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Global Tax Alert

OECD releases BEPS 2.0 Pillar Two Blueprint and invites public comments

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Executive summary

On 12 October 2020, the Organisation for Economic Co-operation and Development (OECD) released a series of major documents in connection with the ongoing G20/OECD project titled "Addressing the Tax Challenges of the Digitalisation of the Economy" (the BEPS 2.0 project). These documents include the long-awaited report on the Pillar Two Blueprint (the Blueprint). Pillar Two of the BEPS 2.0 project addresses the development of global minimum tax rules with the objective of ensuring that global business income is subject to at least an agreed minimum rate of tax.

As the OECD documents make clear, the Blueprint does not reflect agreement by the member jurisdictions of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS) because there are political and technical issues that still need to be resolved. However, the cover statement of the Inclusive Framework refers to the Blueprint as a "solid basis for future agreement" and states that the member jurisdictions have agreed to keep working "to swiftly address the remaining issues with a view to bringing the process to a successful conclusion by mid-2021."

With the release of the Blueprint, the OECD also announced plans for consultations with stakeholders. The Inclusive Framework welcomes comments on all aspects of the Blueprint, with specific questions of particular interest laid out in a public consultation document. Interested parties are invited to submit

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written comments by 14 December 2020, and the OECD is planning to host virtual public consultation meetings in mid-January 2021.

Detailed discussion

Background

In October 2015, the OECD released the Final Report on Action 1 (the Action 1 Final Report), *Addressing the Tax Challenges of the Digital Economy*, together with the final reports on the other 14 elements of the BEPS Action Plan. The Action 1 Final Report provides the OECD conclusions regarding the digital economy and recommended next steps to address the tax challenges presented by its evolution. The Action 1 Final Report expresses the view that special rules designed exclusively for the digital economy would prove unworkable, broadly stating that the digital economy cannot be ring-fenced because it "is increasingly becoming the economy itself," and provides a summary of key features of evolving digital business models that the OECD considers relevant for the overall BEPS analysis. In addition, the Action 1 Final Report considers broader direct and indirect tax challenges raised by the digital economy and evaluates options to address those challenges. However, the Action 1 Final Report does not recommend any of the options analyzed and leaves it up to individual countries to introduce any of them as additional safeguards against BEPS.

In March 2018, the OECD released a document "Tax Challenges Arising from Digitalisation — Interim Report 2018" (the Interim Report) as a follow up to the Action 1 Final Report. The Interim Report sets out the Inclusive Framework jurisdictions' agreed direction of work on digitalization and the international tax rules through 2020. The Interim Report does not make any specific recommendations to countries, indicating instead that further work will need to be carried out to understand the various business models operated by enterprises offering digital goods and services, as well as digitalization more broadly. However, despite the technical complexity and the diverse positions, the Inclusive Framework jurisdictions agreed to undertake a coherent and concurrent review of the rules and achieve a consensus-based solution by 2020.[1]

In January 2019, the OECD released a Policy Note communicating that renewed international discussions would focus on two central pillars: one pillar addressing the broader challenges of the digitalization of the economy and focusing on the allocation of taxing rights, and a second pillar addressing remaining BEPS concerns.[2] Following the Policy Note, in February 2019, the OECD released a Public Consultation Document[3] describing the two pillar proposals at a high level, received extensive comments from stakeholders, and held a public consultation in March 2019.[4]

Following the public consultation, in May 2019, the OECD released the "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy" (the Workplan).[5] The Workplan is divided into two pillars:

- Pillar One is described as addressing the allocation of taxing rights between jurisdictions and considers various proposals for new profit allocation and nexus rules.
- Pillar Two is described as involving the development of a coordinated set of rules to address ongoing risks from structures that are viewed as allowing multinational enterprises to shift profit to jurisdictions where they are subject to no or very low taxation.

On 8 November 2019, the OECD released a Consultation Document on Pillar Two[6] and on 9 December 2019 the OECD held a consultation meeting to give stakeholders an opportunity to discuss their comments with the Inclusive Framework jurisdictions.

On 31 January 2020, the OECD released a Statement by the Inclusive Framework on the two-pillar approach indicating that the members of the Inclusive Framework affirmed their commitment to reach an agreement on new international tax rules by the end of 2020.[7] Attached to the Statement were more detailed documents, including a progress update on Pillar Two.

On 18 July 2020, the OECD released the OECD's Secretary-General report to G20 Finance Ministers and Central Bank Governors which stated that the work on Pillar Two had substantially progressed and that a blueprint report on Pillar Two would be developed for consideration by the Inclusive Framework at the 8-9 October meeting.[8]

On 12 October 2020, the OECD and the Inclusive Framework released a series of documents in connection with the BEPS 2.0 project, including the Blueprint on Pillar Two.

The Pillar Two Blueprint

The Blueprint provides technical details on the design of the Pillar Two system of global minimum tax rules, which includes income inclusion rules and an undertaxed payments rule (referred to collectively as the Global Anti-Base Erosion (GloBE) rules) and a subject to tax rule.

The Cover Statement of the Inclusive Framework, which is incorporated in the Blueprint, describes the Blueprint as providing "a solid basis for a systemic solution." It further indicates that it is recognized and accepted that there may be member jurisdictions that will not implement the Pillar Two rules, but that all jurisdictions that do implement the rules are expected to apply them in a manner that is consistent with the consensus with respect to other jurisdictions that join the consensus and to multinational enterprise groups (MNEs) headquartered in those jurisdictions. It also notes the importance of the subject to tax rule to a large number of member jurisdictions, particularly developing countries, and states that such a rule will be an integral part of a Pillar Two agreement. Looking ahead, the Cover Statement references the need to reach agreement on "the development of model legislation, standard documentation and guidance, designing a multilateral review process if necessary and exploring the use of a multilateral convention, which could include the key aspects of Pillar Two."

The Cover Statement calls out the need to reach agreement on the basis on which the United States (US) Global Intangible Low-Taxed Income (GILTI) rules are to be treated as a Pillar Two compliant income inclusion rule. The Blueprint further indicates that the Inclusive Framework recognizes that agreement on the co-existence of the GILTI rules and the GloBE rules needs to be part of a political agreement on Pillar Two. Further consideration will be given to the technical aspects of the coordination between these rules, which will include consideration of the GILTI rules to US intermediate parent companies of foreign groups that are headquartered in countries that apply an income inclusion rule. The Public Consultation Document specifically requests stakeholder input on the technical design of the coordination of the GILTI rules and the GloBE rules.

The Blueprint notes that the treatment of the GILTI rules as compliant with Pillar Two will need to be reviewed if legislative or regulatory changes were to materially narrow the GILTI tax base or reduce the tax rate. With respect to the undertaxed payments rule that is intended to operate as a backstop to the income inclusion rule under Pillar Two, the Blueprint further notes that the Inclusive Framework "strongly encourages" the US to limit the operation of the Base Erosion and Anti-abuse Tax (BEAT) in the case of payments to entities that are subject to a Pillar Two income inclusion rule.

Scope of GloBE

Chapter 2 of the Blueprint contains the rules for determining whether a taxpayer is within the scope of the GloBE rules. It provides definitions for determining in-scope groups and entities, as well as a list of excluded entities. It also provides rules on the consolidated group revenue threshold test for application of the GloBE rules.

In-scope groups

The determination of in-scope groups and entities is based largely on the definitions and mechanisms that are used in connection with country-by-country reporting (CbCR). Subject to the special treatment of excluded entities, the GloBE rules generally apply to groups and entities that are subject to the CbCR obligations laid out in the final report on BEPS Action 13, using the consolidation standard under financial accounting standards. Like the CbCR rules, the definition of Constituent Entity for GloBE purposes includes entities that would be excluded from consolidated financial statements based on size or materiality. The Blueprint treats a permanent establishment (PE) as a separate Constituent Entity provided it has separate financial statements. The Blueprint notes that the separate treatment of a PE ensures comparable treatment of foreign subsidiaries and PEs under the GloBE. While the CbCR rules do not provide a definition of "permanent establishment," the Blueprint indicates that the determination is made for GloBE purposes based on the applicable tax treaty and in the absence of an applicable treaty, generally based on sufficient presence to trigger net basis taxation under applicable domestic law. In addition, the GloBE rules provide guidelines for the determination of an acceptable accounting standard in order to ensure consistency in determining the MNEs that are in scope.

Excluded entities

Certain entities that are at the top of the ownership chain of an MNE are specifically excluded from the application of the GloBE rules. The Blueprint notes that these excluded entities all have a particular purpose or status under the laws of the jurisdiction where they are created, and they generally are exempt from domestic income tax to preserve a specific policy outcome. These entities are expressly excluded from the GloBE rules based on three principles that: (i) the tax policy rationale of the residence jurisdiction for low or no tax is consistent with the GloBE policy; (ii) the exclusion is necessary to avoid compliance and administration costs;

and (iii) an exclusion would not create material competitive distortions as compared to other businesses. The Blueprint also indicates that further consideration will be given regarding cases where the exclusion should apply to entities that are not at the top of an ownership chain, such as life insurance and pension structures that are consolidated within a group but whose income is not beneficially owned by the group.

The Blueprint lists the excluded entities as follows, providing specific definitions of each: investment funds, pension funds, governmental entities, international organizations, and non-profit organizations. Note that the exclusion is specific to the entity itself and generally does not extend to entities owned by it that are not themselves on the list. However, the exclusion does extend to entities that are established to hold assets or invest funds for the excluded entity, provided that such entity is not carrying on or managing a commercial business. The Public Consultation Document specifically requests stakeholder input on whether additional rules are needed to address investment funds that are not at the top the ownership chain of an MNE.

The Blueprint also provides special rules for entities at the top of an ownership chain of an MNE that are subject to certain tax neutrality regimes in their residence jurisdiction. This applies to regimes that meet the following criteria: (i) the owners of the entity are subject to tax in that jurisdiction on their share of the entity's income; (ii) the owner's tax liability arises immediately; and (iii) the owners are subject to tax at a rate that equals or exceeds the minimum rate. The Blueprint references the US S corporation rules as an example of a tax transparency regime and agricultural cooperative rules as an example of a distribution deduction regime. The special rules for entities that are subject to a tax transparency regime provide that the income of the entity is excluded from the GloBE rules.

Finally, the Blueprint notes that further work will be required on whether and to what extent the GloBE rules should apply to the international shipping sector.

Consolidated revenue threshold

MNEs with total consolidated group revenue below €750 million in the immediately preceding fiscal year generally are excluded from the GloBE rules. The Blueprint notes several advantages from use of this threshold. For this purpose, excluded entities are not considered as members of the group, so their revenue is excluded from computation of the threshold. In such a case, the revenue threshold would be applied to the subgroup that is controlled by an excluded entity (without taking into account the excluded entity). The Blueprint indicates that further work could be undertaken to consider a potential anti-avoidance rule to prevent fragmentation of a group into different subgroups in order to avoid the threshold, taking into account the ongoing work on the 2020 review of the BEPS Action 13 CbCR minimum standard.

Calculating the effective tax rate

Chapter 3 covers the rules and explanations relating to the calculation of the effective tax rate (ETR) and top-up tax under the GloBE rules, specifically defined to mean both the income inclusion rule and the undertaxed payments rule. The starting point for calculating the ETR are the financial accounts of each Constituent Entity prepared in accordance with the financial accounting standard used by the parent of the MNE in its consolidated financial statements. A limited number of adjustments are then made to the financial accounts to add or eliminate specified items in order to arrive at the GloBE tax base. The Chapter also defines the covered taxes that can be taken into account in determining the ETR on a jurisdictional basis.

Adjustments to the GloBE tax base are based on the materiality and commonality of the items among jurisdictions and are generally made to avoid duplication of income and address permanent differences. Therefore, the GloBE tax base adds back deductions for stock-based compensation (based on either the local tax deduction or where there is no income tax regime, the expense recognized for financial accounting purposes). The GloBE tax base eliminates items such as intra-group dividends (including portfolio dividends where there is a low percentage of equity ownership) and investments accounted for on the equity method, as well as gain or loss realized in connection with a nontaxable reorganization or restructuring. Adjustments will also be made for deductions related to immediate expensing and accelerated depreciation to preserve the benefits intended by domestic tax rules, by either modifying the carryforward approach for the deferred tax liability (that will increase the taxes paid under the ETR calculation) or using the local tax depreciation rules to reduce the GloBE tax base. Corporations subject to a distribution-based corporate income tax regime (where tax is assessed only upon distribution of earnings) will increase their covered taxes for the amount that would be due on the income if distributed, but only up to the minimum tax threshold that would be subject to recapture rules if the tax is not actually paid.

Financial accounting will be retained for government grants and tax credit with safeguards for refundable credits that can be treated as income or a reduction to covered taxes.

Covered taxes are more expansive than income taxes, with a focus on tax reported as due and payable in the tax return filed with respect to the income for the tax year. Covered taxes include: any tax on an entity's income or profits (including surcharges and taxes imposed on specific activities, supplementary top-up taxes, and taxes on distributed profits). In lieu of taxes, including those assessed on an alternative basis levied at state or local government level, corporate equity taxes, and taxes paid under controlled foreign corporation (CFC) rules also qualify as covered taxes that will be included in the ETR calculation. A list of non-covered taxes is also provided, with digital services taxes featured on that list along with other taxes that are not based on income.

The jurisdictional ETR requires the income and taxes to be allocated between jurisdictions, generally by identifying the jurisdiction where the income was earned and associating the covered taxes with that location. Income earned by PEs and entities that are liable to tax in a jurisdiction are assigned to that jurisdiction. Entities that do not have a tax residence are treated as stateless entities that belong to a stateless jurisdiction to which the income earned, and corresponding covered taxes, are assigned for purposes of the ETR calculation. Subject to the exclusion rules for entities at the top of the ownership chain, stateless entities include tax transparent entities and reverse-hybrid entities, but each owner's share of the income is generally assigned to the owner's jurisdiction. The Inclusive Framework acknowledges special rules may be needed for taxable branches to avoid over taxation. The assignment of covered taxes can create cross-jurisdictional taxes, whereby tax collected by one jurisdiction may be moved to the ETR calculation of another jurisdiction. This can occur in the case of withholding taxes and CFC taxes. The Blueprint suggests that this could create incentives to structure into transactions so high-taxed income shelters income in low-taxed jurisdictions and notes that anti-abuse rules are being considered to prevent such a result.

The Public Consultation Document specifically requests stakeholder input on the treatment of dividends and gains from stock dispositions, the treatment of reorganizations, rules to adjust for accelerated depreciation, the treatment of tax transparent entities, and the allocation of cross-jurisdictional taxes (with a particular focus on anti-avoidance rules).

Carryforwards and carveout

Chapter 4 sets out a number of adjustments that may be made to the top-up tax calculation, either through the carryover of losses or excess taxes from other periods or through the application of a formulaic substance-based carveout. The carryforward adjustments are intended to ensure that Pillar Two does not result in the imposition of additional tax where the low ETR is simply a result of differences in the timing for recognition of income or the imposition of taxes, while the formulaic substance-based carveout is intended to exclude a fixed return for substantive activities within a jurisdiction from the scope of the GloBE rules.

The top-up tax calculation is impacted by local losses and excess local taxes through adjustment to the ETR calculation or the income inclusion rule (IIR) liability that is owed. Local losses impact the amount of GloBE income for the ETR calculation and have an unlimited carryforward period to ensure MNEs will not be subject to tax under the GloBE rules on more than their economic income because of an expired loss carryforward. Excess taxes paid in a local jurisdiction create either an IIR tax credit that can reduce a shareholder's current year or subsequent tax liability under the IIR or a local tax carryforward that can increase the covered taxes for the ETR calculation. Excess taxes means the amount of local tax paid in excess of the minimum tax rate threshold and will be limited in duration when being used to create an IIR credit or to increase the covered tax expense. Once an IIR credit is created, the use of that credit is unlimited in duration and can be used to reduce an IIR tax liability arising with respect to any jurisdiction. Excess tax first creates an IIR credit to the extent an IIR tax has been allocated to the same jurisdiction during a look-back period that has yet to be defined. Any excess tax that does not create an IIR tax credit will result in a local tax carryforward.

The Inclusive Framework has identified the need for a transition rule to address pre-regime losses and taxes that for the period either prior to implementation of the GloBE rules or prior to an MNE becoming subject to the rules (e.g., before the group reaches the gross revenue threshold). The rule contemplated would allow an MNE to compute an opening balance of its loss carryforward and local tax carryforward as if the GloBE rules had applied during a yet defined transitional period; alternatively, a simplified approach would approximate this approach. Operating losses covered by the transition rule would be for those incurred in the period or periods immediately prior to becoming subject to GloBE rules.

The top-up tax calculation is also impacted by the substance-based carveout by excluding a fixed return for substantive activities within a jurisdiction from the scope of the GloBE rules. In effect, the substance-based carveout reduces the income to which the top-up calculation applies, allocated to each Constituent Entity with positive net income based on the ratio of that entity's net income to the total net income within the jurisdiction. If the adjusted GloBE income for a jurisdiction is zero or a loss, there is no GloBE tax liability for the jurisdiction, and any loss is carried forward under the loss carryforward rules described above. The substantive activities that qualify for the carveout are limited to a yet defined percentage of eligible payroll costs and depreciation or deemed depreciation on certain tangible assets. Eligible payroll comes from costs (salaries, wages, benefits and other remuneration to employees as well as taxes and contributions based on employee wages) paid to all employees and independent contractors based on the residence of the employee or contractor. Eligible tangible assets include a portion of the depreciation of property, plant and equipment, deemed depreciation of land, depletion of natural resources, and depreciation of a lessee's right-of-use on tangible assets. The Blueprint indicates that further consideration will be given to the effect of the carveout on the calculation of the ETR and top-up taxes under the GloBE rules.

The Public Consultation Document specifically requests stakeholder feedback on the treatment of pre-existing losses and excesses taxes, the design of the formulaic substance-based carveout, and the computation of the ETR and top-up tax.

Simplification

Chapter 5 explores a number of simplification measures designed to reduce the compliance burden in particular from the use of a jurisdictional ETR calculation. The Blueprint notes that these simplifications would benefit from further public consultation with the business community in particular and specifies that no decision has yet been taken on which, if any, of these simplification measures to incorporate into the final design of the rules. Four simplification measures have been considered by the Inclusive Framework:

- *Country-by-country (CbC) reporting ETR safe-harbor*: where a jurisdictional ETR based on the CbCR report is above a certain threshold (which may be higher than the agreed minimum rate for the GloBE rules), no further work would be required for that jurisdiction. This simplification mechanism would only be available to MNEs that prepare their CBC reports based on the parent's consolidated financial information, and it would require a series of adjustments to the financial information reported in the CBC report (more precisely, to the "Profit (Loss) before Income Tax" and the "Income Tax Accrued (Current Year)" information).
- *De minimis profit exclusion*: another option being considered would be to exclude jurisdictions from the GloBE rules that have less than a specified percentage of the MNE's pre-tax profit. The Blueprint suggests a de minimis threshold of 2.5% of the group's pre-tax profit as an appropriate threshold. Alternatively, the Blueprint also notes the potential use of a fixed de minimis profit threshold (of €100,000) or the combined use of a relative de minimis threshold (of 2.5% of the group's pre-tax profit) and a fixed de minimis threshold (of €100,000).
- *Single jurisdictional ETR calculation to cover several years*: this approach would mean an MNE would not be required to compute the ETR of a particular jurisdiction for a specified period of years (three to five years – the "grace period") where the ETR of that jurisdiction exceeded a specified threshold rate (in the base year). The threshold rate could be set above the agreed minimum rate. The Blueprint notes that restrictions and anti-abuse measures should be considered to avoid distortions.
- *Tax administrative guidance*: finally, the Blueprint also suggests establishing a process for tax administrations (via the Inclusive Framework) to work together with stakeholders to identify jurisdictions where the tax base does not materially depart from the GloBE tax base and the tax rate is sufficiently high, thus allowing a presumption that an MNE's ETR in that jurisdiction exceeded the agreed minimum rate.

The Blueprint outlines benefit and drawbacks of each of these options and notes that additional work be required for each of these options.

The Public Consultation Document specifically requests stakeholder feedback on the overall approach to simplification (including any other simplification measures that could be explored) as well as on the technical details of each of the measures laid out in the Blueprint.

Income inclusion and switch-over rules

Chapter 6 describes the operation of the IIR. The IIR provides for a mechanism to collect the top-up tax based on the parent entity's direct or indirect ownership of the low-taxed

Constituent Entities. The undertaxed payments rule (UTPR) (see Chapter 7, below) serves as a backstop to the IIR by providing a mechanism to collect any remaining top-up tax in relation to foreign profits that are not in scope of an applicable IIR.

Chapter 6 includes technical rules on how the IIR is applied in the context of a multi-tiered ownership structure, providing for an exception to the top-down approach where the ownership is split with a minority holder outside the group. In such a case, the split-ownership rules require the intermediate parent entity to apply the IIR to the controlled subsidiaries of the sub-group. This chapter also explains the need for a treaty-based switch-over rule that would allow a jurisdiction to override the exemption method to the extent necessary to apply the IIR to the profits of a PE, aiming to ensure equality of treatment of exempt PEs and foreign subsidiaries under the GloBE proposal.

The IIR includes an ordering rule that is designed to ensure that the IIR in different jurisdictions cannot be applied to the same interest in low-taxed income. The primary mechanism for coordinating the application of the IIR in each jurisdiction is through the top-down approach, giving priority to the application of the IIR in the jurisdiction of the Constituent Entity that is at or near the top of the ownership chain in the MNE, starting with the Ultimate Parent Entity (UPE). Only if the UPE is not located in a jurisdiction that has implemented the IIR will the responsibility for applying the IIR fall to its direct subsidiary, and so on, down the chain of ownership.

Both the IIR and the UTPR (discussed below) are based on the same effective tax rate calculation.

The Public Consultation Document specifically requests stakeholder feedback on the top-down approach, any potential integrity measures, and the split-ownership rules.

Undertaxed payment rule

Chapter 7 contains a detailed discussion of the UTPR. The UTPR only applies to those Constituent Entities in the MNE that are not controlled by an entity further up the chain that applies an IIR. In this way, the IRR, with one exception, takes priority over the UTPR. That exception occurs when the UPE has an ETR that is below the minimum threshold ETR, in which case payments from Constituent Entities to the UPE may be subject to the UTPR. The Blueprint includes an extensive discussion of how the UTPR would apply in this situation.

Where the UTPR applies, top-up tax is calculated as if the MNE were subject to an IIR, with the resulting notional top-up tax allocated proportionately among Constituent Entities applying a UTPR, allocating first to those entities making direct payments to the low-tax Constituent Entity and then among all entities in the group that have net intra-group expenditure. Taxpayers allocated UTPR can either disallow or cap related-party payment deductions.

According to the Blueprint, the UTPR is designed to apply in more limited circumstances than the IIR. Nevertheless, application of the UTPR can apply in more complex situations, including when IIRs apply at a sub-group level and not all constituent entities are owned by the same parent applying the same IIR. In this case, some constituent entities may be within scope of an applicable IIR, while others may be subject to a UTPR.

The Blueprint also contemplates caps on the amount of UTPR that may be allocated to a Constituent Entity jurisdiction. The first cap applies to the amount of top-up tax that can be allocated to a UTPR jurisdiction and it is based on the domestic covered tax rate applicable in that jurisdiction. The second cap limits the total top-up tax that can be allocated in respect of the low-tax income of the UPE jurisdiction and is based on the gross amount of deductible intra-group payments. Another cap applies to the UTPR when it is allocated to a UPE jurisdiction. This new language that would limit the application of the UTPR to the UPE acknowledges that the UPE, as the parent entity, cannot restructure itself out of the UTPR and into the IIR and would apply by limiting the application of the UTPR in these cases to the foreign intragroup income of the Constituent Entities located in the UPE jurisdiction.

The Public Consultation Document specifically requests stakeholder input on the general design of the approach as well as on the efficacy of, and potential improvements to, the certification requirements, standardized self-assessment returns, and local filing requirements either in the application of the UTPR or the deactivation of the rule in situations where the IIR applies.

Special rules

Chapter 8 discusses two special rules, one dealing with associates and joint ventures and another dealing with so-called "orphan entities." The first rule applies a simplified IIR to the income of an MNE attributable to ownership interests in entities or arrangements that are reported under the

equity method. The second rule is designed to extend the application of the UTPR to orphan entities or arrangements that could otherwise be used to extract profit from the MNE for the benefit of the controlling shareholders, which are viewed as giving rise to a BEPS risk.

Because it would be challenging to apply the full set of IIR rules to the income of associates and joint ventures (JVs) for a variety of reasons, the Blueprint sets forward a simplified IIR, which has three key differences from the general IIR:

- The simplified IIR is based on worldwide blending of the income and taxes of the associate or JV and all subsidiaries of that entity.
- The income taxes are determined based on the financial accounting rules, including deferred tax accounting.
- The simplified IIR only takes into account taxes that are treated as income taxes for financial accounting purposes.

If the ETR computed for an associate or JV is below the minimum rate, the MNE's equity method income attributable to the ownership interest in the entity is multiplied by the top-up tax percentage (the difference between the minimum rate and the ETR) to determine the top-up tax attributable to that ownership interest.

Orphan entities are entities or arrangements that do meet the criteria for being part of the MNE (and, therefore, are not "Constituent Entities"), even though they may be controlled by the same shareholder or group of shareholders as the Constituent Entities forming the MNE. The Blueprint provides as an example the situation where the underlying shareholder or group of shareholders of the MNE and the entity or arrangement consists of a fund or foundation or a group of connected individuals (such as a family) that does not, itself, form part of the MNE. For these entities, a specific rule would define the circumstances under which profits of these entities should be included in the scope of application of the UTPR, with the aim of avoiding undue compliance and administration costs.

The Public Consultation Document specifically requests stakeholder feedback on technical aspects of the special rules.

Subject to tax rule

Chapter 9 introduces the subject to tax rule (STTR). It describes the framework for the development of a treaty-based rule targeting the risks to source countries posed by BEPS structures involving intragroup payments that take advantage of low or nominal rates of taxation in the other contracting jurisdiction.

With this objective, the STTR would be designed as a standalone tax treaty rule (a) that will be applied to payments; (b) between connected persons; (c) that are "covered payments"; (d) excluding certain entities (consistent with the GloBE rules); (e) provided a materiality threshold is exceeded; (f) triggered by the nominal tax rate; and (g) using a top-up approach.

Applied to payments between residents of two contracting states, the STTR will apply to a defined set of payments giving rise to base erosion concerns. This includes interest and royalty payments, and also payments such as franchise fees, insurance premiums and rent for movable property. The Blueprint proposes an exclusion for payments falling within the listed categories where the payment generates a low return (so-called low-return payments).

In this context, the Public Consultation Document asks for stakeholder responses on whether they consider that the categories of covered payments and the exclusion for low-return payments would ensure that the STTR focuses on the transactions that present significant BEPS risks. It also asks for views on the design and practical application of this rule component. In addition, stakeholders are also invited to share views on the design and application of this exclusion and to propose simplifications.

For the materiality threshold under consideration by the Inclusive Framework, the consultation document also invites views on the inclusion of such rule and the possible approaches for designing such a rule. The approaches under consideration include: (i) the size of the MNE; (ii) a specified Euro-value of covered payments; and (iii) a specified ratio of covered payments to total expenditures.

The STTR differs substantively from the GloBE rules, with the latter using an ETR test while the former will be triggered when a payment is subject to a nominal tax rate in the payee jurisdiction that is below the minimum rate. The tested nominal rate will be adjusted for certain permanent changes in the tax base that are directly linked to the payment or the entity receiving it.

Finally, the chapter also outlines possible administrative approaches and the consultation documents invites stakeholders to indicate which approach is considered most suitable. The approaches on which the Inclusive Framework will conduct further work are: (i) an ex-post annualized charge to apply the top-up tax; (ii) a certification system providing for reduced withholding tax rates; and

(iii) the application of contingent withholding taxes set at a level that would generally result in an annual ex-post balancing payment by the taxpayer. The public consultation also requests stakeholder input on the administrative considerations.

Implementation and rule coordination

Chapter 10 addresses implementation issues and explains how the Inclusive Framework intends to ensure rule coordination and increase tax certainty. It also sets out the Inclusive Framework's thinking on the compatibility of the GloBE rules with existing tax treaty obligations. Finally, it describes the possible development of model legislation and guidance, a multilateral review process and a possible multilateral convention, which could also include new provisions on dispute prevention and resolution.

The ultimate priority of the Pillar Two rules is with the STTR. This follows from the fact that additional tax resulting from the application of the STTR will be taken into account in determining the ETR under the GloBE rules. The IIR would take priority over the UTPR. As a result, no top-up tax may be allocated under the UTPR in respect of a Constituent Entity that is controlled, directly or indirectly, by a foreign Constituent Entity that is subject to an IIR in accordance with the GloBE rules.

The Blueprint concludes that tax treaties should not present any obstacle to jurisdictions implementing an IIR and UTPR along the lines envisaged under the GloBE. It includes a number of references to the OECD Model Tax Convention and its commentaries, noting that, with limited exceptions, tax treaties are not intended to restrict a jurisdiction's right to tax its own residents. For the IIR, reference is made to paragraph 81 of the Commentary to Article 1 of the OECD Model Tax Convention that states that "(...) controlled foreign company legislation structured in this way is not contrary to the provisions of the Convention." The Blueprint regards the IIR as "similarly compatible with the provisions of tax treaties." For the UTPR, the Blueprint includes an analysis of OECD Model provisions and Commentary and comes to the conclusion that there is no conflict with the provisions on business profits (Article 7) and non-discrimination (Article 24).

The Public Consultation Document specifically requests stakeholder input on co-ordination mechanisms or other features of the GloBE that are worth exploring to ensure more tax certainty in applying the Pillar Two rules. It also recognizes the risk of double taxation and controversy resulting from the application the GloBE rules and, in the context of dispute prevention and resolution, requests stakeholder input on additional options to mitigate these risks.

Next steps

The public consultation on the Pillar Two Blueprint will be open for written comment submissions until 14 December 2020 and all comments received will be made publicly available. Public consultation meetings on the Blueprints will be held in January 2021. Looking ahead, the Inclusive Framework has agreed to work quickly to address remaining issues with a view to reaching a successful conclusion by mid-2021.

Implications

The proposals under Pillar Two represent a substantial change to the tax architecture and go well beyond digital businesses or digital business models. These proposals could lead to significant changes to the overall international tax rules under which businesses operate. It is important for businesses to follow these developments closely in the coming months and to consider engaging with the OECD and policymakers at both national and multilateral levels on the business implications of these proposals. Businesses also should evaluate the potential impact of these changes on their business models.

If no agreement can be reached by the Inclusive Framework by the mid-2021 target, it is expected that there will be more activity in the European Union and in individual countries on putting in place their own minimum tax rules. The design work done on the Pillar Two likely would be a starting point for these unilateral actions, with deviations reflecting the particular country's own interests.

The Blueprint and the other developments with respect to the BEPS 2.0 project will be discussed on the upcoming EY Global Thought Center webcast Taxation of the digitalized economy: What's next on 28 October 2020.

Endnotes

1. See EY Global Tax Alert, *The OECD's interim report on tax challenges arising from digitalisation: An overview*, dated 21 March 2018.
2. See EY Global Tax Alert, *OECD's new insights describe growing support on comprehensive changes to international tax policy, beyond digital*, dated 29 January 2019.
3. See EY Global Tax Alert, *OECD opens public consultation on addressing tax challenges arising from digitalization of the economy: time-sensitive issue impacting all multinational enterprises*, dated 14 February 2019.
4. See EY Global Tax Alert, *OECD hosts public consultation on document proposing significant changes to the international tax system*, dated 18 March 2019.
5. See EY Global Tax Alert, *OECD workplan envisions global agreement on new rules for taxing multinational enterprises*, dated 3 June 2019.
6. See EY Global Tax Alert, *OECD issues consultation document on technical design aspects of Pillar Two*, dated 14 November 2019.
7. See EY Global Tax Alert, *OECD documents on BEPS 2.0 include new details and identify issues under consideration on Pillar One and Pillar Two*, dated 7 February 2020.
8. See EY Global Tax Alert, *OECD issues report to G20 finance ministers and Central Bank governors and hosts webcast to provide update on tax work*, dated 29 July 2020.

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