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The OECD/G20's Two-Pillar Solution and Its Implementation in the European Union

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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 the MNEs will pay tax in the future.

After years of work by the IF, a conclusion was reached through the approval of the principles of a two-pillar approach by 138 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:

— a set 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 by the OECD on 8 October 2021 was a key milestone.

Substantial progress towards effective implementation of Pillar Two has been made at OECD level with the publication of the Model GloBE Rules (Pillar Two) report and the related commentary delineating the scope and setting out the operative provisions and definitions of the GloBE (published in December 2021 and March 2022, respectively) and at European level with the approval of the EU Council Pillar Two Directive on 14 December 2022.

The Inclusive Framework Agreement:
The October 2021 announcement in a nutshell

The 8 October 2021 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 1 July 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]

— A 22-page highlights brochure which includes the above, some supporting commentary and a FAQ document [Link here]

Much of the detail remaining outstanding was addressed in the different reports or public consultation documents released by the OECD following the October 2021 Statement.

The remaining slides in this deck set out the main things you need to know about the Two-Pillar Solution and its implementation in the European Union.

Pillar One

The October 2021 Principles

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.

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 ("**Amount A**").

— Revenue will be sourced to the end market jurisdictions where goods or services are used or consumed, with detailed source rules for specific categories of transactions developed following the input received through the public consultation conducted by the OECD (early 2022).

— 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 ("**Amount B**").

Pillar One

Post October 2021 Developments

Amount A

— Significant progress has been achieved on the development of the technical rules relating to Amount A through the publication of various documents devoted to items such as nexus and source of income, determination of the taxable base, scope of application, and the special cases of extractive activities and regulated financial services. Such progress is summarized in the Progress Report on Amount A of Pillar One published on 11 July 2022. [Link here]

— Draft Multilateral Convention ("MLC") provisions are expected to be implemented to translate Amount A into action and reflect the commitments with respect to the removal of all existing digital services taxes ("**DSTs**") and other relevant similar measures. A draft MLC (subject to public consultation) was published on 20 December 2022. This consultation document contains draft MLC provisions implementing the commitments with respect to DSTs and other relevant similar measures, including (1) an obligation to withdraw all existing DSTs and relevant similar measures (a list of which is to be included as an appendix to the MLC provisions) and stop applying them; (2) a definition of the measures the parties to the MLC will commit not to enact in the future; and (3) a mechanism that will eliminate Amount A allocations if this commitment is breached. Comments are due by 20 January 2023. [Link here]

Pillar One

Post October 2021 Developments (cont'd)

Amount B

— As part of the Two-Pillar Solution agreed in the October 2021 Statement, Amount B provides for a simplified and streamlined approach to the application of the arm's length principle to in-country baseline marketing and distribution activities, with a particular focus on the needs of low-capacity countries.

— On 8 December 2022, the OECD released a public consultation document outlining the main features of Amount B (*i.e.*, scope, pricing methodology and current status of discussions concerning an appropriate implementation framework). Public comments are due by 25 January 2023. [Link here]

Pillar One
Implementation in the EU

> Although the EU priority is to ensure that a global agreement is implemented at the OECD level, article 57 of the Pillar Two Directive (see Slides 18 and seq. below) provides that the European Commission shall, by 30 June 2023, submit a report to the Council assessing the situation regarding the implementation of the Pillar One of the October 2021 Statement and, if appropriate, submit a legislative proposal to address those tax challenges in the absence of the implementation of the Pillar One solution.

Pillar One

Key Takeaways and Next Steps

Pillar One residual profit allocation is expected to be highly complex, but only the largest MNEs will be affected.

— With a €20 billion turnover threshold, only about 100 companies are expected to be in scope.

A significant collateral part of the package agreed by the IF members is to remove all existing 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, Austria and Spain.

— So long as the MLC is not implemented, DSTs are expected to remain.

- Note that an agreement was reached between the U.S. and certain European countries levying DSTs (the United Kingdom, Austria, France, Italy, Spain) on 21 October 2021 on the terms of an agreement on the transition from existing DSTs to the new multilateral Pillar One solution. Pursuant to the agreement, the European countries have agreed to provide MNEs subject to DSTs with an interim tax credit up to the excess taxes accrued during the interim period (beginning on 1 January 2022 and ending on the earlier of the date the MLC comes into force or 31 December 2023) over what the companies would be liable for under the new taxing right under Pillar One (in the first year where such measures would apply).

The OECD still expects a signing ceremony of the MLC in the first half of 2023 with the objective of enabling it to enter into force in 2024 once a critical mass of jurisdictions have ratified it.

Pillar Two GloBE Rules

General Background

The Pillar Two GloBE rules, with Model Rules for implementation, were released in December 2021 and the related commentary published in March 2022. [Links here and here]

The GloBE Rules encompass two rules:

- An income inclusion rule ("**IIR**") which 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**").
- An undertaxed payments rule ("**UTPR**") which will entitle any jurisdiction having incorporated such rule in its domestic law to levy the remaining top-up tax that should have been collected pursuant to the minimum ETR rule (after having taken into account any IIR top-up tax imposed on that income). Such rule may be enforced by denying a deduction for a payment or imposing an equivalent adjustment (*e.g.,* deemed taxable income or a new tax).

Pillar Two GloBE Rules

Entities in scope

Members of MNE groups that have at least €750 million of annual consolidated group revenue (*i.e.,* the same groups subject to country-by-country reporting ("CBCR"))

— 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).

— The €750 million threshold has to be met for at least two financial years ("**FYs**") of the four FYs before the tested FY.

→ Note that large-scale purely domestic groups (*i.e.,* those for which the €750 million turnover threshold is met) are also in the scope of the Pillar Two Directive aimed at implementing the GloBE Rules (see Slide 18 below – EU *versus* the OECD approach).

Time-limited exclusion from the UTPR

— Available to MNE groups in the initial phase of their international activity.

— Requirements: a maximum of €50 million tangible assets outside home country and operations in five or fewer jurisdictions outside home country.

Countries are free to apply the IIR to MNE groups headquartered in their country that do not meet the threshold.

Pillar Two GloBE Rules

The Effective Tax Rate

The minimum ETR will be fixed at 15%.

The ETR itself will be calculated on a jurisdictional basis (*i.e.*, no global blending) and by dividing "adjusted covered taxes" by "adjusted GloBE income".

Adjusted GloBE income

- The GloBE income is determined by reference to the financial accounting net income (or loss) subject to certain adjustments.
- Adjustments should be made for consistency with tax policy objectives and there will be mechanisms to address timing differences (*e.g.*, avoiding double counting of previously taxed income, aligning with participation exemption regimes or disallowing deduction for illegal payments).

Adjusted covered taxes

- The amount of adjusted covered taxes is determined by reference to the current tax expense booked in each entity's financial accounts, subject to various adjustments.
- Covered taxes include corporate income taxes or similar taxes (such as withholding taxes on foreign income or taxes levied pursuant to CFC rules).

Pillar Two GloBE Rules

Carve-outs and Exclusions

The IIR top-up tax requirement will not apply to an amount of income that is a percentage (5% after a transition period) of the carrying value of tangible assets and payroll.

— 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 will be effected in a simple manner by solely reducing the denominator of the ETR calculation (*i.e.,* "the adjusted GloBE income").

— This mechanism is similar to the Qualified Business Asset Investment rule under the current U.S. GILTI regime.

Pillar Two GloBE Rules

Carve-outs and Exclusions (cont'd)

There will be a *de minimis* exclusion for jurisdictions where the MNE group 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 corporation will be allowed 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.

Pillar Two GloBE Rules

GloBE Safe Harbours

On 20 December 2022, the OECD released guidance on safe harbours and penalty reliefs (the "**Guidance on Safe Harbors and Penalty Relief**") that may apply in the context of the implementation of the GloBE Rules, with a view to mitigating compliance and administration costs generated by the adoption of the GloBE Rules, as well as ensuring tax certainty for MNE groups.

A transitional safe harbor based on the CBCR should apply to FYs beginning on or before 31 December 2026 and ending no later than 30 June 2028.

The top-up tax for a jurisdiction shall be deemed to be zero if one the following tests is met in that jurisdiction:

- Test #1: in the CBCR, the total revenue is less than €10m and the profit (or loss) before income tax is less than €1m;
- Test #2: the jurisdiction has an ETR that is equal to or greater than the transition rate for the FY, it being specified that the calculation of the ETR is based on data reported in the MNE group's CBCR (which would enable simplified calculations in comparison with the GloBE Rules requirements). The transition rate is 15% for FYs beginning in 2023 or 2024, 16% for FYs beginning in 2025 and 17% for FYs beginning in 2026.
- Test #3: there are no excess profits after excluding routine profits.

Such safe harbor should apply to FYs beginning on or before 31 December 2026 and ending no later than 30 June 2028.

The Guidance also sets out a framework for a permanent safe harbor to be based on tests similar to the above-mentioned tests but with simplified calculations that are yet to be detailed.

Neither the transitional and nor the permanent safe harbor will exempt MNE groups from filing obligations.

The Guidance contains a transitional penalty relief regime waiving penalties and sanctions during a transitional period in connection with GloBE information filing obligations where an MNE has taken reasonable measures to ensure a proper application of the GloBE Rules.

Pillar Two GloBE Rules

The Mechanics of the IIR and the UTPR

Where the ETR in a jurisdiction is below 15%, the GloBE Rules determine an amount of top-up tax for each group entity in such jurisdiction. The IIR is the primary rule to collect this top-up tax.

A top-down approach should be followed for the purposes of determining which entity should pay the top-up tax.

- Under such approach, priority is given to the parent entity located at the top of the ownership structure, assuming the IIR is enforced in the jurisdiction of such parent entity.
- If the IIR is not enforced in the parent entity jurisdiction, the liability with respect to the IIR will "drop" down to an intermediate parent entity (assuming that in its jurisdiction a qualified IIR applies).

Where an entity of the group has a split ownership (*i.e.*, a third-party shareholder owning more than a 20% interest), the top-down approach would not apply, and the top-up tax will be paid at the level of an intermediate parent entity rather than at the level of the ultimate parent entity (in order to collect as much top-up tax as possible).

The amount of the top-up tax to be paid by higher-tier parent entities will be reduced by the amount of the top-up tax collected in applying the IIR to lower-tier entities.

Pillar Two GloBE Rules

The Mechanics of the IIR and the UTPR (cont'd)

The UTPR is contemplated as a "fallback rule" and will apply where insufficient top-up tax is collected under the IIR.

For instance, the UTPR will apply in the following situations:

- Where the IIR is not enforced in the jurisdiction where the ultimate parent entity is located or where the ultimate parent entity is excluded from the scope of the GloBE Rules; and
- Where the ultimate parent entity is located in a jurisdiction where the minimum ETR is not met.

In applying the UTPR, all the top-up tax relating to low-taxed entities (across the group) is aggregated and allocated among jurisdictions in which the MNE group is operating (assuming such jurisdictions have adopted the UTPR into domestic laws).

- The allocation key is based on the relative "substance" of the entities in the jurisdictions where the UTPR is applied (assessed based on the number of employees and the value of tangible assets).

Collecting the top-up tax by applying the UTPR may take the form of a denial of tax deductions or equivalent adjustments (*e.g.*, deemed taxable income or a new tax).

A jurisdiction which does not fully use its top-up taxing rights allocated as a result of the UTPR for a given FY will lose its future rights to collect top-up tax by applying the UTPR for subsequent periods until the amount from the previous years has been imposed.

Pillar Two GloBE Rules

EU *versus* OECD approach – The Pillar Two Directive

On 14 December 2022, the EU Council unanimously adopted a directive aimed at ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the European Union (Council Directive (EU) 2022/2523) (the "**Pillar Two Directive**").

The Pillar Two Directive, which is to be transposed into domestic laws by 31 December 2023, is generally consistent with the OECD GloBE rules, subject to certain adjustments, including those set out below. [Link here]

Adjustments aimed at ensuring that the future EU GloBE rules will comply with the EU principle of freedom of establishment

- The scope of GloBE rules within the EU has been extended to purely domestic groups (with the same €750 million threshold applying) whereas the OECD rules only apply to MNE groups.
- The IIR will apply within the EU not only a cross-border basis (*i.e.*, to income generated by foreign subsidiaries that have been insufficiently taxed) but also on a domestic basis. Under the Pillar Two Directive a parent entity is required to apply the IIR to itself and to low-taxed entities located in the same Member State.

Pillar Two GloBE Rules

EU *versus* OECD approach – The Pillar Two Directive (cont'd)

Election to apply a qualified domestic top-up tax

Member States may opt to apply a domestic top-up tax to constituent entities located in their territory. This election allows the top-up tax to be charged and collected in the Member State in which the low-level of taxation occurred, instead of collecting all the additional tax through the IIR at the level of the ultimate parent entity or through the UTPR at the level of other group entities. When a Member State makes this election and charges a domestic top-up accordingly, the amount of any top-up tax computed by another Member State is to be reduced by the amount of qualified domestic top-up tax.

The Pillar Two Directive replicates the UTPR time-limited exclusion applicable to MNE groups in the initial phase of their international activity and extends it to the IIR. For large-scale domestic groups, the exclusion applies during the first five years, starting from the first day of the fiscal year in which the large-scale domestic group falls within the scope of the Pillar Two Directive for the first time.

Implementation timeline

While the GloBE Rules are expected to be effective for FYs beginning on or after 1 January 2023, the Pillar Two Directive contemplates an application to FYs beginning on or after 31 December 2023, with the exception of the UTPR which is to be applicable for fiscal years beginning on or after 31 December 2024.

Election for a delayed application of the IIR/UTPR

Member States in which there are no more than 12 ultimate parent entities in scope of Pillar Two can choose not to apply the IIR/UTPR for six consecutive FYs beginning from 31 December 2023. The other Member States should nevertheless apply the UTPR to their constituent entities of such groups for fiscal years beginning from 31 December 2023.

Pillar Two GloBE Rules

The Implementation of Pillar Two outside of the EU

The implementation process has been initiated in Australia, Japan, Switzerland and the UK.

The US has not undertaken to implement Pillar Two; the existing US top-up regimes, GILTI and the new CAMT (an alternative minimum tax of 15% times adjusted financial statement income), are both significantly different from Pillar Two's IIR.

— As a result, US-headed MNEs may be subject to these US top-taxes in the U.S. *and* UTPRs imposed on their non-US subsidiaries by Pillar 2-adopting jurisdictions outside the US.

The proposed regime in the UK follows the OECD approach

— Initial draft legislation for a "multinational top-up tax" was published in July 2022.

— Most provisions appear to be similar in effect to the equivalent GloBE rules. The draft legislation also includes administrative provisions (for enquiries, assessment and penalties) in line with other areas of the UK tax code.

— An IIR (applying a 15% effective tax rate), and a qualified domestic minimum top-up tax, will have effect for accounting periods beginning on or after 31 December 2023. A UTPR will come into force later – no earlier than for accounting periods beginning on or after 31 December 2024.

— The draft legislation is a work in progress. Further details are expected soon, for enactment in Finance Act 2023.

Pillar Two GloBE Rules

Key Takeaways and Next Steps

The adoption of the Pillar Two Directive is a significant development towards the effective implementation of the GloBE rules.

Furthermore, in its Communication on Business Taxation for the 21st century published on 18 May 2021, the EU Commission announced its intention of developing an EU Directive requiring in-scope MNEs to publish their effective tax rates calculated based on Pillar Two methodology.

Several public consultations launched by the OECD are ongoing (covering tax certainty for the GloBE Rules and GloBE Information Return). Comments are due by 3 February 2023.

The GloBE rules will affect many multinational groups. The model rules are complex and taxpayers will need to read them closely.

US-headed MNEs and non-US MNEs with US subsidiaries should also focus on how the GloBE rules develop – in particular, with respect to how the GloBE rules take into account taxes imposed on MNEs under the US's GILTI and CAMT regimes.

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 Gross National Income 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.

Pillar Two STTR

Next Steps

A model treaty provision giving effect to the STTR is still being developed by the OECD, together with commentary explaining the purpose and the operation of the STTR.

A multilateral instrument will also be developed to facilitate implementation in relevant bilateral treaties.

There are various other open details, such as what happens if a treaty country ceases to be a "developing country".

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