136 jurisdictions agree on a new international corporate tax framework under BEPS 2.0

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Issue 4

In brief

On October 8, 2021, 136 out of the 140 jurisdictions of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (IF) have joined the updated *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*[1] (the October Statement), which updates and finalises a July agreement (the July Statement) by the IF members to fundamentally reform international tax rules. Mainland China and Hong Kong SAR remain amongst the 136 jurisdictions.

Apart from a few key changes to the July Statement, such as setting the amount of residual profit in excess of 10% of revenue to be reallocated at 25% (previously between 20 and 30%) under Pillar One, and the minimum tax rate for Global anti-Base Erosion (GloBE) rules at 15% rather than 'at least 15%' under Pillar Two, the October Statement also attaches an Implementation Plan which describes the work needed to implement the two-pillar solution and sets out a timeline for that process. The OECD also published a list of Frequently Asked Questions[2].

The October Statement still maintains that both Pillar One and Pillar Two will come into effect in 2023, with the multilateral convention (MLC) for Pillar One developed and open for signature in 2022 and legislation for the Pillar Two brought in 2022 via domestic legislation.

With the overall direction of the two-pillar solution largely agreed by the majority of IF members and the target effective date approaching, while certain technical details await to be clarified, multinational enterprise (MNE) groups that are potentially in scope should start assessing the impact that the new rules may have on them, and continue to monitor the developments, including any announcement by the HKSAR government on potential changes to the domestic law.

In detail

The October Statement on the two-pillar solution

The 136 jurisdictions joining the October Statement[3] include some countries that had expressed reservations about the deal in July such as Ireland, Hungary, Estonia, Barbados and Peru, but have now committed to the agreement. Pakistan, which had signed up to the agreement in July, has now withdrawn its support for the agreement. Three IF members, namely Nigeria, Kenya and Sri Lanka, have not yet signed up. Cyprus, the only country in the European Union (EU) that is not a member of the IF, has previously indicated opposition.

The announcement on October 8, 2021 reinforces the July Statement[4] and indicates the direction of travel for work on the significant technical details for the coming months, while little additional technical detail has been shared.

The most significant changes since the announcements of the provisional agreement in July are set out below.

Key updates on Pillar One

1. Pillar One will be implemented via a MLC for all jurisdictions that join, regardless of whether a tax treaty currently exists between those jurisdictions.

2. The scoping rules have been modified with a reference to a profitability above 10% (i.e. profit before tax/revenue) calculated using an averaging mechanism.

3. The Pillar One allocation will be in respect of 25% (previously between 20 and 30%) of residual profit in excess of 10% of revenue.

4. An elective binding dispute resolution mechanism for Amount A issues for certain developing economies will be available.

5. The IF has mandated the Task Force on the Digital Economy (TFDE) to define and clarify the features of Amount A, develop model rules for domestic legislation to give effect to Amount A, develop the MLC and negotiate its content, with a view to having the MLC open for signature by mid-2022.

6. The MLC will require all parties to remove all Digital Services Taxes (DSTs) and other relevant similar measures with respect to all companies, and to commit not to introduce such measures in the future. No newly enacted DSTs or other relevant similar measures will be imposed on any company from October 8, 2021 and until the earlier of December 31, 2023 or the coming into force of the MLC.

7. The IF has mandated Working Party 6 and the Forum on Tax Administration – Mutual Agreement Procedure Forum (FTA MAP Forum) to jointly finalise the work on Amount B by the end of 2022.

Key updates on Pillar Two

1. The minimum tax rate for GloBE rules is now firmly expressed as 15% rather than 'at least 15%'.

2. An exclusion from the Undertaxed Payment Rule (UTPR) will be available for certain small- and medium-sized MNEs (i.e. MNEs that have a maximum of EUR50 million tangible assets abroad and operate in no more than five other jurisdictions) that have just started expanding abroad, limited to a period of five years after the MNE comes into the scope of the GloBE rules for the first time.

3. The formulaic substance carve-out is refined and will exclude an amount of income that is 5% of the carrying value of tangible assets and payroll (yet to be defined precisely). In a transition period of ten years, the amount of income excluded will be:

    - For tangible assets: 8% of the carrying value, with a 0.2% reduction for each of the first five years (after which it will be 7%) followed by a 0.4% reduction for each of the last five years

    - For payroll: 10%, with a 0.2% reduction for each of the first five years (after which it will be 9%) followed by a 0.8% reduction for each of the last five years

4. The *de minimis* exclusion is specified to be for those jurisdictions where the MNE has revenues of less than EUR10 million and profits of less than EUR1 million.

5. The application of the Subject to Tax Rule (STTR) has been restricted to double tax treaties between a developing country and a country that applies nominal corporate income tax rates lower than 9% (previously 7.5% to 9%).

6. Model rules to give effect to GloBE rules and a model treaty provision to give effect to STTR will be developed by the end of November 2021.

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

8. The timeline for UTPR is pushed back from 2023 to 2024, while that for Income Inclusion Rule (IIR) remains to be 2023.

Our observations: *The timelines for implementation remain ambitious. Given the level of technical detail that needs to be finalised across both pillars, it will take a huge effort from all parties to facilitate agreement within this timeline. For Pillar One, because Amount B is not being developed in conjunction with the timeline for Amount A, it appears that Amount A profit reallocations will, at least in the initial year of implementation, not take account of in-country baseline marketing and distribution activities.*

For Pillar Two, while the minimum rate is now set at 15%, eliminating speculation of a higher rate, it is unclear how 15% minimum rate is to be locked in across countries and across time, and what the mechanism for changing it will be. However, it has been confirmed that any EU Directive implementing Pillar Two will not look to introduce a rate higher than 15%.

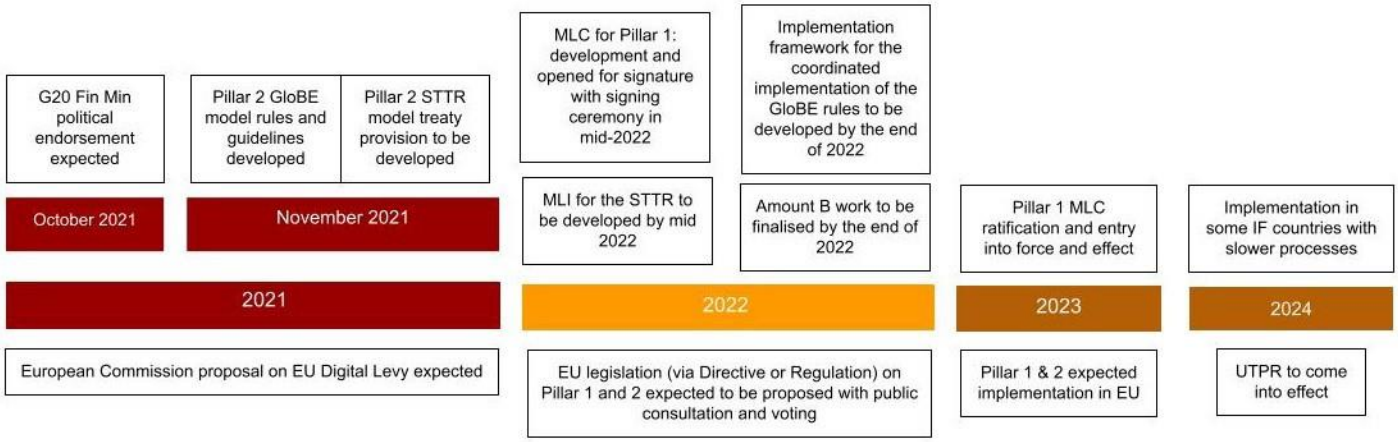
What's still to be agreed?

The October Statement is still very general with respect to some of the key design features of the two pillars. This implies that the IF will continue to work in an effort to reach agreement on some of the key features of both pillars until November 2021 for some designated items, with other elements intended for early, mid, or the end of 2022.

Elements left to be agreed		
Pillar One	***Pillar Two***	***General / others***
• The identification of surrendering entities • The safe harbour for marketing and distribution activities • Detailed sourcing rules • Mandatory and binding dispute prevention and resolution mechanisms	• Rules accounting for book-tax differences created by loss carryforwards and depreciation • Definitions of payroll and tangible assets in the substance-based carve-outs • The terms for recognition of equivalent IIR regimes, e.g. US GILTI • The terms for recognition of equivalent UTPR regimes, e.g. US BEAT or SHIELD • Implementation of STTR and detailed scope of 'other' payments affected • Details of the effective tax rate (ETR) safe harbour(s)	• Model rules and commentary • Challenges in constructing the MLC for Pillar One and MLI plus a model treaty provision for Pillar Two • Guidance on scope for allowing / preventing new unilateral rules (e.g. EU Digital Levy) and rolling back / restricting existing measures (e.g. DSTs)

What's next?

A significant amount of technical work still remains to be finalised, with a suggestion that more detailed documents, including draft rules, will be released by the end of 2021. A consultation seems to be indicated but has not been announced. The possible timeline and upcoming key events are shown in the diagram below:



The takeaway

The OECD considers the agreement reached on October 8 to be ‘a major victory for effective and balanced multilateralism’ and ‘a far-reaching agreement which ensures our international tax system is fit for purpose in a digitalised and globalised world economy’. Under Pillar One, taxing rights on more than USD125 billion of profit are expected to be reallocated to market jurisdictions each year, with more revenue gains to developing countries than more advanced economies. Pillar Two is estimated to generate around USD150 billion in additional global tax revenues annually.

While progress has been made since July, the effective implementation of the agreement by the targeted timeline will require further significant effort.

As noted in our July news flash, the HKSAR government welcomes the consensus largely reached by the international community on the key principles of the BEPS 2.0 package, and the Advisory Panel on BEPS 2.0 set up by the government will submit a report to the Financial Secretary as soon as possible after the OECD finalises the technical details of the BEPS 2.0 package.[5]

Meanwhile, it is understood that the government has been considering possible responses to the two pillars. The adoption of Pillar One involves translating the rules into domestic law and participating in the MLC, although the overall increase in tax revenue brought about by Pillar One to Hong Kong is not expected to be significant. As regards Pillar Two, which may have a more significant potential impact on MNEs with operations in Hong Kong, the alternatives being considered by the government include adopting the common approach of applying IIR and UTPR, introducing a domestic minimum tax in addition to applying IIR and UTPR (with optionality to be further studied), and adjusting the existing profits tax regime with a view to increasing the ETRs of Hong Kong entities.

MNE groups that are potentially in scope should start assessing the impact that the new rules may have on them, and fine-tune the assessment based on further details to be announced by the OECD and HKSAR government in due course.

Endnotes

1. The OECD’s press release and the October Statement can be accessed via this link:
https://www.oecd.org/tax/beps/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm

2. The list of Frequently Asked Questions can be accessed via this link:
https://www.oecd.org/tax/beps/faqs-statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf

3. The list of members of the IF that have signed the Statement can be accessed via this link:
https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-members-joining-statement-on-two-pillar-solution-to-address-tax-challenges-arising-from-digitalisation-october-2021.pdf

4. Our news flash on the July Statement can be accessed via this link:
https://www.pwccn.com/en/tax/publications/intl-tax-newsflash-jul2021-3.pdf

5. The HKSAR government's press release in July can be accessed via this link: https://www.info.gov.hk/gia/general/202107/02/P2021070200714.htm

Let's talk

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