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136 countries agree to OECD/G20 Inclusive Framework's two-pillar solution to international tax reform

OCTOBER 12, 2021 9 MIN READ

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The international tax landscape for some multinational enterprises (MNEs) is changing — probably. But many details remain to be worked out and political uncertainty (particularly in the United States) still must be navigated for a deal that aims to raise approximately US$150 billion a year from MNEs and reallocate some additional taxing rights to market jurisdictions.

The OECD and G20 have been working for the past two years on a two-pillar approach to international tax reform to address the taxation of the digital economy and unresolved BEPS issues. On October 8, 2021, 136 countries of the OECD/G20 Inclusive Framework announced that they have agreed to this two-pillar solution [PDF] (the Statement). The Statement largely confirms the elements laid out in their July 1, 2021, statement, with some added details, but there is still significant further detail to come. For a discussion on the July 1, 2021, statement, see our Osler Update and our submission to the OECD [PDF] on the blueprint reports on Pillar One and Pillar Two.

The changes to implement Pillar One would be done primarily through a to-be-developed multilateral convention (MLC) to be signed in mid-2022 and to come into effect in 2023. Rules to give effect to the Pillar Two changes are to be developed by the end of November 2021, with an additional multilateral instrument to be developed by mid-2022 and an implementation framework by the end of 2022.

Pillar One

The three key elements of Pillar One remain the same: a new taxing right for market jurisdictions (where customers are located) to obtain a share of residual profit of an MNE (Amount A), the calculation of a fixed return for certain baseline and marketing and distribution activities in jurisdictions where an MNE has a physical presence (Amount B), and dispute prevention and resolution mechanisms (referred to by the OECD as Tax Certainty).

The scope of MNEs targeted remains the same as previously announced in July 2021 and is focused on the largest and most profitable MNEs (having moved away from the concept of applying the rules only to digital businesses or consumer-facing businesses). The following rules apply (the first three of which are the same as in the July 2021 statement):

- MNEs will be in-scope if they have global turnover above €20 billion and profitability above 10%, with the revenue threshold to be reduced to €10 billion pending successful implementation (determined 7–8 years after Pillar One comes into effect), including with respect to tax certainty on Amount A.

- Profits and losses are to be measured by reference to financial accounting income, with a small number of adjustments. Losses will be carried forward (although it is unclear whether the carry-forward period will be indefinite).
- Segmentation will occur only in exceptional circumstances where, based on the segments disclosed in the financial accounts, a segment meets the scope rules.
- 25% of residual profit (defined as profit in excess of 10% of revenue) will be allocated to market jurisdictions with sufficient nexus (measured using a revenue-based allocation key). The July 2021 statement had specified a 20%–30% range.

The special purpose nexus rule remains as previously announced to determine whether an MNE has a sufficient nexus such that Amount A must be calculated for that jurisdiction — at least €1 million in revenue from that jurisdiction (or €250,000 for jurisdictions with GDP below €40 billion).

The Statement does not, however, provide any additional guidance on how to calculate revenue sourcing except to say that detailed rules will be developed.

The previously announced marketing and distribution profits safe harbour to apply where the residual profits of an in-scope MNE are already taxed in a market jurisdiction remains part of the framework, but no further details were included.

Double taxation is to be eliminated through either the exemption or credit method, with the entity (or entities) earning residual profit bearing the tax liability for Amount A.

The Statement does not provide any further details on the mandatory and binding dispute prevention and resolution mechanisms contemplated to avoid double taxation for Amount A. The Statement confirms that the dispute prevention and resolution mechanism will be elective for developing countries that are eligible for deferral of BEPS Action 14 peer reviews and have no or low levels of mutual agreement procedure (MAP) disputes.

The carrot offered up to MNEs as part of this new framework is that the MLC will require countries to remove all digital services taxes and other relevant similar measures, and to commit not to introduce such measures in the future. The parties committed not to impose any new digital services taxes or other relevant similar measures from October 8, 2021, until the earlier of December 31, 2023, or the coming into force of the MLC. The details as to exactly which taxes meet the digital services tax definition are not specified and the timing and method for removing existing taxes is not specified.

Shortly after the release of the Statement, Chrystia Freeland, Canada's Deputy Prime Minister and Minister of Finance, stated that "[t]o ensure that Canadians' interests are protected in any circumstance," the Canadian government intends to move forward with its digital services tax proposal outlined in its 2021 budget (to be imposed as of January 1, 2024). However, the Minister acknowledged the tax would only be applied if the OECD/G20 proposal were not implemented, noting that "[i]t is our sincere hope that the timely implementation of the new international system will make this unnecessary." Legislation to implement Canada's digital services tax will be released in 2021 — so that the tax will apply retroactively back to January 1, 2022, if the global agreement does not come into force by January 1, 2024.

All eyes will be on the United States' desire and ability to enact the Pillar One proposals in a timely manner. While the current U.S. administration has backed the proposals, getting them through the U.S. Congress will likely be difficult. Failure by the United States to enact the proposals would significantly raise the risk to the global deal.

Pillar Two

The Pillar Two proposals (also referred to as the GloBE proposal) remain largely the same as in July 2021 with some additional detail and minor variation. The proposals consist of

- Two domestic rules:
  - an income inclusion rule (IIR), which would impose current taxation on the income of a foreign-controlled entity (or foreign branch) if that income was otherwise subject to an effective tax rate that is below a certain minimum rate;
  - an undertaxed payments rule (UTPR), which would either deny a deduction or require an equivalent adjustment on base eroding payments unless the payments are subject to tax at or above a specified minimum rate in the recipient's jurisdiction; and
- A treaty-based rule, known as the subject to tax rule (STTR), which would allow source countries to impose withholding taxes on certain related party payments (particularly interest and royalties) that are subject to tax below a minimum rate in the recipient jurisdiction. The Statement also indicates that the STTR taxes will be creditable as a covered tax under the GloBE rules.

While the previous statement had indicated the global minimum tax rate would be *at least* 15% on a country-by-country basis, the Statement confirms that the rate will be 15%. (This was a key concession to getting Ireland on board with the proposals.)

The Statement contemplates Pillar Two having the status of a "common approach" whereby members are not required to adopt the Pillar Two Measures, but if they do, they will implement and administer the rules in a manner consistent with the outcomes provided for under Pillar Two. If an MNE is not subject to the agreed-upon minimum rate in a particular state, then another state (e.g., where a parent entity is located) would have the right to collect additional tax from the parent entity up to the minimum rate.

With respect to the scope of Pillar Two, the Statement confirms

- The new rules will apply to MNEs that meet the €750-million threshold used for purposes of country-by-country reporting (CbCR). Countries are free to apply the IIR to MNEs headquartered in their country even if they do not meet the threshold.
- There will be a formulaic substance carve-out that will exclude an amount of income that is 5% of the carrying value of tangible assets and payroll in a jurisdiction, and a *de minimis* exclusion (where the MNE has revenues of less than €10 million and profits of less than €1 million). A transition period of 10 years will exclude 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. In addition, a carve-out will be provided for international shipping income.
- An exclusion from the UTPR for 5 years for MNEs in the initial phase of their international activity, defined as those MNEs that have a maximum of €50 million of tangible assets abroad and that operate in no more than 5 other jurisdictions.

Exclusions are contemplated for government entities, international organisations, non-profit organisations, pensions funds and investment funds that are the ultimate parent of the

group or any holding vehicles used by such entities, organisations or funds.

According to the Statement, the calculation of the effective tax rate in a jurisdiction (which will drive the application of Pillar Two) will use a common definition of covered taxes and a tax base determined by reference to financial accounting income (with agreed adjustments consistent with the tax policy objectives of Pillar Two and mechanisms to address timing differences).

The Statement also specified that the minimum rate for the STTR will be 9% (the prior statement had indicated a range of 7.5% to 9%).

While the Statement acknowledges the need to clarify the interaction between the GloBE and the U.S. GILTI rules, details surrounding how the rules will co-exist remain outstanding. These details are needed to address important issues such as which regime will take priority where, for example, a low-taxed subsidiary is owned by a U.S. corporation that in turn is owned by a corporation in a jurisdiction that adopts Pillar Two.

Next steps

The Statement contains an appendix setting out an implementation timeline covering both Pillars, and is expected to be ratified by the G20 leaders in Rome at the end of the October 2021.

Pillar One

The MLC will be developed which will contain the rules necessary to determine and allocate Amount A and to eliminate double taxation, as well as the simplified administration process, the exchange-of-information process and the processes for dispute prevention and resolution.

The MLC will be supplemented by an Explanatory Statement that describes the purpose and operation of the rules and processes.

The OECD/G20 Inclusive Framework is targeting to have the text of the MLC and the Explanatory Statement by early 2022, with a goal of a signing ceremony by mid-2022 and an objective of the MLC entering into force in 2023, once a critical mass of jurisdictions have ratified it.

The Statement acknowledges that changes to domestic law may be necessary to implement the Pillar One proposals. Model rules (along with a commentary) will be developed by early 2022.

Pillar Two

Model rules to give effect to the domestic GloBE rules and the STRR will be developed by the end of November 2021.

A multilateral instrument (MLI) will be developed by mid-2022 to facilitate the implementation of the STTR in relevant bilateral treaties.

By the end of 2022, an implementation framework will be developed that facilitates the coordinated implementation of the GloBE rules. This implementation framework will cover

agreed administrative procedures (e.g., detailed filing obligations and multilateral review processes) and safe-harbours to facilitate both compliance by MNEs and administration by tax authorities, and may include a multilateral convention in order to further ensure co-ordination and consistent implementation of the GloBE rules.

For further information on these international tax developments and how they may impact Canadian businesses (or other tax matters), please contact any member of our National Tax Group.