IFA webinar on "Recent Developments on Pillar 1-2 with digital taxation"

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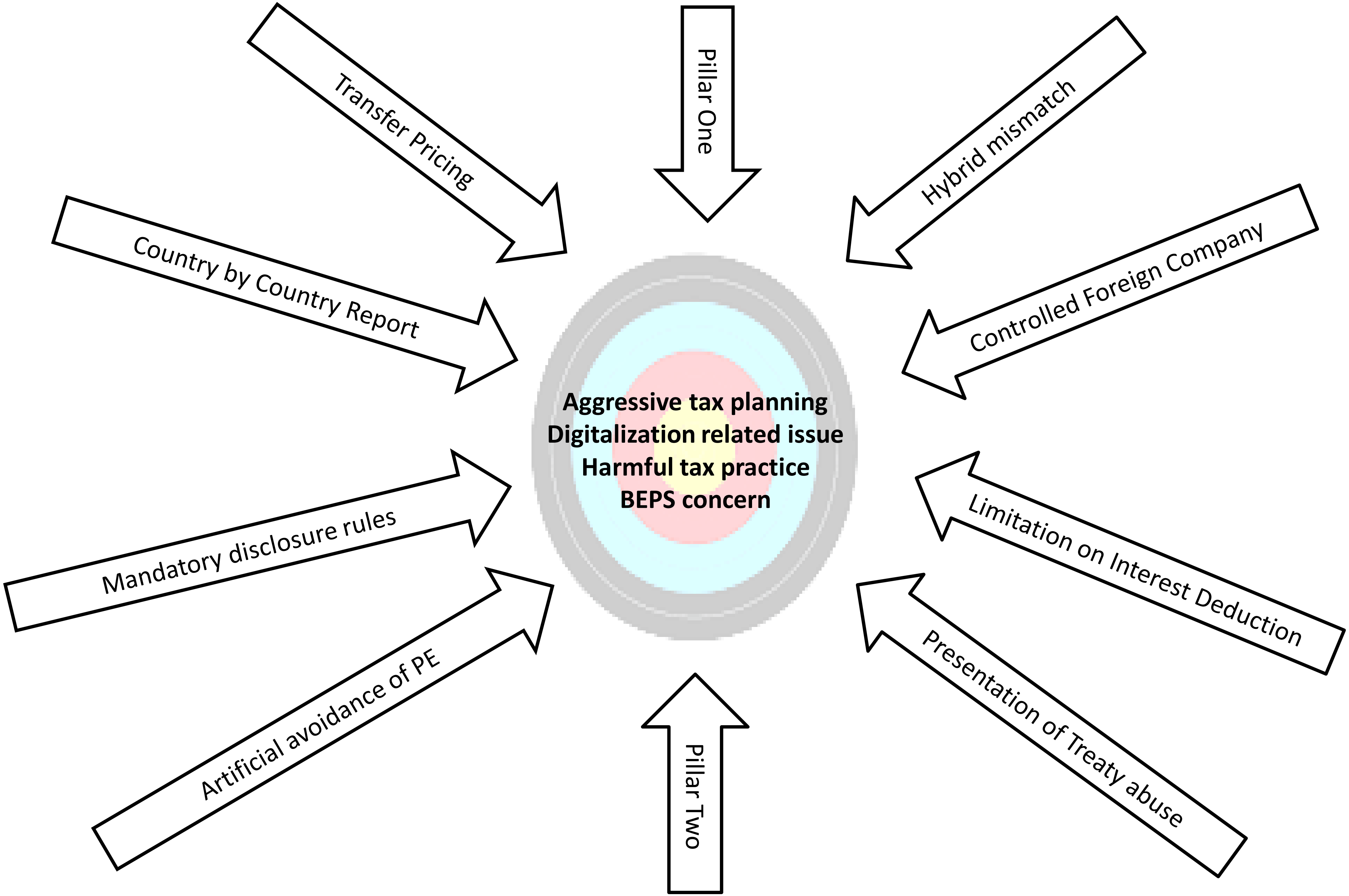
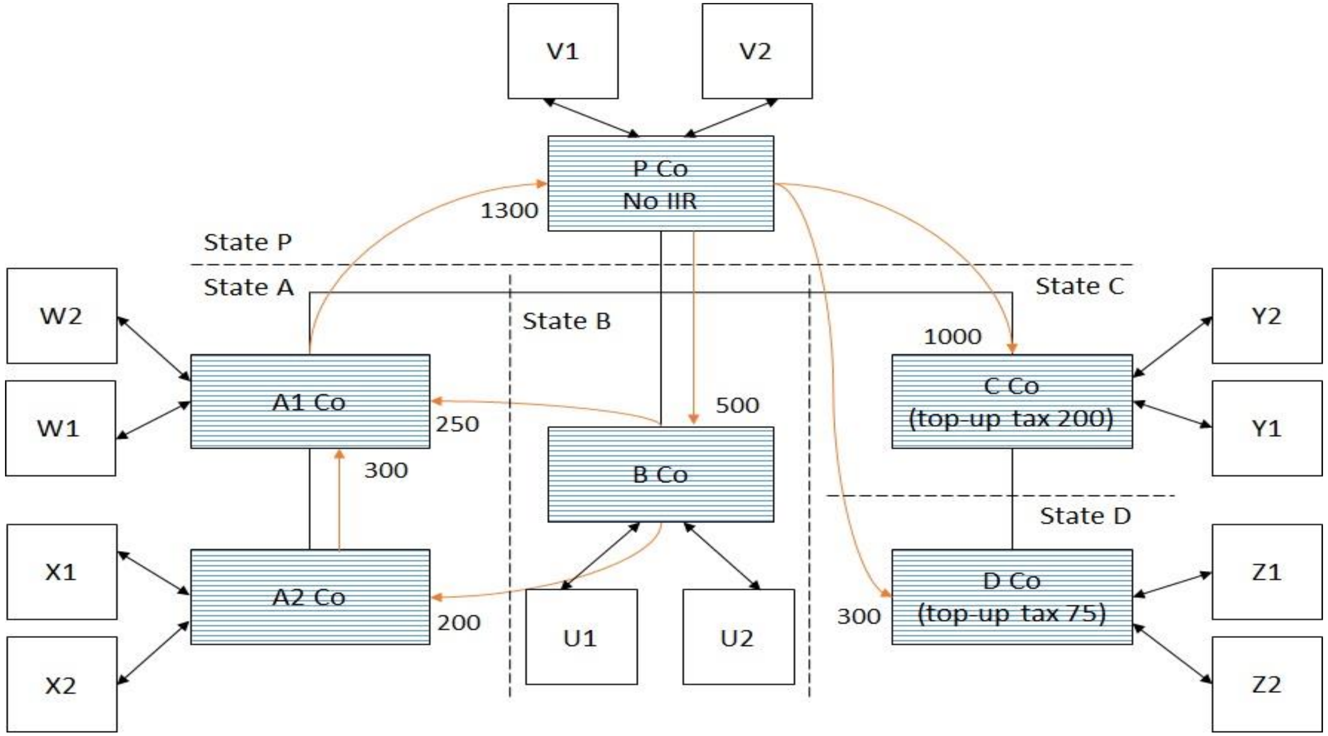
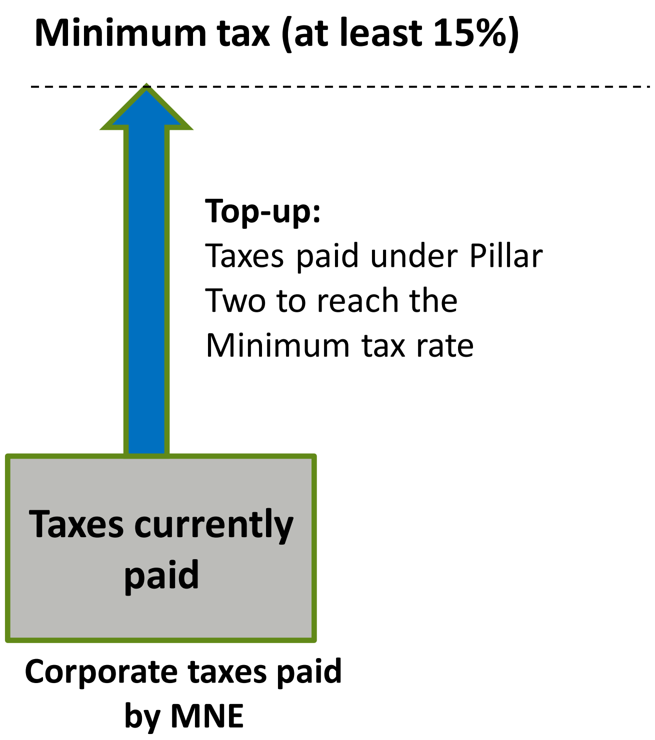
September 3, 2021

Introduction


Transfer Pricing
Pillar One
Hybrid mismatch
Country by Country Report
Controlled Foreign Company
Aggressive tax planning
Digitalization related issue
Harmful tax practice
BEPS concern
Mandatory disclosure rules
Limitation on Interest Deduction
Artificial avoidance of PE
Presentation of Treaty abuse
Pillar Two

Pillar Two approach





- Pillar Two is focused on the *remaining BEPS challenges* and proposes a systematic solution designed to ensure that **large internationally operating businesses pay a minimum level of tax** regardless of where they are headquartered or the jurisdictions they operate in.
- Pillar Two leaves jurisdictions free to determine their own tax system, including whether they have a corporate income tax and where they set their tax rates, but also **considers the right of other jurisdictions to apply the rules contained in this report where income is taxed at an effective rate below a minimum rate**
- GloBE rules will have the status of a common approach.

Scope of the GloBE Rules

Scope of GloBE Rules

- MNE Groups having total consolidated group revenue €750 million or above, in the immediately preceding fiscal year, are subject to application of the GloBE rules.
- Countries are free to apply the IIR to MNEs headquartered in their country even if they do not meet the threshold
- The consolidated group revenue threshold is applied to all those CEs that are owned and controlled by the same UPE
- Excluded entities
  - Investment Fund
  - Pension Fund
  - Governmental Entity
  - International Organisation
  - Non-profit Organisation
  - Any holding vehicles used by such entities, organisations or funds
  - Shipping industry

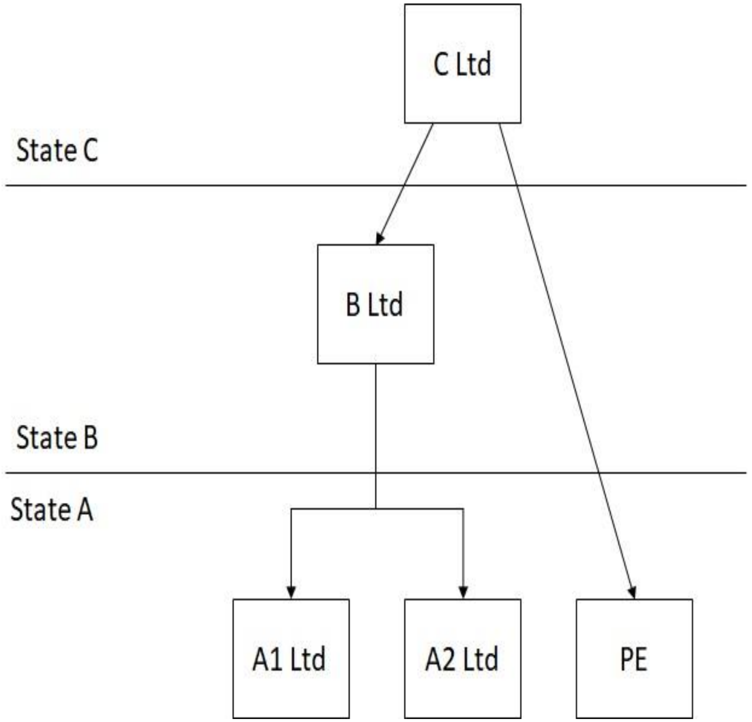
GloBE Rules	**Subject to Tax Rule**
Income Inclusion Rule (**IIR**)	
Undertaxed Payment Rule (**UTPR**)	Switch-over Rule (**SOR**)

Concepts and threshold adopted from CbCR mechanism

Income Inclusion Rule (IIR)

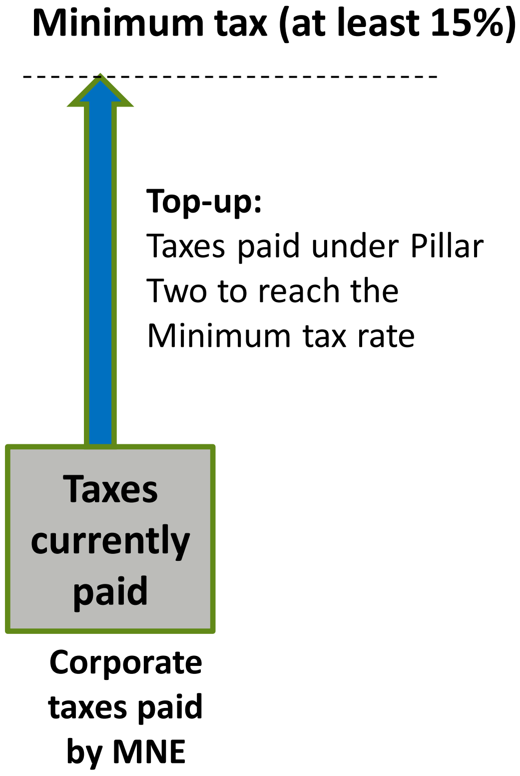
Computation of ETR – Jurisdictional Blending

Determination of IIR top-up tax payable by shareholder



Scenario 1	Total	A1 Ltd	A2 Ltd	PE
Covered Taxes	**351**	100	120	131
GloBE Income	**3900**	1200	1400	1300
ETR %	**9.00**	8.33	8.57	10.08

Scenario 2	Total	A1 Ltd	A2 Ltd	PE
Covered Taxes	**400**	50	150	200
GloBE Income	**3900**	1200	1400	1300
ETR %	**10.26**	4.17	10.71	15.38



- **Reasons for low ETR**

A Parent (including a Partially Owned Intermediate Parent) that owns (directly or indirectly) an equity interest in a foreign low-taxed Constituent Entity at the end of a reporting period shall be subject to a top-up tax under the IIR in respect of its proportionate share of the income of that Constituent Entity for that period.

ETR – Some theory

Definition of covered taxes

Covered taxes means any tax on an entity's income or profits (including a tax on distributed profits), and includes any taxes imposed in lieu of a generally applicable income tax. Covered taxes also includes taxes on retained earnings and corporate equity.

Definition of taxes used for statistical purposes by many international organisations including OECD, EU, IMF, World Bank and UN.

Covered Taxes inclusions	Covered Taxes exclusions
• Any tax on an entity's income or profits	• Consumption and sales taxes
• Tax on distributed profits	• Excise taxes
• Taxes imposed in lieu of a generally applicable income tax	• Digital services taxes
• Taxes on retained earnings and corporate equity	• Stamp and other transfer taxes
• Taxes based on multiple components	• Payroll taxes and social security contributions
• Taxes paid under CFC rules	• Property taxes

GLoBE Tax Base - calculated by reference to consolidated financial accounts

- **Determine tax base in accordance with financial accounting standard**

  - The starting point for determining the GloBE tax base is the profit (or loss) before income tax as determined using the relevant financial accounting standard.
  - GloBE tax base to be calculated on the basis of the financial accounting standard used by the parent in the preparation of its consolidated financial statements.
  - The acceptable financial accounting standards are IFRS and any equivalent financial accounting standard

- **Determination of profit (loss) for each entity**

- **Some adjustments to the tax base**
  - **Intercompany items**
    - Exclude intercompany items to the extent the transaction is between group members in the same jurisdiction
    - Cross border transactions to be taken at ALP
  - **Income of permanent establishment**
    - HO-PE transactions considered for determining taxable income are considered

- **Intra-group dividends**
  - To be excluded to avoid over taxation

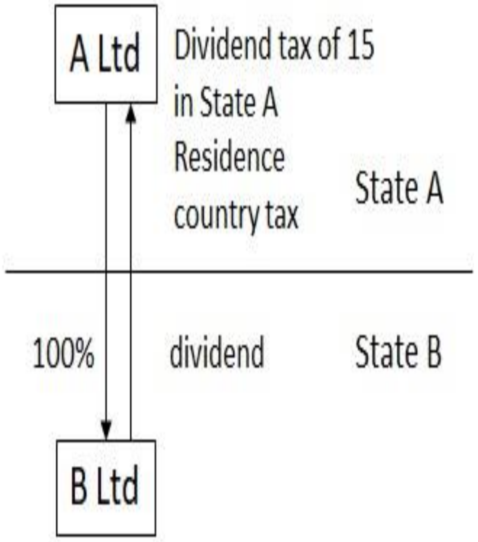
GLoBE Tax Base – Other adjustments to tax base

- **Other adjustments**
  - ➢ No deduction for bribes, kickbacks (and other illegal payments), fines, penalties (limit of Eur 50,000)
  - ➢ Gains / loss on restructuring or reorganization – tax deferrals
  - ➢ Covered taxes on income excluded from tax base should also be excluded
  - ➢ Investment returns of life insurance policyholder
  - ➢ Adjustment for Pillar One Outcomes

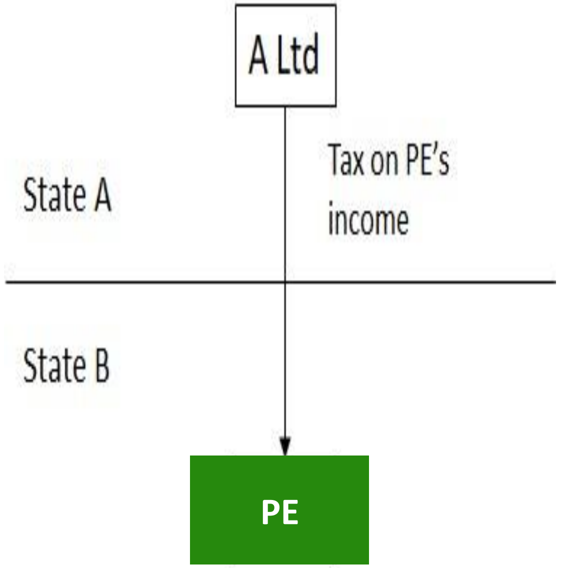
- **Others items not covered (in this session)**
  - ➢ Modification to address immediate expensing and accelerated depreciation of assets
  - ➢ Modification to address distribution based corporate income tax systems
  - ➢ Treatment of government grants and tax credits
  - ➢ Stock based compensation
  - ➢ Stock gain exclusion rule – Push down accounting
  - ➢ Equity interest accounted under fair value accounting

ETR – Assignment of income and taxes

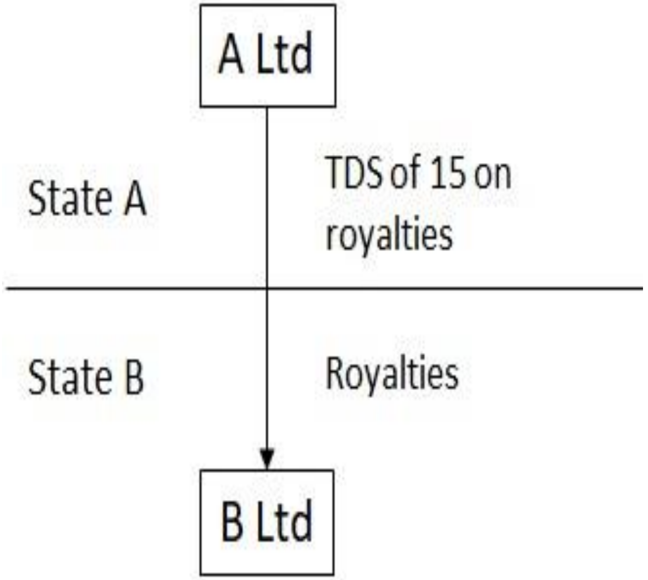
- The jurisdictional ETR computation requires ***assignment of the income and taxes*** among the jurisdictions in which the MNE operates and to which it pays taxes.
- Assignment of taxes to follow assignment of income
  - ✓ Covered taxes paid by a CE with respect to dividends distributed by another CE are assigned to the jurisdiction of the CE that paid the dividend.
  - ✓ Tax paid under CFC regime is assigned to the CFC jurisdiction as it is in respect of such income



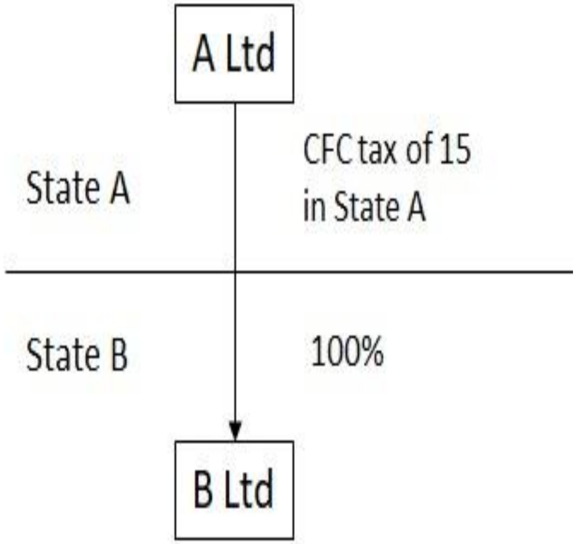
Tax on dividend of 15 paid in State A assigned to State B



Tax on PE's income paid in State A assigned to State B



TDS on royalties 15 paid in State A assigned to State B

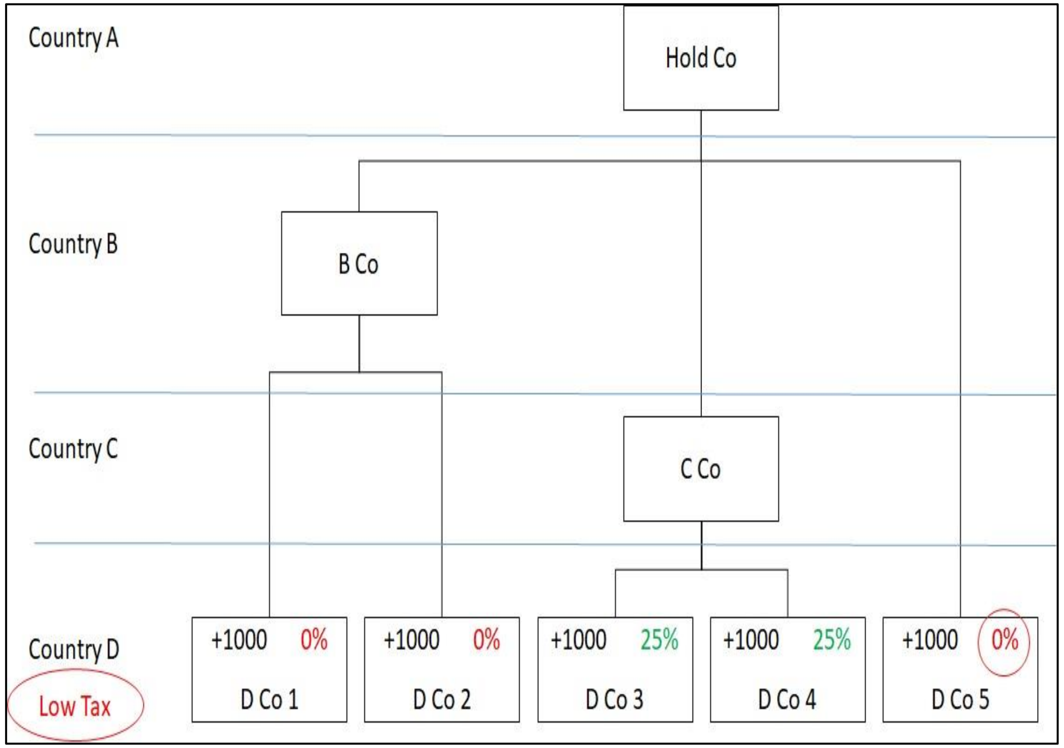


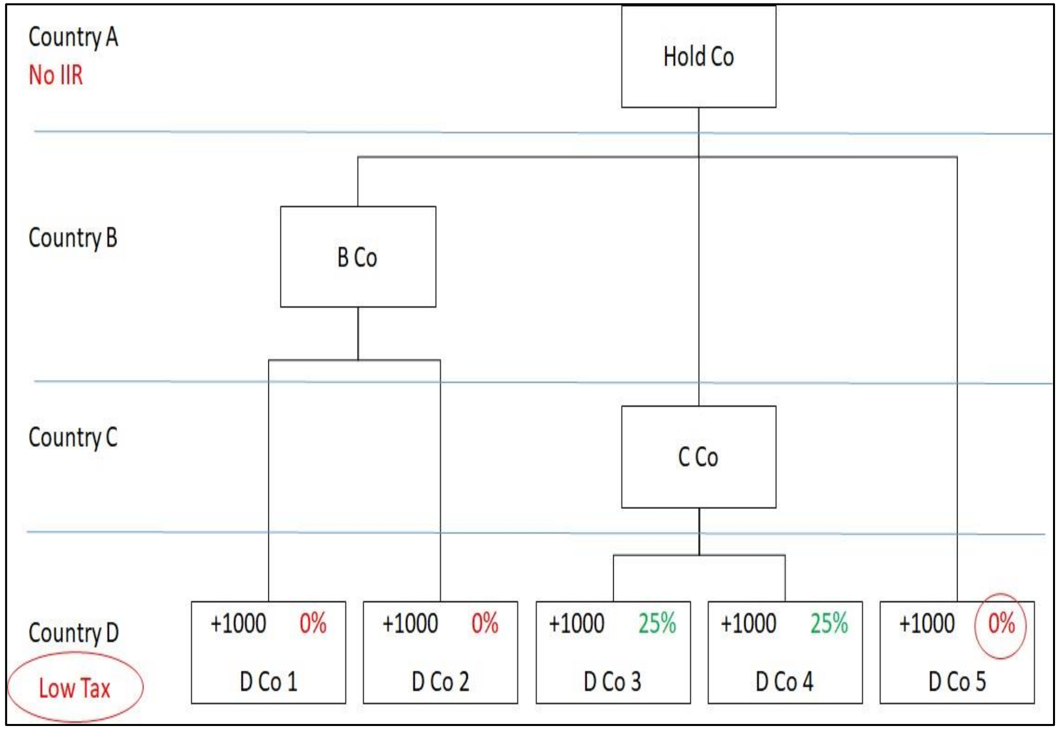
CFC tax of 15 paid in State A assigned to State B

Application of IIR

Top-down approach

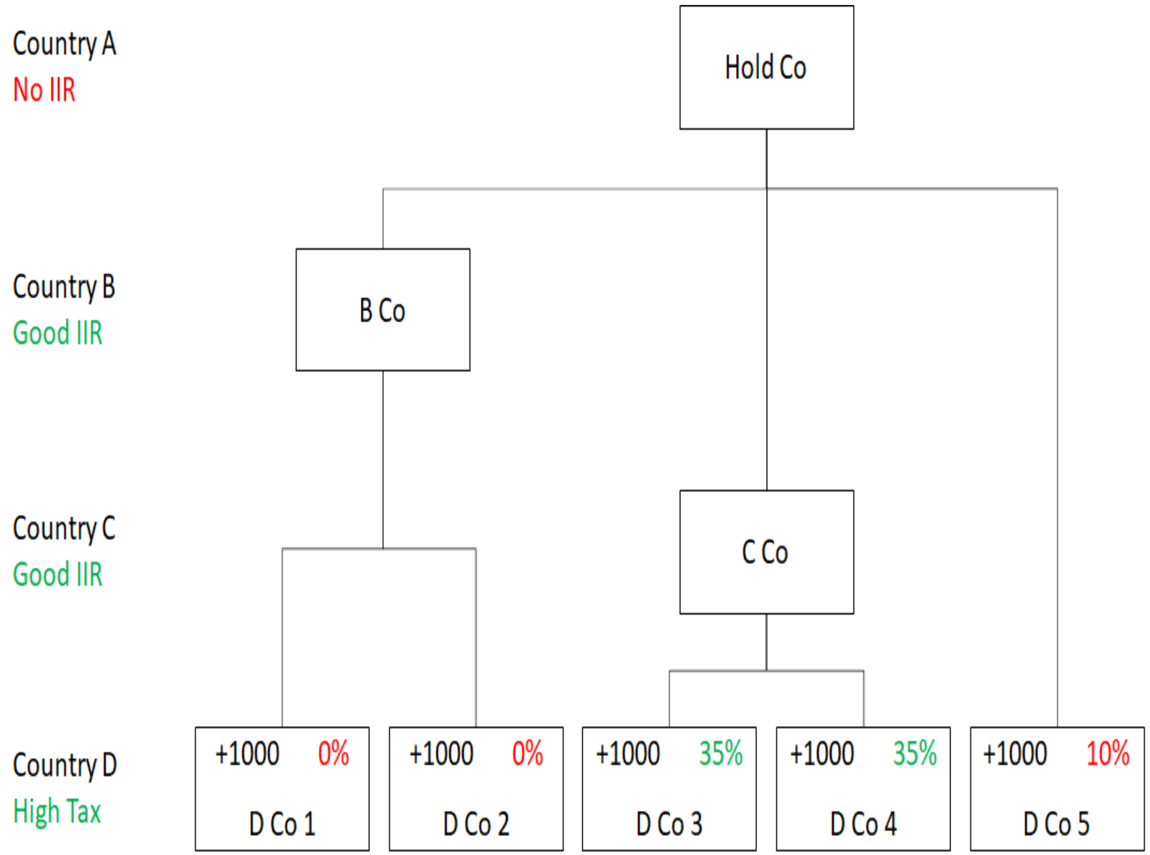
Top-down approach
This approach gives priority to the application of the income inclusion rule in the jurisdiction of the Constituent Entity that is at or near the top of the ownership chain in the MNE Group, starting with the UPE. In the event the UPE is not located in a jurisdiction that has implemented the IIR, then responsibility for applying the IIR falls to the CE that is directly owned and controlled by that UPE, and so on, down the chain of ownership.





Computation of ETR when UPE does not apply IIR (high tax jurisdiction)

Modified version of Example 6.1A



- Minimum rate agreed is 15%
- B. Co. and C. Co. are required to apply IIR under the top-down approach.
- Entities owned by B Co. [i.e. D Co. 1 and D Co. 2 are paying tax @0%. B Co. is still not required to pay IIR for the reason that jurisdictional blending does not result In shortfall.

Aggregate PBT	5000
Aggregate Covered Tax	800
(350 + 350 + 100)	
Jurisdictional ETR	16%
Top up tax for each entity	0

Carry Forward and Carve-outs

Carry forwards

MNE allowed to carry-forward losses incurred or excess taxes paid in prior periods into a subsequent period in order to smooth-out any potential volatility arising from the mix of taxes imposed under local law or resulting from timing differences. This adjustment is intended to ensure that Pillar Two does not result in the imposition of additional tax where the low ETR in a jurisdiction in a particular period is simply a result of the timing of the imposition of covered taxes on items of GloBE income or differences in the timing of the recognition of income under financial accounting and local tax law.

- **Measures to avoid excess tax on account of timing difference**
    - Loss carry-forward
    - Pre-regime losses
    - Excess taxes (limited period)
    - IIR tax credits
    - Local tax carry forward (limited period)
    - Post filing adjustment of tax liability
    - Transfer of tax attributes

Formulaic substance-based carve-out

Calculation of effective tax rate – tax base – **formulaic substance-based carve-out**

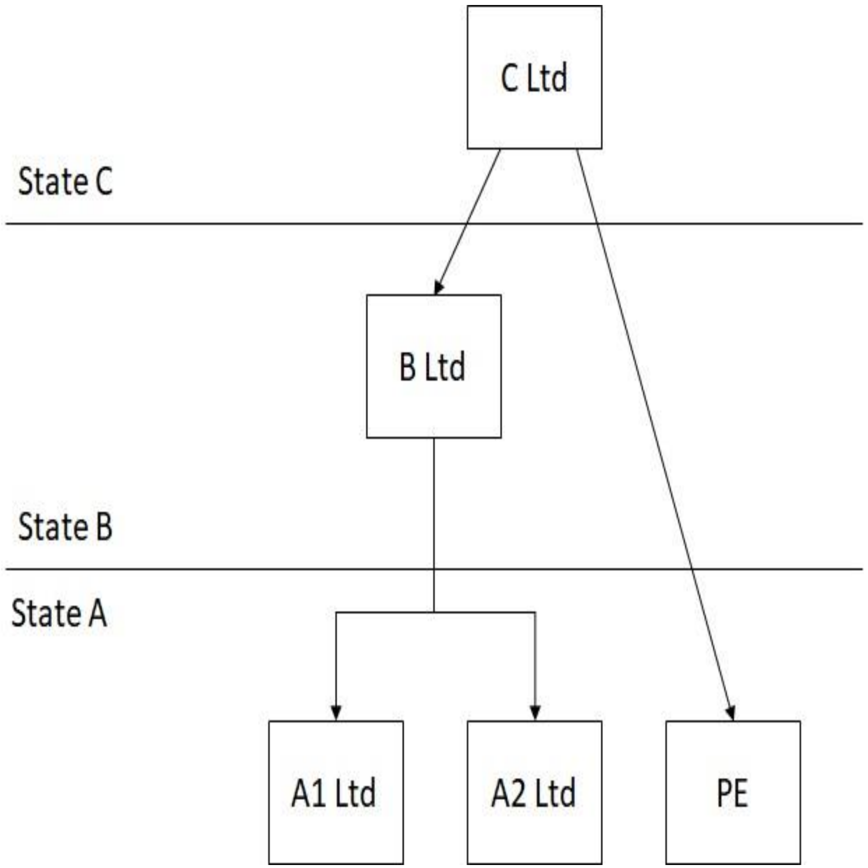
Regimes compliant with BEPS Action 5 (harmful tax practices) are not excluded

Payroll component	Tangible asset component
• **7.5% mark-up** on **payroll costs** of in-country **employees** – Includes bonuses, pensions, benefits and employer social security contributions – Includes independent contractors – Reduced to 5% mark-up after five year transition period	• **7.5% mark-up** applied to **carrying value of tangible assets** – Reduced to 5% mark-up after five year transition period

Switch-over Rule

Switch Over Rule

Modify/eliminate exemption provided in residence state for income earned through a foreign PE where that income would otherwise be subject to an ETR that is below the minimum rate.



- C Ltd. is the Ultimate Parent Entity (UPE)
- As per State C Income Inclusion Rule, C Ltd. has the obligation to pay IIR top-up tax on the income earned by PE
- Article 23 of the tax treaty between State C and State A adopts “exemption method”
- In terms of the treaty State C is not authorized to levy tax on the income earned by PE in State A. State A has exclusive taxing right.
- Conflict between IIR and tax treaty
- Switch Over Rule addresses this conflict

Undertaxed Payment Rule

Undertaxed Payment Rule - Theory

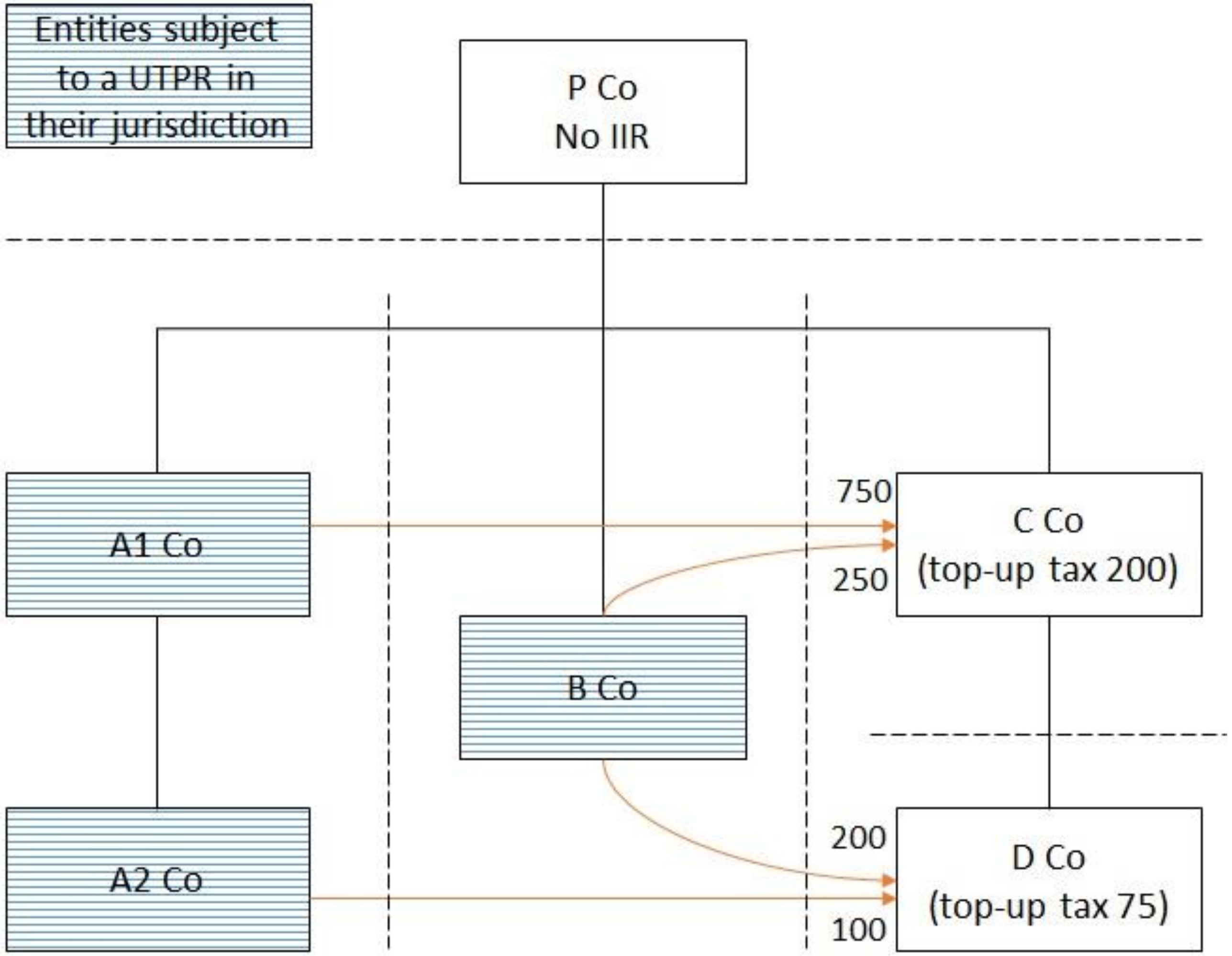
- UTPR taxpayer - Any CE that is located in a jurisdiction that has implemented the UTPR in accordance with the GloBE rules (a UTPR Jurisdiction). Applies in respect of the income of low-tax CEs
- The IIR has priority over the UTPR
- Serves the following hybrid purpose:
  - as a backstop to the IIR and reduces the incentives for tax driven inversions by providing a mechanism for making an adjustment in respect of any remaining top-up tax in relation to profits of a CE that is not in scope of an applicable IIR.
  - Addresses base erosion through deductible intra-group payments.
- Applies to the profits of a low-tax CE where such low-tax CE is controlled by another foreign Constituent Entity that is not subject to an IIR in accordance with the GloBE rules
- Uses the same mechanics as the IIR for determining the MNE’s jurisdictional ETR and the amount of top-up tax allocable under the rule.
- Balance top-up tax liability to be carried forward for recovery / adjustment in future year
- **Domestic law mechanism** - The GloBE rules do not prescribe the mechanism by which UTPR adjustment must be made. This is a matter of domestic law implementation that is left to the jurisdictions that choose to adopt the UTPR. The adjustment could be through a limitation or a denial of a deduction for payments made to related parties or could be in the form of an additional tax.
- **Information requirement** - necessary to ensure that the UTPR Taxpayers and the MNE will provide the information necessary to compute and allocate the top-up tax

Undertaxed Payment Rule

Example One – First Allocation Key

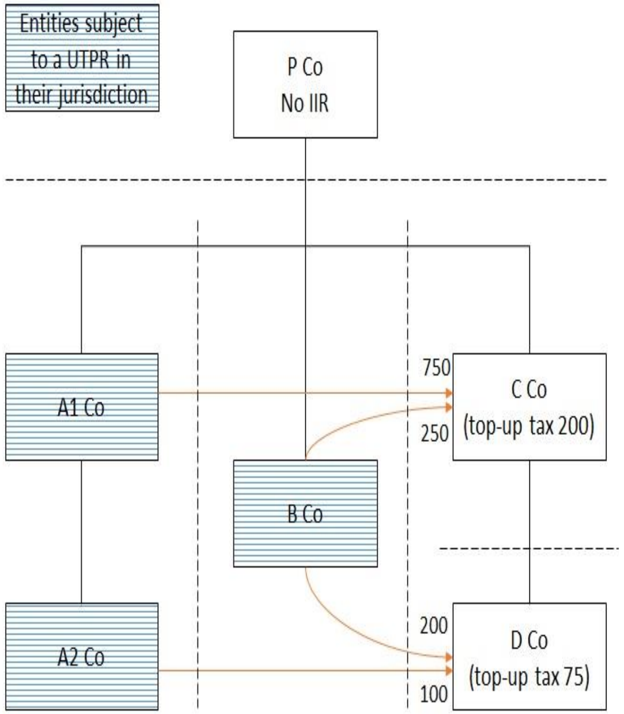
- No IIR in State P
- The ETR in Country C and Country D are below the minimum rate
- Top up tax payable in respect of C Co. and D Co. is 200 and 75 respectively

UTPR acts as a backstop to IIR



Undertaxed Payment Rule

Example One – First Allocation Key



Influence of domestic tax rate on UTPR top up tax

Allocation of top up tax in relation to C Co's profits

UTPR Taxpayers	Amount of direct payments made to C Co	Proportion of direct payments
A1 Co	750	**750/1000 = 75%**
B Co	250	**250/1000 = 25%**
Total	1000	100%

UTPR Taxpayers	Proportion of direct payments	Allocated top-up tax
A1 Co	75%	**75% x 200 = 150**
B Co	25%	**25% x 200 = 50**
Total	100%	200

Allocation of top up tax in relation to D co's profits

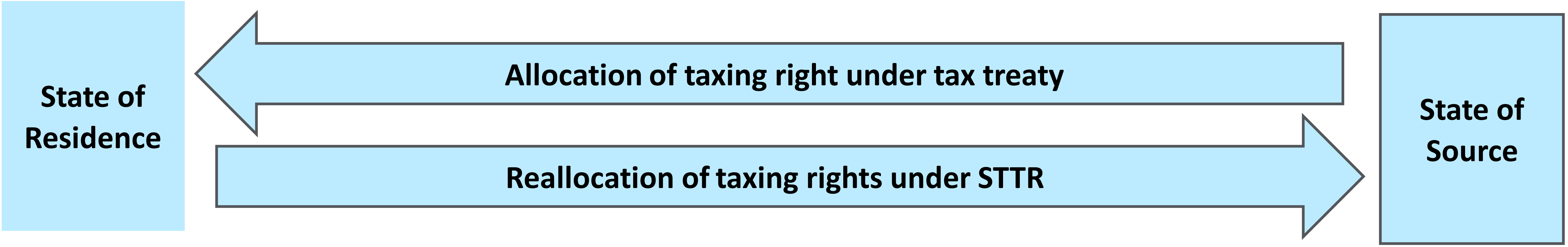
UTPR Taxpayers	Amount of direct payments made to D Co	Proportion of direct payments
A2 Co	100	**100/300 = 33.33%**
B Co	200	**200/300 = 66.66%**
Total	300	100%

UTPR Taxpayers	Proportion of direct payments	Allocated top-up tax
A2 Co	33.33%	**33.33% x75=25**
B Co	66.66%	**66.66% x75=50**
Total	100%	75

Subject to Tax Rule

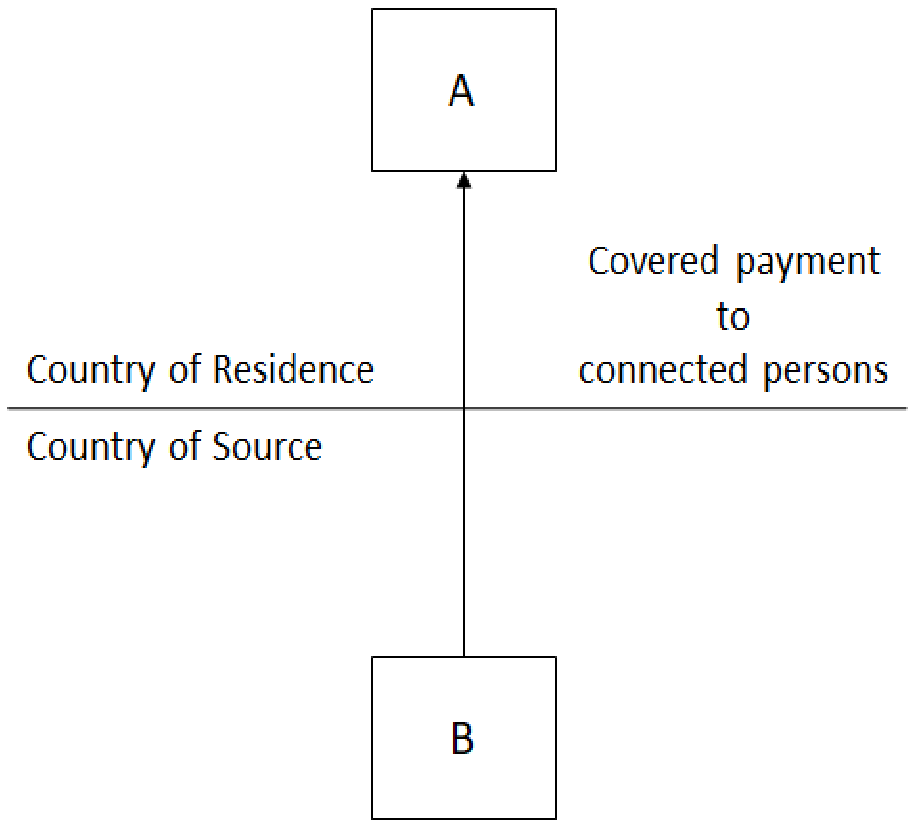
Subject to Tax Rule - Rationale

- STTR targets those cross-border structures relating to intragroup payments that exploit certain provisions of the treaty in order to shift profits from source countries to jurisdictions where those payments are subject to no or low rates of nominal taxation.
- The STTR does not seek to address broader tax treaty policy questions regarding the allocation of taxing rights between jurisdictions. STTR reallocates taxing rights.
- The GloBE rules focus on the remaining BEPS issues and seek to develop rules that would provide jurisdictions with a right to "**tax back**" up to the agreed minimum rate where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.
- STTR is based on the rationale that a source jurisdiction that has ceded taxing rights in the context of an income tax treaty should be able to apply a top up tax to the agreed minimum rate where, as a result of BEPS structures relating to intragroup payments, the income that benefits from treaty protection is not taxed or is taxed at below the minimum rate in the other contracting jurisdiction.



Subject to Tax Rule [STTR] - scope

- Targets cross-border intragroup payments (***connected persons***) that exploit certain treaty provisions
- Enables source jurisdiction to protect itself against base eroding payments to no or low tax jurisdictions and bring back taxing rights
- Scope of STTR :
  - ➢ *Applied to cross-border payments between connected persons (excludes payments made to or by individuals)*
  - ➢ ***Covered payments*** - These include interest, royalties and the following other payments (***related to mobile risk, asset or capital***):
    a. A franchise fee or other payment for the use of or right to use intangibles in combination with services;
    b. Insurance or reinsurance premium;
    c. A guarantee, brokerage or financing fee;
    d. Rent or any other payment for the use of or the right to use moveable property;
    e. Consideration for the supply of marketing, procurement, agency or other intermediary services



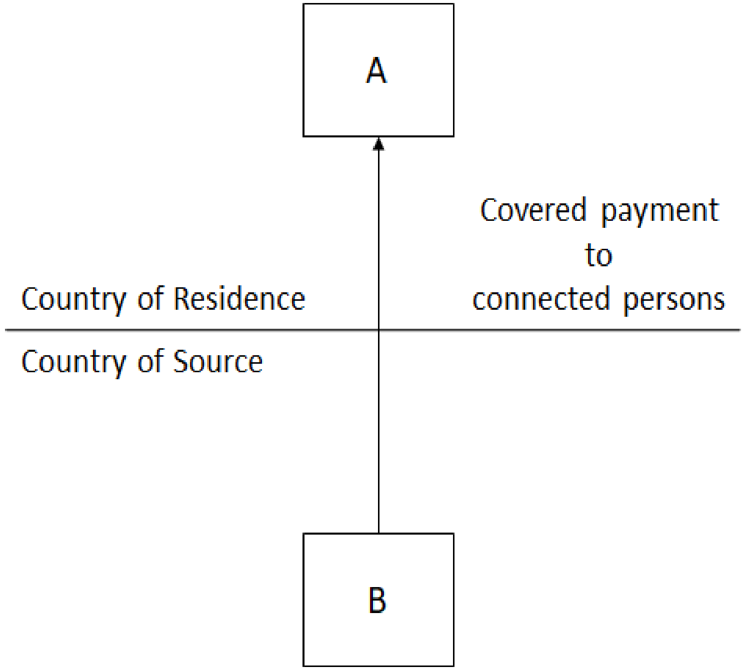
Minimum STTR rate 7.5% to 9%
STTR to be implemented through a separate standalone treaty provision

Subject to Tax Rule - scope

- Rule triggered when the ‘adjusted nominal tax rate’ is below the agreed minimum rate:
    - Based on nominal statutory tax rate applicable to company receiving the payment
    - Adjusted for features of the local tax system (e.g. preferential regime rates)

Using a top-up approach

- Allow the payer jurisdiction to apply a top-up tax to bring the tax on the payment up to an agreed minimum rate; (e.g. if agreed minimum rate is 7.5%, adjusted nominal rate is 5%, top-up rate for withholding would be 2.5%)
- Where treaty already provides taxing rights to the source country (ordering rule)



Implementation and Rule co-ordination

Implementation and Rule co-ordination

Common Approach

Rule order:

- STTR applies even if the MNE Group is subject to the IIR or the UTPR. By taking the tax charged as a consequence of the STTR into account in calculating the ETR of the payee, the GloBE rules effectively give priority to the application of the STTR.
- IIR applies in priority to the UTPR under the GloBE rules. Includes SOR
- UTPR

Implementation Plan - New law / instruments to be expected

<table>
<tr><th>International – Pillar One</th><th>International – Pillar Two</th><th>Domestic Law</th></tr>
<tr><td colspan="2">October 2021 – Final implementation plan</td><td rowspan="2">Feb 2022 – Finance Bill, 2022?
2022 – Income Tax (Amendment Act), 2022?
Feb 2023 - Finance Bill, 2023?</td></tr>
<tr><td>2022 – MLI for implementing Amount A to be made available for signature (Amount A MLI)</td><td>2022 – Global Model Rules for implementation of GloBE rules
2022 – MLI to implement to GloBE rules (GloBE MLI)
2022 – STTR model provision and MLI for facilitation of STTR adoption in the tax treaty (STTR MLI)
2022 – Transition rules – Possibility of deferred implementation of UPTR</td></tr>
<tr><td>2023 – Pillar One to be implemented</td><td>2023 – Pillar Two to be implemented</td><td></td></tr>
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