TEI-SJSU High Tech Tax Institute

OECD Pillars One & Two – What Should Tech Companies Focus On?

Speakers

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Agenda

- BEPS 2.0 Timeline
- Pillar One
  - Overview of Rules
  - Impact on Tech Companies
- Pillar Two
  - Overview of Rules
  - Impact on Tech Companies
- Q&A

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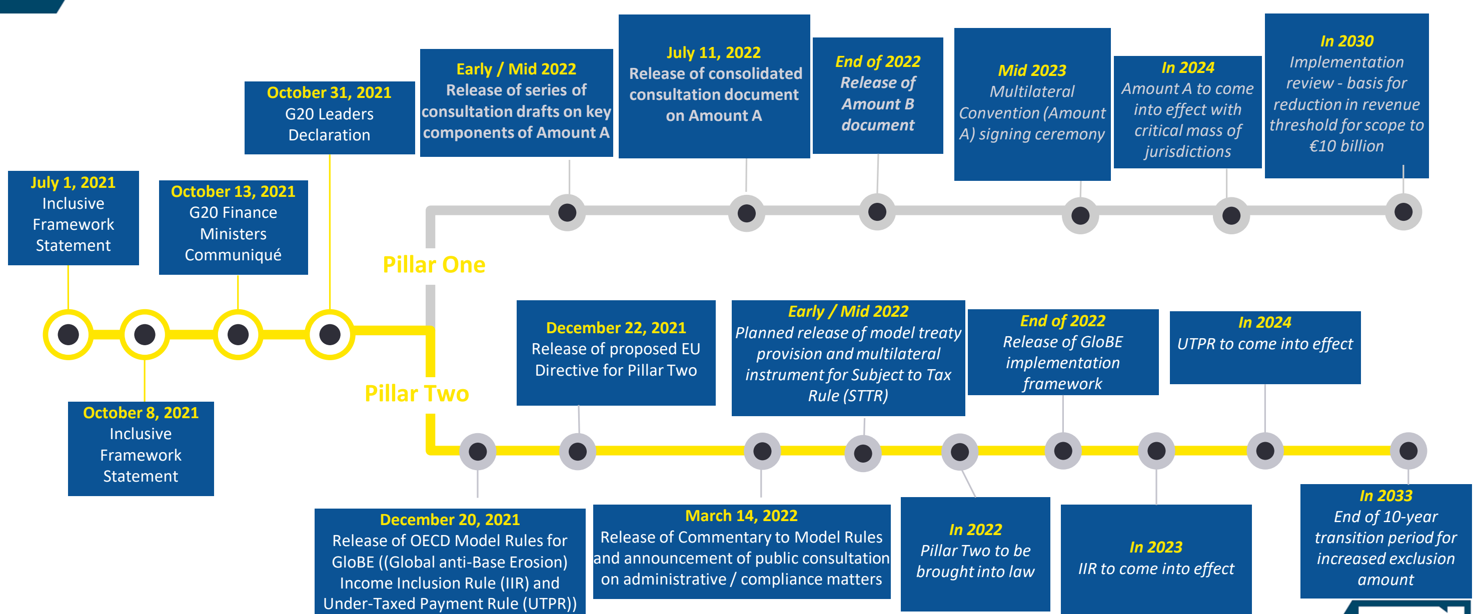
BEPS 2.0 timeline – To date and as planned



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Pillar One

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OECD/G20 Base Erosion and Profit Shifting Project

Progress Report on Amount A of Pillar One

TWO-PILLAR SOLUTION TO THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY

Public consultation
11 July – 19 August 2022

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BETTER POLICIES FOR BETTER LIVES

Source: progress-report-on-amount-a-of-pillar-one-july-2022.pdf (oecd.org)

- Title 1: Scope
  - Schedule A: Supplementary provisions for scope
  - Schedule B: Exclusion of Revenues and profits of a Qualifying Extractives Group
  - Schedule C: Exclusion of Revenues and profits from Regulated Financial Services
  - Schedule D: Covered Segment
- Title 2: Charge to tax
- Title 3: Nexus and revenue sourcing rules
  - Schedule E: Detailed revenue sourcing rules
- Title 4: Determination and allocation of taxable profit
  - Schedule F: Asset Fair Value or Impairment Adjustments
  - Schedule G: Acquired Equity Basis Adjustments
  - Schedule H: Transferred Losses
- Title 5: Elimination of double taxation with respect to Amount A
  - Schedule I: Elimination tax base
  - Schedule J: Elimination of double taxation - Return on Depreciation and Payroll
- Title 6: Administration
- Title 7: Definitions

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Revenue Sourcing Rules Initial Observations

- Transaction-by-transaction basis has been taken out
- Transition rule (Section 11 of Schedule E) - first three periods
  - Finished goods
  - Component allocation key
  - Services allocation key
- Additional guidance will be provided in Commentary or Conference of the Parties
- Special rules for sales of finished goods through an independent distributor
- Distinction between B2C services and B2B services has been removed
- Components still sourced to place of delivery of finished goods to final customer
- Cargo Transport services split 50/50 between origin and destination
- Intellectual property (IP) services: category added for IP relating to finished goods

Reliable Method: Indicators or Allocation Keys

- Reliable indicators:
  - Enumerated Reliable Indicator
  - Another Reliable Indicator
  - New: Alternative Reliable Indicator
- Alternative Reliable Indicator
  - Part of advance certainty
- *Use of allocation keys if no* ***Enumerated Reliable Indicator*** *is available*

- Allocation keys:
  - Regional allocation key
  - Global Allocation key
  - Aggregate Headcount Allocation key
  - Low Income Jurisdiction Allocation Key
  - Specific allocation keys
    - Component Allocation Key
    - Service Allocation Key
    - Transportation specific

Marketing and Distribution Safe Harbor (MDSH)

- The 2020 Blueprint considered alternative approaches to mitigate "double counting"
- The 2021 October statement announced the development of a MDSH
- Title 4 presents a possible mechanism for a MDSH, capping the Amount A allocated to a jurisdiction
- Key aspects are still under development, including
  - Specific metrics to identify residual profits in a market country
  - The portion of that residual profits that will offset (and reduce) Amount A allocations, and
  - The interaction of this adjustment with the elimination of the double taxation mechanism
- It seems that the MDSH for a Jurisdiction does not affect the Elimination Profit of that Jurisdiction for the elimination of double taxation

MDSH: Profit allocation and safe harbor adjustment

Profit allocation

- $Q = (P - R \times 10\%) \times 25\% \times \frac{L}{R}$
- The amount of profit of the Covered Group allocated to a jurisdiction for a Period (Q) is equal to
  - The difference between
    - The Adjusted Profit Before Tax of the Covered Group for a Period (P) and
    - The Revenues of the Covered Group for a Period (R) times a profitability threshold of 10%
  - Times a reallocation percentage of 25% times the ratio of the Revenues arising in the jurisdiction (L) to the Revenues of the Covered Group (R)

Safe Harbor Adjustment

- $M = (MIN((EP-PEP) \times [Y\%], Q))$
  - M shall be deducted from the amount of profit allocated to a Jurisdiction
  - EP: the Elimination Profit of the Covered Group in the Jurisdiction
  - PEP: Portion of Elimination Profit of the Covered Group in the Jurisdiction which would result in [a Return on Depreciation and Payroll of the Covered Group in the Jurisdiction equal to the higher of
    - The Elimination Threshold Return on Depreciation and Payroll of the Covered Group; or
    - 40 per cent]
  - Y: the offset percentage (the portion of a Jurisdiction's residual profits (i.e. EP-PEP) that is eligible for offset under the MDSH mechanism
  - Q: the amount of profit of the Covered Group allocated to the Jurisdiction for a Period
  - MIN(,) means that M, the amount of the adjustment, is the lower of (EP–PEP) × Y% or Q

Elimination of Double Taxation

Step	Description
Identify Specified Juridictions	► Identify the smallest group of Jurisdictions with respect to which the aggregate Elimination Profit totals at least 95% of a Covered Group's total Elimination Profit ► Add each other Jurisdiction with respect to which the Elimination Profit > EUR 50 million
Tier 1	► Identify Specified Jurisdictions with an Adjusted Jurisdictional Return on Depreciation and Payroll that is > 1500% of the Group's Return on Depreciation and Payroll ► Apply the waterfall method
Tier 2	► Identify Specified Jurisdictions with an Adjusted Jurisdictional Return on Depreciation and Payroll that is > 150 % of the Group's Return on Depreciation and Payroll ► Apply the proportionate method

Tier 3A	► Identify Specified Jurisdictions with an Adjusted Jurisdictional Return on Depreciation and Payroll that is
	  ► > the Elimination Threshold Return on Depreciation and Payroll of the Covered Group
	  ► > 40 %
	► Apply the proportionate method

Tier 3B	► Identify Specified Jurisdictions with an Adjusted Jurisdictional Return on Depreciation and Payroll that is > the Elimination Threshold Return on Depreciation and Payroll of the Covered Group ► Apply the proportionate method

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Determination of tax base and elimination profit: initial observations

- Book-to-tax differences:
  - Group level: Adjusted Profit before tax of a Group
  - Entity level: Adjustments to determine Elimination Profit
  - Pillar One harmonized with Pillar Two GloBE Model Rules
    - Some differences (e.g., Tax Expense)
    - Direct references to GloBE Model Rules, although in minimal instances (e.g., LTE, HTE)
    - Pillar 2 data points plus many more

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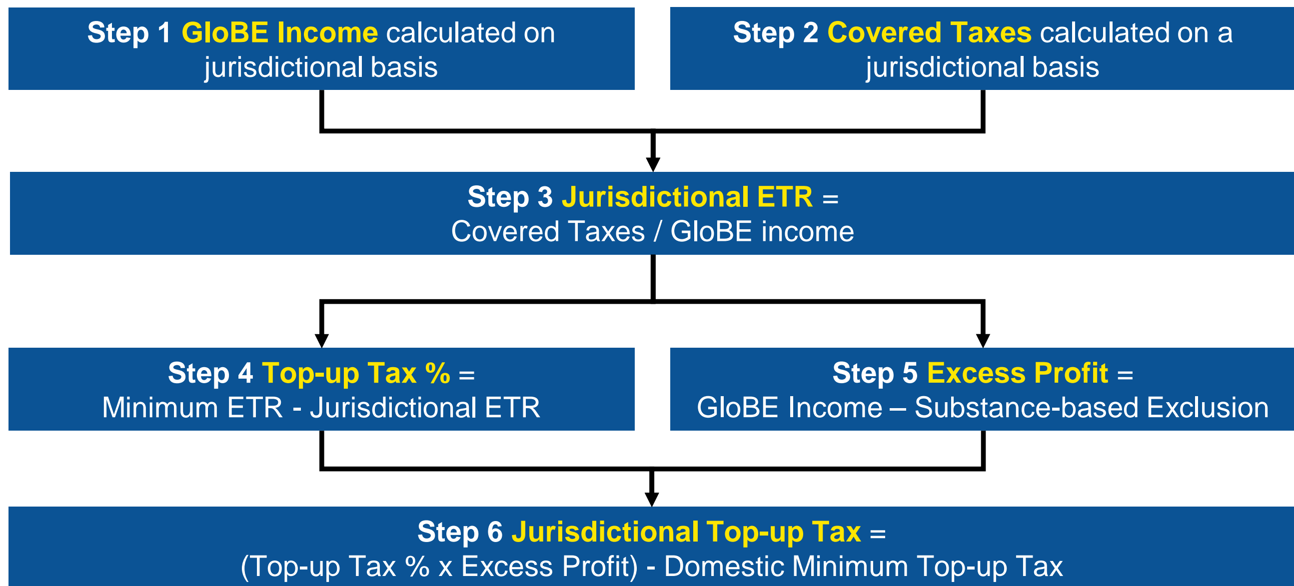
Pillar Two

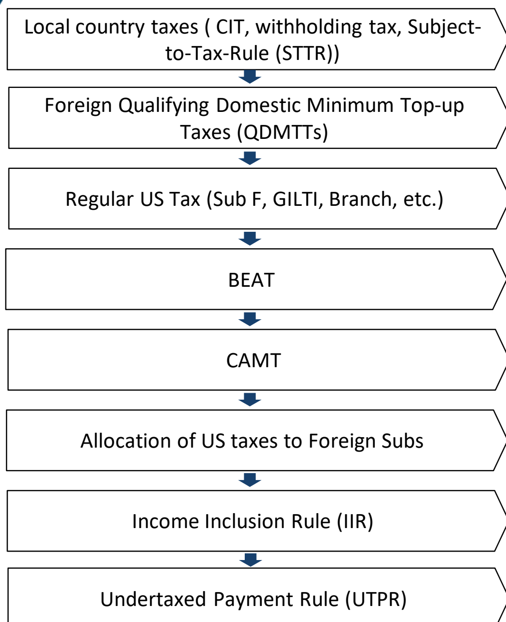
Pillar Two in a Nutshell

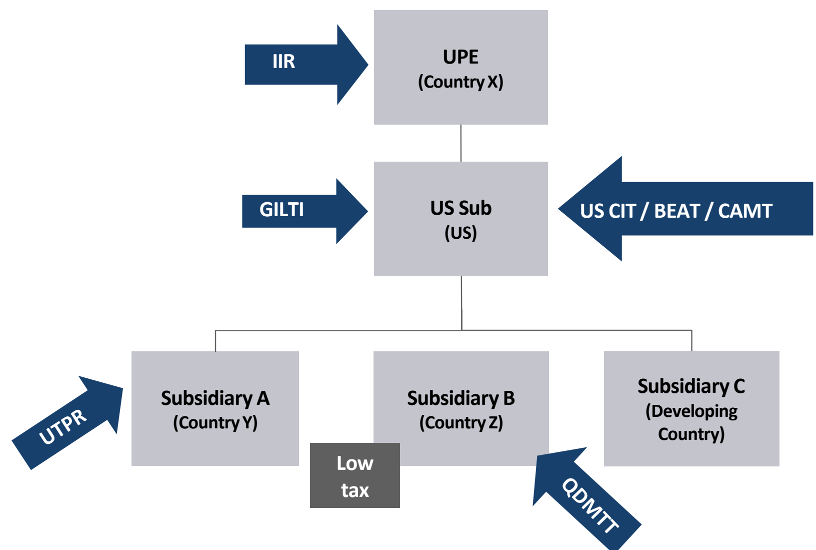
- **Scope:** MNCs with global revenue of at least €750M (but a jurisdiction can opt to impose an IIR on its headquartered MNEs regardless of the threshold)
- **GloBE minimum rate:** 15% for income inclusion rule (IIR) and undertaxed payments rule (UTPR), applied based on effective tax rate in each jurisdiction
- **Substance-based income exclusion:** 8% of carrying value of tangible assets and 10% of payroll costs, both phasing down to 5% over 10 years
- **De minimis exclusion:** Jurisdictions where MNC has global revenues below €10M and profits below €1M
- **Subject to tax rule (STTR) rate**: 9%, applied based on nominal tax rate in each jurisdiction
- **Implementation:** Generally optional for countries, through changes to domestic law (and treaty provision for STTR)
  - To take effect in 2023 (2024 for UTPR)

Top-up tax calculation under the GloBE Model Rules



Pillar Two: Potential interplay with the US tax system





How do Pillar Two rules intersect with US tax rules ?

- Is **GILTI** a "Qualified IIR" regime for Pillar Two?
  - *Likely not if regime is not modified, but final assessment outstanding*

    "Qualified IIR means a set of rules equivalent to Article 2.1 to Article 2.3 of the GloBE Rules (including any provisions of the GloBE Rules associated with those articles) that are included in the domestic law of a jurisdiction and that are implemented and administered in a way that is consistent with the outcomes provided for under the GloBE Rules and the Commentary provided that such jurisdiction does not provide any benefits that are related to such rules. "

- If GILTI is not an IIR, will it qualify as a **CFC regime** for Pillar Two purposes?
  - *Likely yes, but final assessment outstanding*

    "Controlled Foreign Company Tax Regime means a set of tax rules (other than an IIR) under which a direct or indirect shareholder of a foreign entity (the controlled foreign company or CFC) is subject to current taxation on its share of part or all of the income earned by the CFC, irrespective of whether that income is distributed currently to the shareholder."

How do Pillar Two rules intersect with US tax rules ?

- Is **BEAT** a "Qualified UTPR" regime for Pillar Two?
  - *Likely not*

    "Qualified UTPR means a set of rules equivalent to Article 2.4 to Article 2.6 of the GloBE Rules (including any provisions of the GloBE Rules associated with those articles) that are included in the domestic law of a jurisdiction and that are implemented and administered in a way that is consistent with the outcomes provided for under the GloBE Rules and the Commentary provided that such jurisdiction does not provide any benefits that are related to such rules. "

- The **Subject-to-Tax Rule** will require a treaty change before entering into effect.
  - Will the US modify relevant tax treaties and how quickly?

- **Switchover rule** is also a treaty rule that denies the treaty branch exemption and replaces it by the credit mechanism
  - Will the US modify relevant tax treaties and how quickly?

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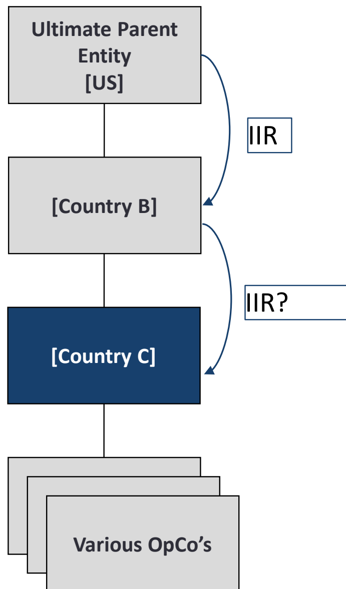
Application of the Income Inclusion Rule (IIR)



- The application of the IIR is done "top down" so that an IIR of the UPE of the group overrides lower-tier IIRs.
- If the UPE does not apply an IIR, through a waterfall effect its subsidiary can apply the IIR and so on through the chain of ownership stopping with a subsidiary that applies the IIR, if any.
- The application of the IIR will turn off the application of the UTPR to any low-taxed subsidiaries that are subject to the IIR.
- If GILTI is a "Qualified IIR," it will prevent the waterfall effect of the IIR and turn off the application of the UTPR to foreign subsidiaries of a US UPE

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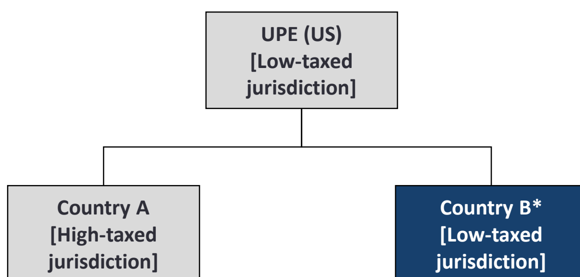
Application of the Undertaxed Payment Rule (UTPR)



- If UPE has not adopted the IIR, Country A can apply the UTPR to Country B.
- In any case, Country A also can apply the UTPR to UPE's low-taxed profit, if any, even if UPE country has implemented the IIR.
- Qualification of GILTI as a "Qualified IIR" would prevent other countries from applying the UTPR to foreign subsidiaries of a US UPE but not to the US UPE itself.

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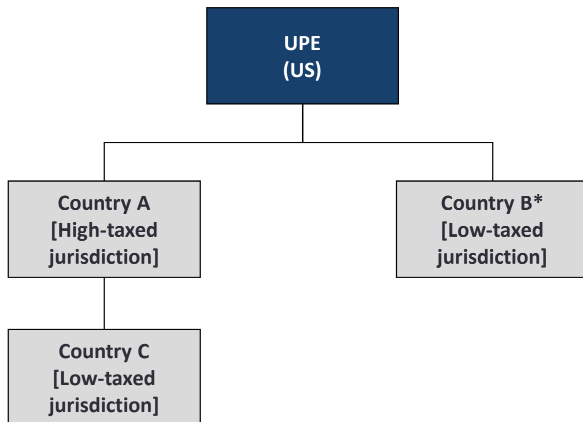
What if GILTI is a "Qualified IIR?



Expected consequences:

- Application of GILTI as a qualified IIR will prevent application of a Country A IIR to Country C and the application of any UTPR to Country B or Country C.

Additional comments:

- If GILTI becomes a jurisdictional blending regime, differences would still remain with Pillar Two calculations

  → Must confirm whether all countries consider GILTI as IIR equivalent

- If countries implement **Qualified Domestic Minimum Top-Up Taxes,** must assess the amount of such taxes and how this interacts with US FTC rules.
- US MNEs must still comply with the administrative rules under Pillar Two calculations

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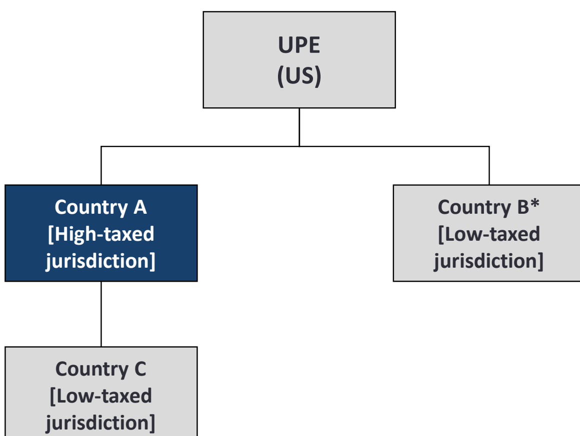
What if GILTI is NOT a "Qualified IIR"?



Expected consequences:

- Country A could apply IIR to its subsidiary, Country C
- GILTI will not deactivate UTPR
  - Country A (as well as Country C) could be allocated Country B top-up tax if they have UTPR in place.

Additional comments:

- Need to determine whether GILTI qualifies as a CFC regime under Pillar Two, which would result in any GILTI tax being allocated to the low-taxed subsidiaries.
- Need to assess how IIR and UTPR levied by Country A (and possibly country C) will be considered from a US FTC perspective.

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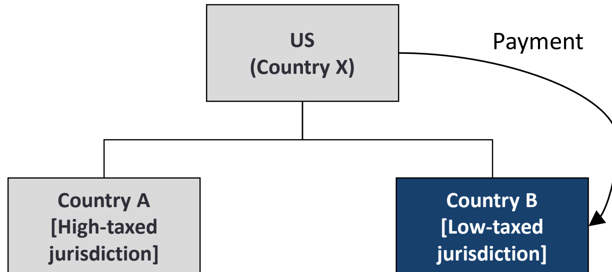
What about BEAT?



SHIELD was expected to be the UTPR "equivalent" – however, this proposal appears to have been abandoned.

BEAT is not a UTPR equivalent.

Consequences:

- Under UTPR, top-up tax not captured by a qualified IIR is allocated among UTPR taxpayers
    - BEAT is not equivalent → no UTPR top-up tax allocated to the US.
- Even if a payment to a low-taxed entity would be captured by BEAT, the beneficiary of that payment could be subject to UTPR by other group entities.
- Unlikely that any "credit" would be provided for the BEAT in the UTPR calculation.

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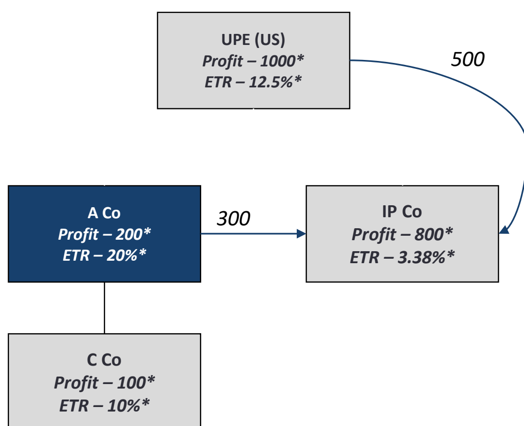
Worst case illustration



Royalties

** Profit and ETR calculated per Pillar 2 rules – may differ from local tax calculation*

Facts

- GILTI not IIR equivalent and not a CFC regime for P2 calculations.
- BEAT not UTPR equivalent, nor considered in ETR calculation of beneficiary of payment.
- P2 rules and/or Qualifying Domestic Minimum Tax ('QDMT') implemented in all other countries (non-US) involved.
- No FTC granted for any of GloBE taxes (e.g. IIR, UTPR and QDMT).
- STTR applying to payments between subsidiaries.

STTR

- Royalty subject to nominal rate of 0% in IP Co
- WHT on royalty from A Co to IP Co. Additional WHT of **27** (300 x 9%). STTR will be taken into account for GloBE ETR of IP Co (QDMT / IIR / UTPR).

QDMT

- IP Co QDMT = **92.96** (800 x 11.62%)
- C Co QDMT = **5** (100 x 5%)

IIR

- No IIR levied by UPE (US having not implemented the rules) nor A Co (C Co been subject to QDMT).

UTPR

- A Co, IP Co and C Co are allocated a portion of the **25** (1000 x 2.5%) of the UTPR top-up tax relating to low-taxed profit of UPE in US. Note that any GILTI top-up taxes is ignored for the calculation of the ETR for Pillar 2 in this worst case scenario.

US taxes

BEAT and GILTI to be levied on top of all the above taxes

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Interaction of CAMT and Pillar 2

Covered Tax vs. QDMTT

- CAMT is expected to be a “Covered Tax” for Pillar 2 purposes
- No expectation to consider it a QDMTT for Pillar 2 purposes
- Treasury’s Greenbook in March confirms this – in proposing a QDMTT for the US it notes that CAMT would be a Covered Tax that goes into the Pillar 2 ETR calculation

Deferred Taxes on CAMT Carryforwards

- A taxpayer that pays CAMT gets a tax credit to offset regular tax in future years, which would normally give rise to a DTA.
  - This typically means deferred tax expense is reduced in the year the CAMT is paid (and the DTA is recorded), and deferred tax expenses is increased in the year the CAMT carryforward is utilized
  - However, deferred tax expense related to tax credits is not included in the GloBE ETR under Article 4.4.1(e)
  - Thus, CAMT may make US taxpayers worse off under Pillar 2, even though they are paying more tax by reason of CAMT

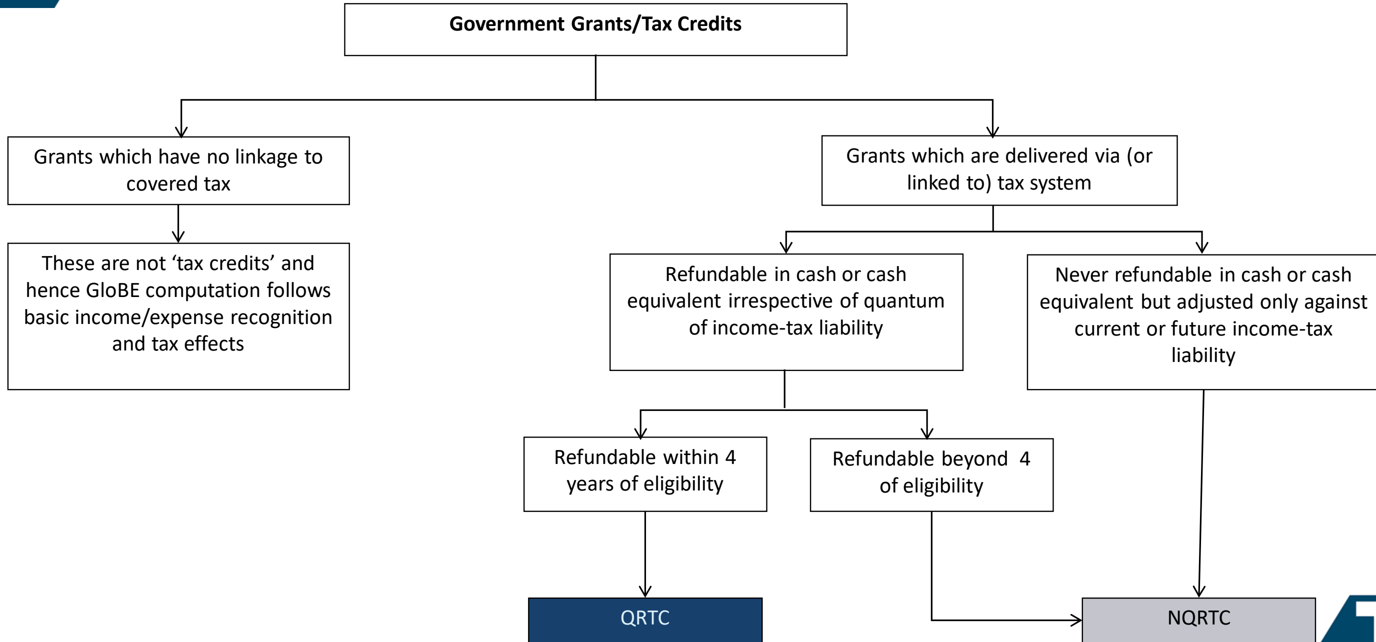
Allocation of CAMT to CFCs

- Because CAMT is applied to CFC income, it could be considered a CFC regime tax under Pillar 2
  - If so, some portion of CAMT could potentially be “pushed down” and treated as covered tax of CFCs for Pillar 2 purposes (similar to how GILTI will need to be pushed down)

Other issues of note

- Interaction with US transfer pricing rules (including safe harbor rules such as AFR, SCM) and Pillar Two to be considered – Pillar Two requires restatement of all transaction at arms’ length if not recorded as such in financial statements.
- Particular Pillar Two provisions relevant for US MNEs:
  - Anti step-up provisions – impact on M&A and acquisition integrations.
  - Specific permanent establishment definition.
  - Specific anti-hybrid provisions.
- Application of definition of “foreign income tax” for purposes of FTC rules

Incentives under GloBE rules



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Summary observations – incentives/credits

Behavioral impacts

- QRTC are much more efficient than NQRTC post-GloBE. Countries are likely to reconfigure tax incentives to meet the QRTC definition.
- Sub-15% tax rate incentives in high tax rate countries are much more competitive post-GloBE than pre-GloBE because they now compete vs 15% tax rate rather than 0%. High tax rate countries will create/retain/extend low tax rate incentives and rely on in-country blending to preserve the full efficacy of the low tax rate incentive.
- Countries whose incentives are mainly delivered to HQ companies will model the impact of in-country blending, monitor the proliferation of UTPR rules and evaluate a QDMTT
- Countries whose incentives are mainly delivered to CEs below the UPE country have a complex policy choice depending on whether they are mainly incentivizing US HQ, IIR HQ or neither. Because the GILTI base is so different from the GloBE base in some cases (eg where incentives are mainly impacting US UPE investments) a QDMTT will make limited sense (subject to UTPR proliferation).

Insight areas

- Need to collect information on tax incentives, book treatment, QRTC analysis and common sub-15% ETR outcomes
- It is helpful to model how profit-based tax holidays look if shifted towards direct grants. In some high-margin businesses the value of the direct grant is likely to exceed all local costs
- It will be useful to explore WTO/FTA and/or state aid law barriers to moving tax incentives to direct grants
- We refer to tax credits and incentives but some NQRTC (eg FTCs) are not 'tax incentives' in the most common meaning of the phrase.

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Other incentives/credits considerations

Based on a preliminary analysis, the majority of the federal US tax credits should be considered NQRTC. How is this going to impact private investment?

> *"US Treasury is seeking some certainty as to how US incentives would be treated under the global anti-base erosion (GloBE) rules and the related Pillar Two commentary. We're confident that the value of many of our general business credits is preserved under the OECD rules"* – A senior US Treasury official, May 2022.

According to Lily Batchelder (US treasury) (reported on 5 May 2022), US tax credits relating to low-income housing, renewable energy and new markets generally should not be impacted by Pillar 2.

In-country blending ameliorates the impact of diluted ETR from tax credits and incentives in high tax rate countries on a fact specific basis (ie different MNEs are affected differently depending on their country specific high-tax/low-tax mix)

Will countries change their tax incentives to align with the definition of QRTC under the GloBE rules?

Will this conflict with tax incentives with a social / cultural / economic benefit (e.g., R&D for vaccine development or renewables or green incentives) that are not considered "refundable"?

"tax credits that are, as a matter of substance and not merely form, likely to be refunded" (Comm., definition of QRTC, pag. 215, parag. 136). How can the liklihood to be refunded be determined?

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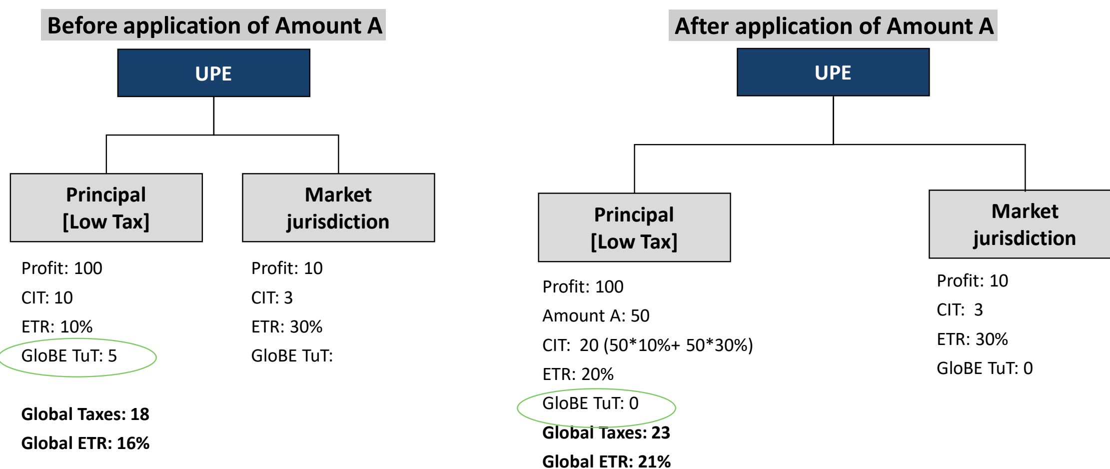
Interaction between Pillar 1 and Pillar 2



Impact of profit allocation:

- Profit from Principal allocated to market jurisdiction is taxed under local CIT rules. This is, however, a tax of the surrendering entity, which enters into account for the calculation of Pillar 2 and the ETR of the surrendering entity
- Unclear nor whether surrendering entity would need to provide for an exemption or a credit (relating to profit surrendered)