of MNEs earning income from international shipping.
- UTPR provides an exclusion for MNEs who have a maximum of €50 million tangible assets abroad and that operate in no more than 5 other jurisdiction. The exclusion is limited to five years after MNEs come into GLoBE rules scope.

3.5 Other Clarifications

- IIR allocates top-up tax based on top down approach subject to split ownership rule for shareholding below 80%;
- GLoBE rules will operate to impose top up tax using effective tax rate (ETR). ETR would be computed on jurisdictional basis and that uses a common definition of covered taxes and a tax base determined by reference to financial accounting income, with certain adjustments;
- GLoBE rules implementation framework will include safe harbours and/or other mechanisms for easy compliance and administration;
- US GILTI regime will co-exist with the GloBE rules

3.6 Implementation of two pillar solution

The statement provides that two pillar solutions will be implemented through a multilateral convention (MLC), which will be developed to introduce multilateral framework for all jurisdiction irrespective of the fact they have tax treaties or not. In the Annexure to the statement, detailed implementation plan with respective mandated authority, timelines etc. is provided. The timelines aim for implementation of Amount A under Pillar 1 is 2023. With respect to Amount B effective date is not provided, however it is mentioned that final deliverables to be released by the end of 2022. Pillar two is also aimed to be effective from 2023 with UTPR coming into effect in 2024.

[2] In a transition period of 10 years, the amount of Income excluded will be 8% of carrying value of tangible assets and 10% of payroll, declining annually by 0.2 percentage points for the first five years and 0.4% for the tangible assets and 0.8% points for payroll for the last 5 years.

4.0 OUR COMMENTS:

4.1 Basis the OECD statement in July 2021, under Pillar One, taxing rights of more than USD 100 billion of profits are expected to be reallocated to market jurisdictions each year. With respect to Pillar Two, with a minimum rate of at least 15%, the global minimum tax is estimated to generate around USD 150 billion in additional global tax revenues per year.

4.2 Basis the current framework, Pillar 1 is expected to be applied to approx. 100 companies only globally and Pillar 2 may apply to only few companies in India; therefore, the immediate impact from an India standpoint appears to be limited. On the other hand, as an IF member and a signatory to the Two-Pillar Statement, India may need to repeal digital tax measures like equalization levy and possibly significant economic presence provisions in due course. Whereas this may be a good measure on an overall basis, it may take away rights to tax smaller MNEs which are currently covered under equalization levy in India, as India has provided threshold for applicability of EL at INR 20 million only. Therefore, from Indian standpoint, it may require further deliberation.

4.3 Pertinently, in April 2021, UN Model Tax Convention incorporated Article 12B to provide taxation of automated digital service by withholding taxes on payments made for digital services. Article 12B is based on conventional source-based taxation as compared to Pillar One by IF which involves lots of complexities in deriving formula and source nexus for allocation of tax between tax jurisdictions. Further, Article 12B provides treaty negotiation between two assenting jurisdictions and has an edge in terms of simplification, administration, limited scope to only automated business etc. Article 12B does not prescribe a high in-scope threshold as provided under Pillar 1 and leaves it to taxing jurisdiction to negotiate; thus providing an upper hand to developing economies, who are generally importer of technologies. The Article has been already incorporated in UN Model, however with the proposed model by OECD with blessings of around 136 countries, fate of UN proposals is not clear.

4.4 The formula-based approach under the Two-Pillar solution overrides traditional transfer pricing rules as reallocation of profits to market jurisdiction is not envisaged under conventional methods, and also prescription of safe harbour rules for marketing and distribution function could potentially dilute transfer pricing principles.

4.5 Completion of the above proposals by 2023 appears to be enormous task considering numerous open ended items. Countries like India may need to evaluate the efforts involved in achieving a consensus on the proposed rules vis-à-vis likely gains resulting from same and also considering the impact of removal of equalization/ other similar measures, which again is a matter of further discussion. In any case, one can expect further changes in the rules before they are finally implemented and therefore it is important to 'wait and watch' the developments with keen eyes.

For further information please contact:

RSM Astute Consulting Pvt. Ltd.

8th Floor, Bakhtawar, 229, Nariman Point, Mumbai - 400021.

T: (91-22) 6108 5555/ 6121 4444
F: (91-22) 6108 5556/ 2287 5771

E: emails@rsmindia.in

W: www.rsmindia.in

Offices: Mumbai, New Delhi - NCR, Chennai, Kolkata, Bengaluru, Surat, Hyderabad, Ahmedabad, Pune, Gandhidham, and Jaipur.

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