

Pillar One and Pillar Two

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The document only contains a high-level overview of Pillar One and Pillar Two. It does not contain detailed technical aspects and the method of computation of amounts under the Pillars.



Historic tax deal - The journey so far

Existing tax laws, along with the nexus and profits attribution rules, were built around traditional business forms and rely on their physical presence in a country. The existing international tax rules are based on agreements made in the 1920s and are enshrined in the global network of bilateral tax treaties. However, business models have evolved as a result of digitalisation and globalisation. Today, everything, right from starting a business to selling products/services, is digitally managed without the need for physical presence. Thus, it is imperative that the current international tax laws be reformed to address how the digital economy is taxed.

These tax challenges were first identified as a focus area of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, leading to the 2015 BEPS Action 1 Report,¹ titled "Addressing the Tax Challenges of the Digital Economy". More than 130 countries in the Inclusive Framework have been working on the Two Pillar approach. As an outcome, the OECD Secretariat,

on 12 October 2020, released a package comprising a report on the Pillar One Blueprint and Pillar Two Blueprint.² Since, the Inclusive Framework members have continued to work towards reaching a consensus on these proposed solutions.

On 5 June 2021, the G7 countries³ announced⁴ a political agreement on Pillar One and Two. The changes proposed by the US in April 2021 formed the basis for the political agreement. This was followed by a statement⁵ by the Inclusive Framework on 1 July 2021, announcing a consensus by 130 countries.⁶ In the meeting during 9–10 July,⁷ G20 accepted the Two Pillar solution.

Pillar One provides taxing rights to market jurisdictions on part of the residual profits earned by MNE groups with an annual global turnover exceeding €20 billion and 10 percent profitability. Pillar Two requires MNE groups with an annual global turnover exceeding €750 million to pay at least 15 percent tax.

¹ OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, released in November 2015.

² <https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint-beba0634-en.htm>
<https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint-abb4c3d1-en.htm>

³ Canada, France, Germany, Italy, Japan, the United Kingdom and the United States

⁴ <https://www.g7uk.org/g7-finance-ministers-and-central-bank-governors-communiqué/>

⁵ <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.htm>

⁶ Subsequently two more countries agreed to the package.

⁷ <https://www.g20.org/wp-content/uploads/2021/07/Communique-Third-G20-FMCSG-meeting-9-10-July-2021.pdf>

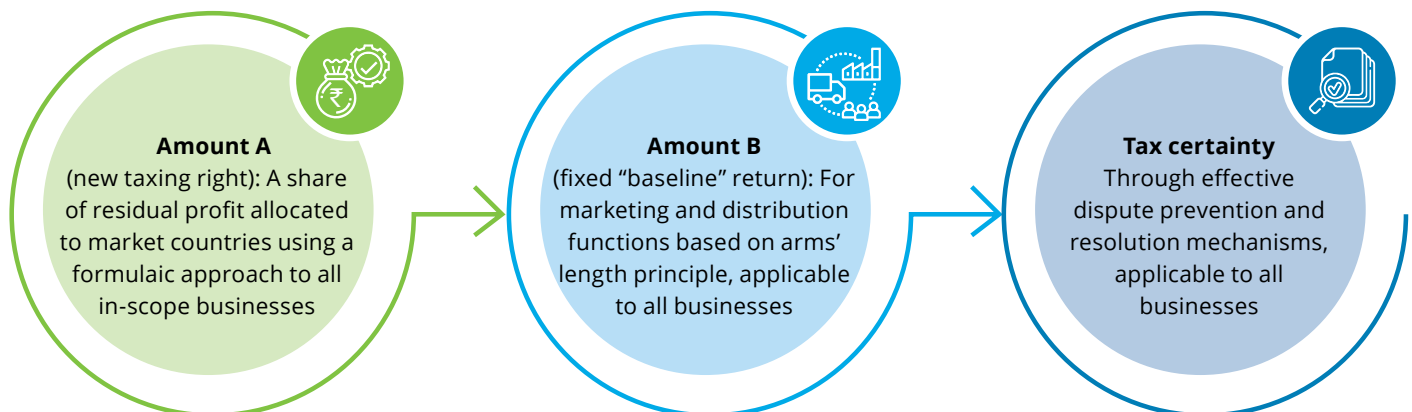


Pillar One Blueprint: An overview

Pillar One seeks to adapt the international income tax system to new business models through changes to the profit allocation and nexus rules applicable to business profits. It expands the taxing rights of market jurisdictions where there is an active and sustained participation of a business in the economy of that jurisdiction through activities in, or remotely directed at, that jurisdiction.

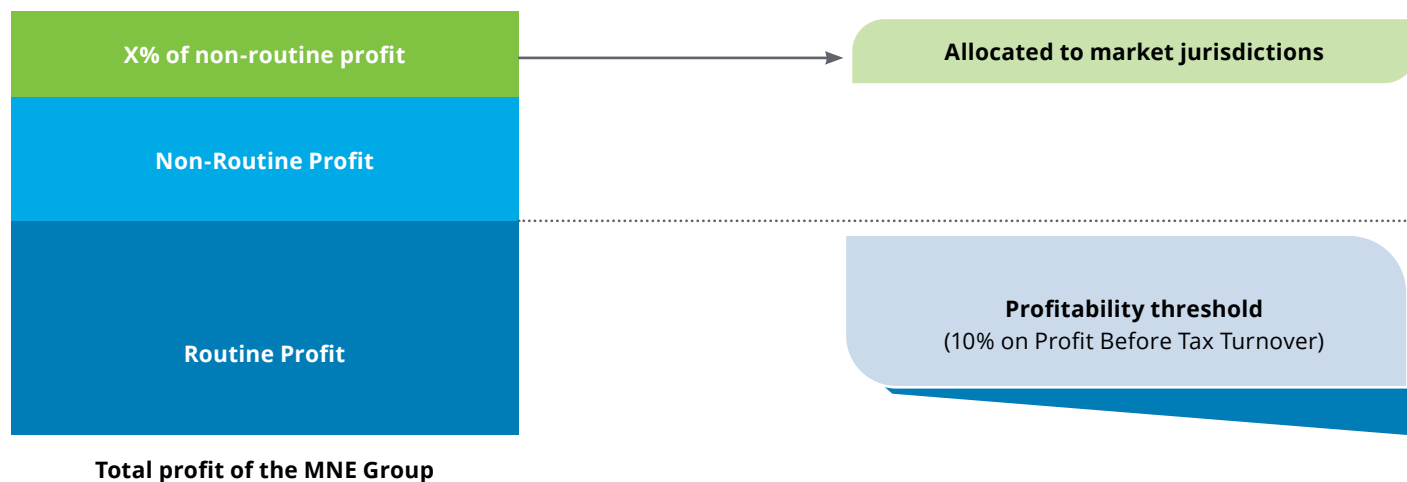
Pillar One applies to about 100 of the biggest and most profitable MNEs and distributes part of their profit to countries where they sell their products and provide their services.⁸

The key elements of Pillar One can be grouped into three components:

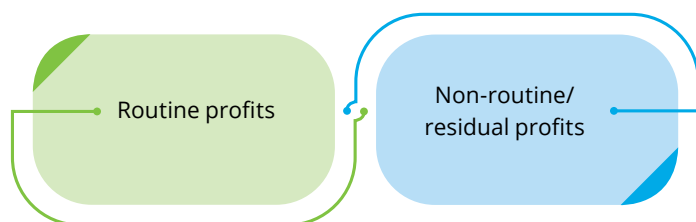


⁸ https://www.oecd.org/tax/beps/brochure-addressing-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf?utm_source=Adestra&utm_medium=email&utm_content=Highlights%20brochure&utm_campaign=Tax%20News%20Alert%2008-07-2021&utm_term=ctp

The diagram below represents Amount A:



The bar represents the total amount of profit before tax of the MNE group, which is divided into two parts:



The profits within the profitability threshold of 10 percent are routine profits, while those beyond the profitability threshold are residual or non-routine profits. Between 20 and 30 percent of residual profits⁹ is treated as Amount A and distributed amongst market jurisdictions. This is the new taxing right under Pillar One.

Scope: All MNE groups with gross revenue exceeding €20 billion¹⁰ and profitability above 10 percent (Profit before tax / revenue) are considered in-scope for Amount A.¹¹

Exclusions: Extractives and regulated financial services are out of scope.

Revenue sourcing rules: Revenue will be sourced to the end market jurisdictions where goods or services are used or consumed. To facilitate the application of this principle,

detailed source rules for specific categories of transactions will be developed. In applying the sourcing rules, an MNE must use a reliable method based on the MNE's specific facts and circumstances.

Nexus: Amount A is allocated to the market jurisdiction only if the nexus exists. To establish nexus, the market revenue thresholds (€1 million¹² /€250,000 for jurisdictions with GDP lower than €40 billion¹³) will apply to the in-scope revenue of a group, generated in a market jurisdiction. Market revenue will be identified and measured per the revenue sourcing rules.

Tax base determination: Tax base will be quantified using an adjusted Profit Before Tax (PBT) measure, derived from the consolidated financial accounts¹⁴ of in-scope MNE groups, rather than on a separate entity basis. To these, a limited number of book-to-tax adjustments will apply for certain items such as dividends, gains/losses under equity method of accounting, and bribes.

Losses will be carried forward.

Profit allocation: For in-scope MNEs, between 20 and 30 percent of residual profit defined as profit in excess of 10 percent of revenue will be allocated to market jurisdictions with nexus, using a revenue-based allocation key.

⁹ As per the Statement issued by Inclusive Framework on 1 July 2021

¹⁰ As per the Statement issued by Inclusive Framework on July 1 2021, the turnover threshold to be reduced to 10 billion euros, contingent on successful implementation including of tax certainty on Amount A, with the relevant review beginning 7 years after the agreement comes into force, and the review being completed in no more than one year

¹¹ The Blueprint considered MNE groups exceeding revenue threshold of Euro 750 million as in-scope. Further, MNEs crossing the threshold had to fall in either of the following two categories of businesses – Automated Digital Services (ADS) or Consumer Facing Business (CFB). The definitions of ADS and CFB have been provided.

¹² As per the Statement issued by Inclusive Framework on 1 July 2021

¹³ As per the Statement issued by Inclusive Framework on 1 July 2021

¹⁴ Consolidated financial accounts prepared by the ultimate parent entity under GAAP, that produce equivalent or comparable outcomes, to consolidated financial accounts prepared under IFRS will mainly be used. Eligible GAAPs: GAAPs of Australia, Canada, China, Hong Kong, Japan, New Zealand, India, Korea, Singapore and US.

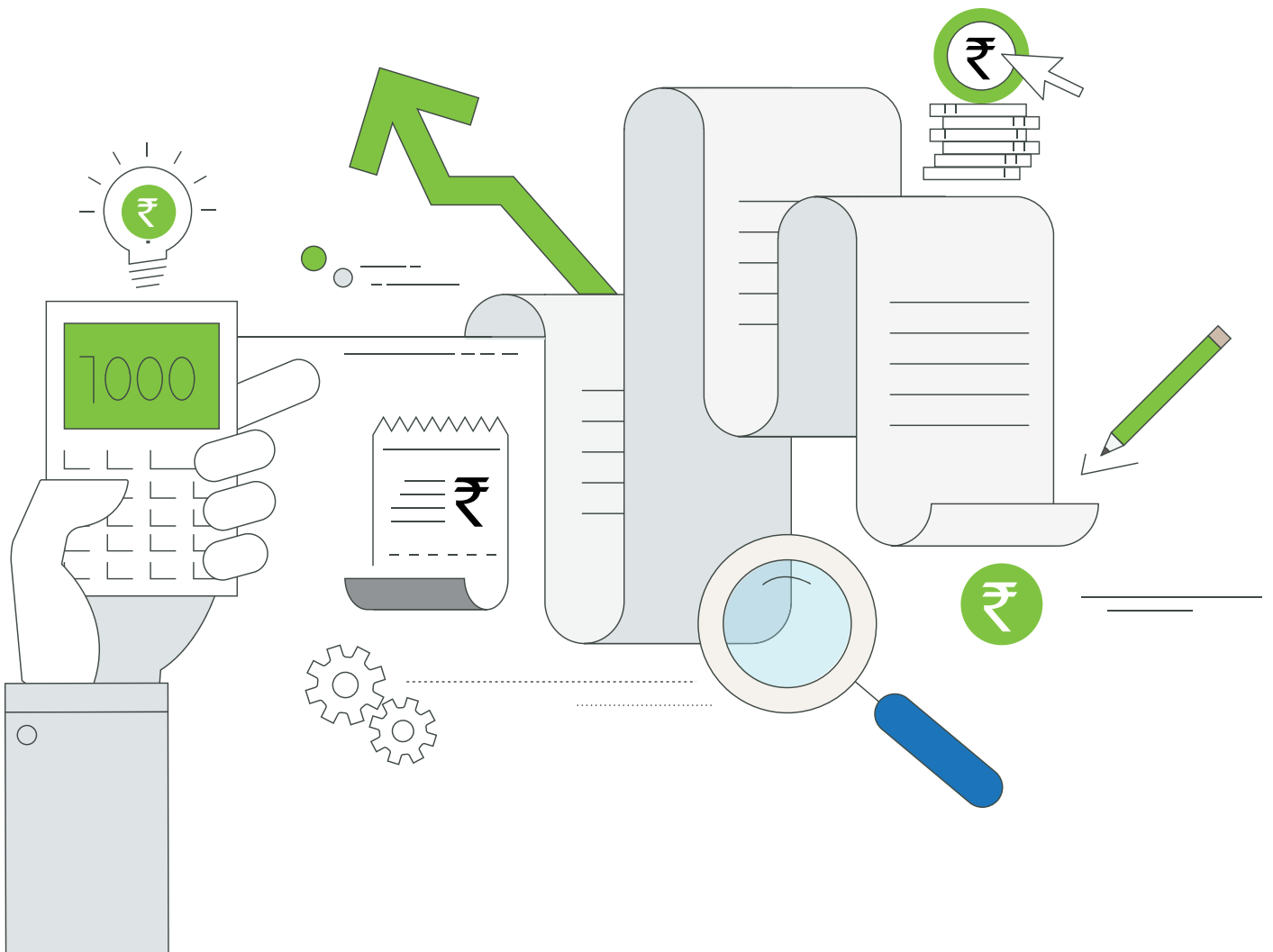
Double taxation and double counting: The proposed mechanism to eliminate double taxation will have two components: (i) Identification of paying entities; and (ii) methods to eliminate double taxation. Approaches being considered include a marketing and distribution profits safe harbour, mechanism to eliminate double taxation and domestic business exemption.

Amount B: It aims to standardise the remuneration of related party distributors that perform “baseline marketing and distribution activities” to align with the Arm’s Length Price. Further work is being done on this and is expected to be completed by the end of 2022.¹⁵

Tax certainty: Pillar One aims to significantly improve tax certainty by introducing innovative dispute prevention and resolution mechanisms. The Blueprint embeds a mechanism to

ensure that the application of the new taxing right to a particular MNE group is agreed upon by all interested jurisdictions. A panel mechanism would be implemented for tax administrations working with relevant MNEs to agree on: (i) The tax base, (ii) the result of the implementation of the formula, and (iii) any other feature of the new taxing right, including paying entities and elimination of double taxation. A mandatory binding timely dispute resolution mechanism, for disputes not related to the application of the new taxing right is also being developed.

Unilateral measures and implementation: Appropriate coordination between the application of the new international tax rules and the removal of all Digital Service Taxes and other relevant similar measures on all companies will be provided. The multilateral instrument through which Amount A is implemented will be developed and opened for signature in 2022, with Amount A coming into effect in 2023.



¹⁵ As per the Statement issued by Inclusive Framework on 1 July 2021

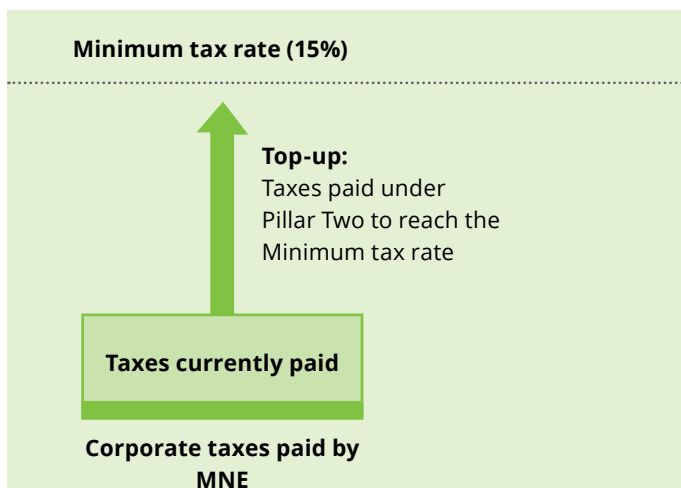


Overview of Pillar Two Blueprint

Many jurisdictions are engaged in tax competition (referred to as the race to bottom) by offering reduced taxation—and often zero taxation—to attract foreign direct investment. Further, growth of intangibles, like brands, copyright, and patents enhances the companies' ability to shift profits to jurisdictions that impose little or no tax.

Pillar Two addresses remaining BEPS challenges and is designed to ensure that large internationally operating businesses pay **at least 15 percent** tax, regardless of where they are headquartered or the jurisdictions they operate in.

The below diagram explains this:



In a situation where the Effective Tax Rate (ETR) paid by an entity in a jurisdiction is less than 15 percent, the objective of Pillar Two is to recover the balance as top-up tax from the MNE group. Assuming that the ETR of the MNE group in the jurisdiction is 10 percent, the Pillar Two rules aim to recover the balance 5 percent as top-up tax.

Pillar Two rules are divided into the following two parts:



Scope: Applicable to the MNE groups with total consolidated group revenue of €750 million or above, in the immediately preceding fiscal year. Countries are free to apply the IIR to MNEs headquartered in their country, even if they do not meet the threshold. The concepts and thresholds are adopted from the Country by Country Reporting mechanism, prescribed BEPS Action 13. The consolidated group revenue threshold is applied to all those Constituent Entities that are owned and controlled by the same Ultimate Parent Entity ('UPE').

Exclusions: Government entities, international organisations, non-profit organisations, pension funds, or investment funds that are UPEs of an MNE Group or any holding vehicles used by such entities, organisations or funds, are not subject to the GloBE rules.

Income inclusion Rule (IIR) and Undertaxed Payment Rule (UTPR): IIR is the principal mechanism to achieve GloBE rules outcome with UTPR acting as the backstop. IIR operations are, in some respects, based on traditional Controlled Foreign Company (CFC) principles and trigger inclusion at the shareholder level, UPE or intermediate parent entity, where the income of a controlled foreign entity is taxed below the ETR. The UTPR is a secondary rule and only applies where a Constituent Entity is not already subject to an IIR.

Computation of ETR: It is determined using the following formula:

$$\text{GloBE ETR} = \frac{\text{Amount of covered taxes}}{\text{Amount of income as determined under the GloBE rules}}$$

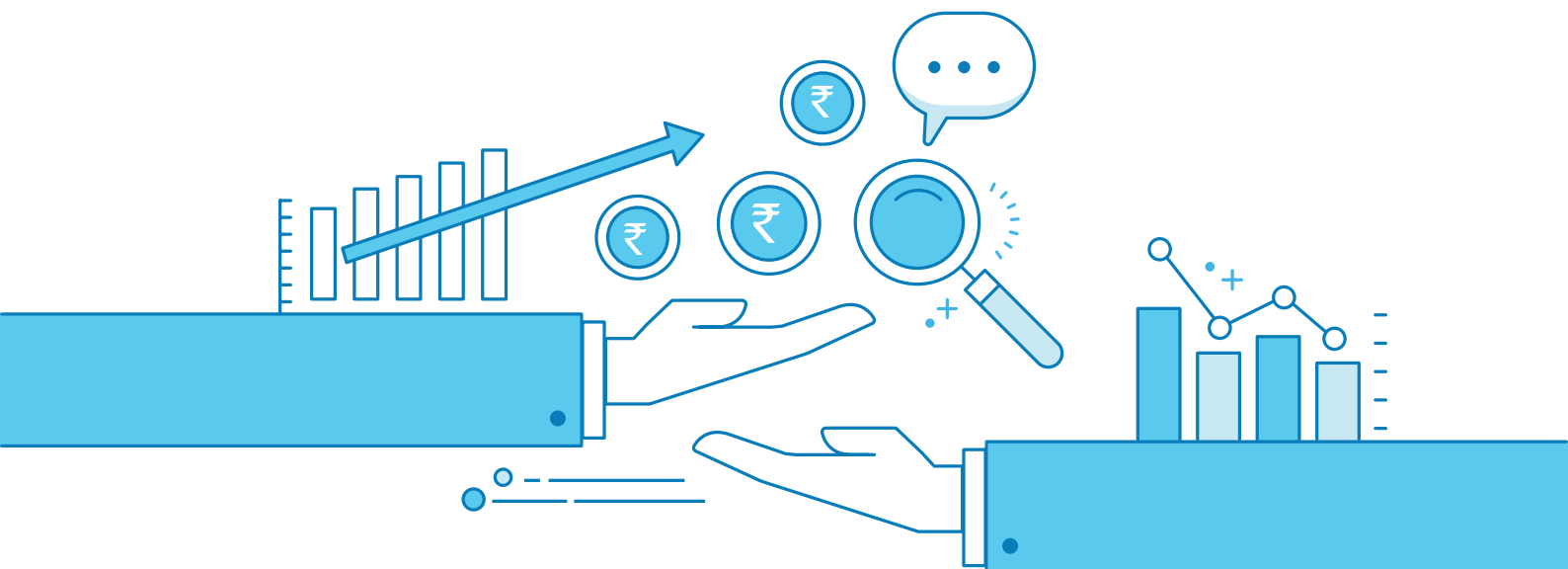
The starting point for determining the GloBE tax base (denominator) is the profit (or loss) before income tax, as determined using the financial accounting standard¹⁶ used by the parent in the preparation of its consolidated financial statements. A limited number of adjustments are then made to add or eliminate certain items to arrive at the GloBE tax base.

Covered taxes (numerator) mean 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.

The ETR is calculated at a jurisdictional level. ETR computation also requires the assignment of the income and taxes amongst jurisdictions in which the MNE operates and to which it pays taxes. Further adjustments for substance carve-outs, carry-forward of losses, and excess tax credits are to be made.

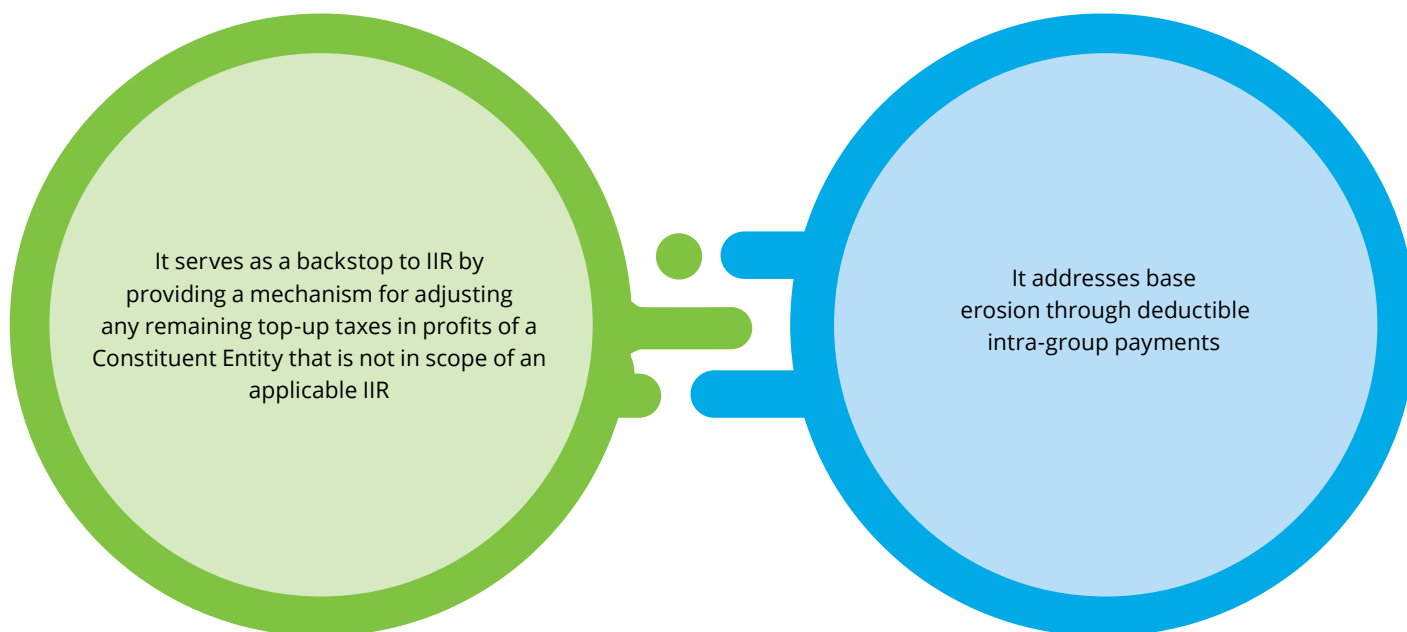
Top-up tax: Top-up tax is determined as the excess of the agreed minimum tax rate over the ETR, as calculated for a jurisdiction in the relevant period. This top-up tax is payable either by way of IIR or UTPR.

Top-down approach: The primary mechanism for co-ordinating the application of the IIR in each jurisdiction is through the top-down approach. This approach prioritises the application of the IIR in the Constituent Entity's jurisdiction that is at or near the top of the ownership chain in the MNE group, starting with the UPE. In the event that the UPE is not located in a jurisdiction that has implemented the IIR, then responsibility for applying the IIR falls on the Constituent Entity that is directly owned and controlled by that UPE, and so on, down the chain of ownership.



¹⁶ The acceptable financial accounting standards are IFRS and any equivalent financial accounting standard. Equivalent financial accounting standards include the generally accepted accounting principles of Australia, Canada, Hong Kong (China), Japan, New Zealand, the People's Republic of China, the Republic of India, the Republic of Korea, Singapore, and the United States. Any other accounting standard as used in the UPE jurisdiction could be used, if it does not result in material competitive distortions in the application of the GloBE rules.

UTPR: It has a hybrid purpose which is achieved through the following:



Where the UTPR applies, top-up tax is allocated proportionately amongst Constituent Entities applying UTPR in a co-ordinated way. First, to those entities making direct payments to the low-tax Constituent Entity, and then, amongst all entities in the group that have net intra-group expenditure.

Subject to Tax Rule (STTR): It complements the GloBE Rules. It is a treaty-based rule that targets those cross-border structures that relate to intragroup payments exploiting certain provisions of the treaty to shift profits from source countries to payee jurisdictions, where those payments are subject to no or low rates of nominal taxation. In such circumstances, it reallocates taxing rights to source jurisdictions.

It applies to certain prescribed cross-border payments (known as covered payments—interest, royalties, brokerage, marketing, procurement, agency or other intermediary services, etc.) between connected persons (defined in the Blueprint). It is triggered when a payment is subject to a

nominal tax rate in the payee jurisdiction that is below the minimum tax rate, after adjusting for certain permanent changes in the tax base that are directly linked to the payment or the entity receiving it. The minimum tax rate under STTR is from 7.5 percent to 9 percent.¹⁷

Rule order: The STTR applies even if the MNE Group is subject to the IIR or the UTPR. The taxes charged as a consequence of the STTR are taken into account in calculating the ETR of the payee. IIR applies in priority to the UTPR.

GILTI co-existence: It is agreed that Pillar Two will apply a minimum rate on a jurisdictional basis. In that context, consideration will be given to the conditions under which the US GILTI regime will co-exist with the GloBE rules, to ensure a level playing field.

Implementation: This would require changes to the domestic tax laws and bilateral tax treaties.

¹⁷ As per the Statement issued by Inclusive Framework on 1 July 2021



Impact of Two Pillar solution

The two Pillar solution represents a historic development and seeks to rewrite century-old tax laws and will affect all large groups. Both Indian headquartered groups with international operations (India outbound) and foreign headquartered groups (India inbound) with Indian operations, satisfying the threshold requirements, would be required to evaluate the impact of this in terms of additional tax outflow, as well as compliance burden.

India outbound groups will have to determine whether the jurisdictions in which they operate qualify as low-tax jurisdictions and whether, additional tax is payable on that account. Similarly, analysis of applicability of STTR is also

important for cross-border payments between connected persons (both for inbound and outbound).

For outbound groups that cross the thresholds for Pillar One, the compliance and tax costs may increase. The Indian UPE will have to play the role of a co-ordinating entity. Per the OECD estimate, Pillar Two will generate additional annual tax revenue of US\$150 billion and Pillar One will result in the tax reallocation to the extent of US\$100 billion, in favour of market jurisdictions.

What's next?

The statement released by Inclusive Framework suggests an aggressive timelines for implementation.

Timeline	Pillar One	Pillar Two
October 2021	Final implementation plan	Final implementation plan
2022	MLI for implementing Amount A to be made available for signature (Amount A MLI)	Global Model Rules for implementation of GloBE rules MLI to implement to GloBE rules (GloBE MLI) STTR model provision and MLI for facilitation of STTR adoption in the tax treaty (STTR MLI) Transition rules: Possibility of deferred implementation of UPTR
2023	Implementation of Pillar One	Implementation of Pillar Two

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