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The OECD/G20's Inclusive Framework Agreement on Global Tax Reform

A Guide to the Statement on a Two-Pillar Solution, Published on October 8, 2021

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Background to the Inclusive Framework and the Two-Pillar Solution to Global Tax Reform

- The OECD/ G20 Inclusive Framework (“**IF**”) is a group of 140 countries looking at fundamental changes to the taxation of large multinational enterprises (“**MNEs**”), affecting the manner, and the countries, where they will pay tax in the future.
- Years of work by the IF are now reaching their conclusion – the principles of a two-pillar approach have finally been agreed by 136 of the IF countries (including all the OECD and G-20 countries).
- Pillar One focuses on nexus and profit allocation for the largest companies in the world, allowing market jurisdictions to tax more of their profits.
- Pillar Two consists of:
  - global anti-base erosion (“**GloBE**”) rules designed to ensure that international businesses pay a minimum level of tax wherever they are headquartered or have their operations
  - a “subject to tax” rule (“**STTR**”) to allow source jurisdictions to impose withholding tax on related-party payments that are subject to income tax below a minimum rate
- The agreement – announced on October 8, 2021 – will be delivered to the G-20 finance ministers for approval during their October 13th meeting in Washington D.C., and then presented to the G-20 Leaders Summit in Rome on October 30-31.

The Inclusive Framework Agreement: What Was Announced on October 8, 2021?

- The October 8 announcement builds on discussion-draft "blueprints" for the two pillars that were published in October 2020 (the "**2020 Blueprints**"), and a high level agreement on certain key components that was reached by 134 members of the IF on July 1, 2021 (the "**July 2021 Agreement**").
- It reflects additions, modifications and clarifications to the July 2021 Agreement, and consists of the following publications:
  - A five page "Statement on a Two-Pillar Solution to Address the Tax Challenges of the Digitalisation of the Economy" (the "**October 2021 Statement**"), with a two page Annex containing a "Detailed Implementation Plan" [Link here]
  - Three pages of FAQs [Link here]
  - A 22-page highlights brochure which includes the above and some supporting commentary [Link here]
- Much of the detail remains outstanding, and implementation challenges remain, but this nonetheless represents a clear breakthrough.
- The remaining slides in this deck set out the main things you need to know about the contents of, and the omissions from, the October 2021 Statement.

The October 2021 Statement
Pillar One

Entities in scope

- MNEs – excluding extractives/ mining companies and regulated financial services companies – with global turnover above €20 billion and profitability (i.e., profit before tax/revenue) above 10%.
- The turnover threshold may be reduced to €10 billion, contingent on successful implementation of the new rules, with a review beginning seven years after coming into force.
- Segmentation of businesses can occur, but only in exceptional circumstances.

The October 2021 Statement
Pillar One

What the rules will do

- 25% of residual profit (i.e., profit in excess of 10% of revenue) will be allocated to market jurisdictions, with nexus determined using a revenue-based allocation key.
- Revenue will be sourced to the end market jurisdictions where goods or services are used or consumed, with detailed source rules (yet to be developed) for specific categories of transactions.
- As a secondary measure, the application of the arm's length principle to in-country baseline marketing and distribution activities will be simplified and streamlined.

The October 2021 Statement
Pillar One

Next steps, per the Detailed Implementation Plan

- A multilateral treaty and model domestic rules for the allocation of residual profit will be available by mid-2022, with the rules coming into effect in 2023.
- Rules for the secondary measure relating to in-country marketing and distribution will be finalised by the end of 2022.

The October 2021 Statement
Pillar One

Key takeaways

- Pillar One residual profit allocation will be highly complex, but only the world's very largest MNE groups (or business segments) will be affected.
  - Only about 100 companies are thought to be in scope (the turnover threshold is above €20 billion).
- A significant collateral part of the package agreed by the IF members is to remove all existing digital services taxes ("**DSTs**") and similar measures, and not to introduce any more in future.
  - This would require the removal of unilateral DSTs in countries such as the UK, France, Italy and Spain.
  - It remains unclear whether this puts an end to the Digital Levy being contemplated by the EU.

The October 2021 Statement

Pillar Two GloBE Rules

What the GloBE rules will do

- An income inclusion rule ("**IIR**") will require the parent of a multinational group to apply a top-up tax to income of a subsidiary that is taxed in the subsidiary's jurisdiction at below the GloBE rule minimum effective tax rate **("ETR").**
  - Special rules will apply if a parent owns less than 80% of a subsidiary.
- An undertaxed payments rule ("**UTPR**") will apply when a payor makes a payment to an entity whose income is not subject to tax at a rate of at least the minimum ETR (after taking into account any IIR top-up tax imposed on that income).
  - It will operate by denying a deduction for the payment, or requiring an equivalent adjustment.

The October 2021 Statement
Pillar Two GloBE Rules

Entities in scope

- Members of MNE groups that have at least €750 million annual consolidated group revenue (i.e., the same groups subject to country-by-country reporting).
  - Excludes government entities, international organisations, non-profit organisations, pension funds and investment funds that are ultimate parent entities of an MNE Group (and any holding vehicles used by such entities, organisations or funds).
- Countries are free to apply the IIR to MNE groups headquartered in their country that do not meet the threshold.
- Time-limited exclusion from the UTPR:
  - Applies to MNEs in the initial phase of their international activity.
  - Requirements: a maximum of €50 million tangible assets outside home country and operating in five or fewer jurisdictions outside home country.

The October 2021 Statement
Pillar Two GloBE Rules

The effective tax rate

- The October 2021 Statement confirms that the minimum ETR will be fixed at 15%.
  - This is a notable departure from the July 2021 Agreement which had referred to a minimum ETR of "*at least* 15%".
- We anticipate that the ETR itself will be calculated by
  - dividing "adjusted covered taxes" by "adjusted GloBE income" – this is the formula contemplated in the 2020 Blueprint.
- The October 2021 Statement clarifies that:
  - Calculations will be performed on a jurisdictional basis (i.e., no global blending).
  - The computation will involve a common definition of the relevant "covered" taxes.
  - The income component will be determined by reference to financial accounting income.
  - Adjustments will be made for consistency with tax policy objectives and there will be mechanisms to address timing differences.

The October 2021 Statement
Pillar Two GloBE Rules

Carve-outs and exclusions:

- The IIR top-up tax requirement will not apply to an amount of income that is 5% of the carrying value of tangible assets and payroll. (This is like the QBAI rule under the current U.S. GILTI regime.)
  - For an initial 10 year transition period, the amount of income excluded will be
    - 8% of the carrying value of tangible assets and 10% of payroll, declining annually by 0.2 percentage points for the first five years, and by 0.4 percentage points for tangible assets and by 0.8 percentage points for payroll for the last five years.
  - This carve-out could be effected in a simple manner by solely reducing the denominator of the ETR calculation (i.e., "the adjusted GloBE income"), but the 2020 Blueprint left open the possibility of a corresponding and proportional adjustment to the numerator as well (i.e., "adjusted covered taxes").
    - These computational issues are not addressed in the October 2021 Statement.

The October 2021 Statement
Pillar Two GloBE Rules

Carve-outs and exclusions (contd.)

- There will be a de minimis exclusion for jurisdictions where the MNE has revenues of less than €10 million and profits of less than €1 million.
- There will be an exclusion for international shipping income.
- Where a country has a "distribution tax system" (i.e., an income tax regime that imposes tax on a corporation when its income is distributed to its shareholders, rather than when it is earned), a mechanism will be introduced so that there is no top-up IIR liability if earnings are distributed within four years and taxed at or above the minimum ETR.
  - The 2020 Blueprint contemplates a system to achieve this by (broadly speaking) allowing the corporation to increase its "adjusted covered taxes" for a year by the amount of the distribution tax that would be due on its income for the year, with a recapture to the extent the distribution tax is not actually paid within the four year period.

The October 2021 Statement
Pillar Two GloBE Rules

Next steps, per the Detailed Implementation Plan

- Model rules to give effect to the GloBE rules will be developed by the end of November 2021.
  - They will define the scope and set out the mechanics of the GloBE rules, including rules for determining the ETR on a jurisdictional basis and the relevant exclusions (such as the carve-out based upon tangible assets and payroll).
  - They will also cover administrative provisions that address an MNE's filing obligations and the use of any administrative safe harbors.
  - They will include transition rules and will be supplemented by commentary that explains the purpose and operation of the rules and addresses the need for a "switch-over rule" to permit the proper application of the IIR in certain circumstances where a treaty or other rule would exempt the profits of a permanent establishment from taxation.
- IF members are expected to bring the rules into law in 2022, with the IIR to be effective in 2023 and the UTPR to be effective in 2024.

The October 2021 Statement
Pillar Two GloBE Rules

Implementation of the GloBE rules in different countries

- The October 2021 Statement confirms that IF members are not required to adopt the GloBE Rules.
  - However, if a country *does* adopt the GloBE rules, it will have to implement and administer the rules in a way that is consistent with the Pillar Two outcomes.
- The October 2021 Statement also confirms that, in any event, IF members are required to accept the application of the GloBE rules applied by other members, including agreement as to rule order and the application of any agreed safe harbours.

The October 2021 Statement
Pillar Two GloBE Rules

Implementation of the GloBE rules in different countries, ***cont'd***

- How these rule will interact with the existing GILTI and BEAT regimes in the U.S. remains unclear.
  - The U.S. is currently considering modifications to both of those regimes, some of which would bring the regimes closer to the GloBE rules.
- The October 2021 Statement includes the paragraph below. It is somewhat vague but seems to be suggesting that there will be a move to accommodate the U.S. rules, despite design differences, so long as this results in a fair outcome:

  "*It is agreed that Pillar Two will apply a minimum rate on a jurisdictional basis. In that context, 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.*"

The October 2021 Statement
Pillar Two GloBE Rules

What do we still not know?

- The components of the ETR computation, and the required adjustments to those components, remain to be confirmed.
  - In particular more details are required about the way timing differences will be addressed, the treatment of carried forward losses (including pre-regime losses), and the treatment of excess taxes in a jurisdiction for a year.
- Certain unspecified safe harbors and/or other mechanisms are to be introduced:

  "*to ensure that the administration of the GloBE rules are as targeted as possible and to avoid compliance and administrative costs that are disproportionate to the policy objectives*".
- Clarification is required about how the GILTI and BEAT regimes in the U.S. will co-exist with the GloBE rules, particularly if the U.S. seeks to use a rate other than 15% in the case of either or both rules.

The October 2021 Statement
Pillar Two GloBE Rules

Key takeaways

- The GloBE rules will affect many multinational groups.
- Although headline items (like the agreed minimum ETR of 15%) have now been confirmed, much of the detail remains unclear.
  - Particular gaps relate to the computation of the ETR and the nature of the safe harbors.
- The model rules that are supposed to be released by the end of November 2021 will accordingly need to address more than just fine tuning. They will be complex and taxpayers will need to read them closely.
- Taxpayers should also focus on the progress of amendments to the GILTI and BEAT regimes in the U.S., and how the GloBE rules develop to accommodate them.

The October 2021 Statement
Pillar Two STTR

What the rule will do

- IF members with nominal corporate income tax at rates below 9% will be required to implement a new rule into their bilateral treaties with developing country IF members – if requested by those countries to do so – permitting the imposition of source-based withholding taxation in the other country on related-party interest, royalties and certain other payments.
  - Developing countries are defined as countries with a GNI per capita, calculated using the World Bank Atlas method, of USD12,535 or less in 2019 (to be regularly updated).
- The amount of tax that the source country will be permitted to impose will be the difference between the 9% rate and the actual tax rate on the payment.
- Tax imposed under the STTR will be creditable as a covered tax under the GloBE rules.

The October 2021 Statement
Pillar Two STTR

Next steps, per the Detailed Implementation Plan

- A model treaty provision to give effect to the STTR will be developed by the end of November 2021, together with commentary that explains the purpose and the operation of the STTR.
- A multilateral instrument will be developed by mid-2022 to facilitate implementation in relevant bilateral treaties.
- The reason for the two separate processes may be to address both new treaties and existing treaties, although this is not clear.
- There are various other open details, such as what happens if a treaty country ceases to be a "developing country". These will hopefully be resolved in the model treaty and the accompanying commentary.