

Technology & Tax Series

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TECHNOLOGY & TAX SERIES – ISSUE XII: OECD TWO-PILLAR SOLUTION: LIGHT AT THE END OF TUNNEL?

On October 8, 2021, after years of intensive negotiations, over 137 members of the OECD/ G20 Inclusive Framework (“IF”) on Base Erosion and Profit Shifting (“BEPS”) agreed to a sweeping overhaul of the global tax system by way of a two-pillar solution (“Two-pillar Solution”).¹ This agreement to prevent BEPS is envisaged to transform a century old international taxation system by the adoption of the Two-pillar Solution. A year after the agreement, OECD and governments across the world are working towards developing rules and implementation of the Two-pillar Solution.

A. PILLAR ONE

Existing Status:

As per the progress report on Amount A of Pillar One released by OECD on July 11, 2022 (“Progress Report”),² significant progress has been made with respect to the technical aspects of Pillar One. The key aspects of Pillar One are summarised below:

- **In-scope MNEs and quantum:** Amount A applies to MNEs with a global turnover above ₹ 20 million with a profit margin above 10%. This involves the reallocation of 25% profit above 10% to market jurisdictions through proposed profit allocation rules.
- **Nexus:** A special purpose nexus rule has been proposed to determine whether a market jurisdiction qualifies for an Amount A allocation (consisting of quantitative thresholds based on the amount of revenue which a MNE group generates in a market jurisdiction). Accordingly, the nexus rules are proposed to be applicable to a market jurisdiction when an in-scope MNE group derives at least ₹ 1 million in revenue from that particular jurisdiction. For market jurisdictions with a GDP lower than ₹ 40 billion, a lower nexus threshold has been proposed, which is met if ₹ 250,000 is generated from such market jurisdictions.
- **Revenue sourcing:** The nexus rule is supported by a revenue sourcing rule which provides a mechanism for determining which market jurisdictions the revenue generation takes place in (based on reliable indicators or allocation keys).
- **Exclusions and safe harbour:** Certain sectors relating to extractives and regulated financial services have been excluded from the scope of Amount A entirely. An in-scope MNE group that has been subject to tax in a market jurisdiction will also be provided a safe harbour by capping the residual profits allocated to that particular jurisdiction.

The Progress Report recognises that it is important to balance the political interest in swift implementation with the need to properly finalise the design of innovative new rules under Amount A. It also notes that the substance of these rules must be fully stabilised before the development and completion of a Multilateral Convention (“MLC”), to be signed and ratified by IF members.

Recently, draft rules to enable administrability and tax certainty of Amount A have also been introduced for public consultation.³ With respect to administrability, this primarily includes provisions around filing of relevant information, payment of taxes, and access to double taxation relief. OECD has proposed a solution based on the existing corporate tax regimes and legal frameworks, to allow for the implementation of amount A without any significant modifications to the existing tax infrastructures across countries (thereby reducing the burden on taxpayers and tax authorities). To ensure tax certainty, voluntary mechanisms have been proposed to determine and ensure the correct application of Amount A rules (usually to be conducted by the tax authorities of the ultimate parent entity (“UPE”).

Amount B applies to MNEs that perform defined baseline “marketing and distribution activities” in a market, without any scope limitation of Amount A. It aims to standardise the remuneration in a manner that is aligned with the arm’s length principle. It is intended to simplify the administration of transfer pricing rules and enhance tax certainty. Currently, OECD has not released any draft rules / guidance on Amount B. Technical work on Amount B is expected to be delivered by the end of 2022.

Implementation Plan:

The signing ceremony of the MLC and its explanatory statement is expected to be held in the first half of 2023, with the objective of the MLC coming into force in 2024, once a critical mass of jurisdictions (as defined by the MLC) have ratified it.

The MLC will contain the rules necessary to determine and allocate Amount A and eliminate double taxation. It will also contain information relating to the administrative process, exchange of information process and the process for dispute resolution, thereby ensuring consistency and certainty in the application of Amount A. The MLC will be

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supplemented by an explanatory statement that describes the purpose and operation of the rules and processes. The Progress Report provides that the MLC will also contain provisions requiring the withdrawal of all existing digital service taxes (“DSTs”) and relevant similar measures with respect to all companies, as well as a commitment not to enter into such measures in the future.

Challenges:

While the OECD has estimated taxing rights on more than USD 125 billion of profit are expected to be reallocated to market jurisdictions each year⁴, corporations still consider the Pillar One (specifically the revenue sourcing rules) to be too complex for implementation.⁵ The G24 Working Group on Tax Policy and International Tax Cooperation (“G24”) in its comments⁶ on the Progress Report, while acknowledging the complexity of Pillar One rules, reiterated the need for intensive capacity building to facilitate streamlined implementation and adoption of Amount A rules. With respect to commitment on removal of DSTs, the G24 urged that any commitment from jurisdictions should be in the nature of political commitments only. Considering that the Progress Report provided that the MLC will contain provision for withdrawal of DSTs or similar measures, the G24 highlighted that such high legal bar runs the risk of undermining the consensus solution and raise constitutional concerns in various jurisdictions. Therefore, an agreement on this aspect seems to be essential for fruition of Pillar One. The OECD has estimated that increase in unilateral measures at national level could give rise to retaliatory tariffs which could cost the global economy up to 1% of global GDP.⁷

Another issue which was raised by the G24 was with respect to inclusion of withholding taxes in Amount A (i.e. as a further deduction from the computation of residual profit under Amount A). In this regard, the Progress Report notes divergent views on whether withholding taxes on deductible payments made to in-scope MNEs (in accordance with relevant tax treaties) relate to the elimination of double taxation and to double counting. While the Progress Report does not deal any further with withholding taxes, it highlights the contradictory positions on whether withholding taxes should be included or excluded for the purposes of computation of Amount A. The G24 has stated that consideration of withholding taxes as further deduction from the computation of residual profit under Amount A, will result in erosion of the existing rights, and will deem Pillar One meaningless for developing countries. Treatment of withholding taxes under Amount A will be another contentious issue for consensus on Pillar One.

Some of the comments received during the public consultation of the Progress Report also highlight that a relatively small number of mature market jurisdictions are likely to gain additional taxing rights from Pillar One. One of the reasons for this is the manner of computation of reduction in Amount A allocation to a jurisdiction under the Marketing and Distribution Safe Harbour (“MDSH”)⁸. Even the G24 highlighted concerns with respect to the broader MDSH design provided in the Progress Report.

Concerns have also been expressed in the public comments regarding the MLC coming into force only upon ratification by a “critical mass of countries” which includes the resident jurisdiction of the UPEs.⁹ US, being a resident jurisdiction of a significant number of MNE groups, would need to agree to Pillar One, by ratification of the proposed MLC by at least 2/3rd majority of the US Senate. Reports suggest that this may be unlikely (given the internal political conflicts within the US Congress¹⁰ and potential loss of revenue on account of Pillar One¹¹). Though the U.S. Treasury Secretary, Janet Yellen, believes that Amount A would roughly be revenue neutral¹², for the US Senate to accept the two-pillar solution, the increase in revenue generation on account of Pillar Two would need to be higher for the US.

B. PILLAR TWO

Existing Status:

Pillar Two proposes to introduce a framework for a global minimum tax of 15% for in-scope MNE groups (i.e. MNE groups with the annual revenue higher than □ 750 million). The underlying intent is to ensure that all streams of income within such in-scope MNE groups, regardless of the jurisdiction it emanates from, are taxed at the minimum rate of at least 15% (i.e., either in the source jurisdiction, or the resident jurisdictions to which such income is up-streamed). In this respect, OECD through the course of 2022 released draft provisions for the Pillar Two Global Base Erosion Rules (“GloBE Rules”), a commentary, and a set of illustrative examples to clarify the working of the rules.¹³ The basic design of Pillar Two can be categorised into:

- a. **GloBE Rules** (consisting of the (a) **Income Inclusion Rule (“IIR”)** and (b) **Undertaxed Payment Rule (“UTPR”)**):
 - **IIR**: The IIR imposes a top-up tax on a parent entity of an MNE group with respect to the income of downstream group entities (i.e., subsidiaries and permanent establishments) that is taxed at less than a 15% minimum effective tax rate (“ETR”) in the source jurisdictions. The first right of taxation under the IIR is offered to the jurisdiction of the UPE. Subsequently, if not exercised by the UPE jurisdiction, the taxing right under the IIR flows to the jurisdiction of the next downstream entity in the MNE group.
 - **UTPR**: A supporting UTPR denies deductions or requires an equivalent adjustment in the event a parent entity’s allocable share of the top-up tax regarding a low-taxed constituent entity is not subject to tax under an IIR.
 - **Exclusion**: The GloBE Rules also provide for a de minimis exclusion for jurisdictions in which MNEs have a turnover of less than □ 10 million and profits of less than □ 1 million. Further, (a) investment funds, and (b) real estate investment vehicles (such as REITs), have also been excluded from the scope of the GloBE Rules to the extent that such entities also qualify as the UPE of the MNE Group (to which it belongs). Pension funds on the hand have been offered a blanket exclusion.
 - **Administration**: While a draft of the key provisions of the GloBE Rules have been put forth by the OECD, the two interlocking rules (i.e., IIR, and UTPR) are envisaged to be implemented through the introduction of such provisions into the domestic tax legislation of countries. Thus, the template framework suggested by the OECD is envisaged to allow countries to incorporate the GloBE Rules into their domestic tax infrastructure, in order to increase the ease of implementation. Note that IF members are not obliged to adopt the GloBE Rules; however, if rules are designed for the application of the minimum tax, the idea is for such rules not to be inconsistent with

- b. **Subject to Tax Rule ("STTR"):** The STTR on the other hand is envisaged to be a treaty-based rule to tax certain related-party payments, (including interests, royalties, and certain other payments¹⁴) that are not subject to a consolidated ETR of 9% in the resident and source jurisdiction (together). Unlike the GloBE Rules, the first right of taxation under the STTR is offered to the market jurisdiction. Consequently, the IIR is envisaged to be an additional taxing right under Pillar Two, (primarily offered) to market jurisdictions to tax certain kinds of payments that would otherwise escape the tax net in both countries (i.e., source and recipient jurisdictions). Note that the draft rules with respect to the STTR are yet to be released by the OECD, and are expected by the end of 2022.

Implementation Plan:

The IF aims for countries to begin the domestic implementation of the GloBE Rules by 2022, with the IIR coming into effect in 2023, and the UTPR in 2024.¹⁵

STTR, on the other hand, is a treaty-based rule; and therefore its implementation would depend on bilateral negotiations between states. In this context, the STTR is envisaged to be implemented through a multilateral instrument which has to be ratified by the participating countries.¹⁶

Albeit the ambitious timeline, the work continues on the model treaty provisions (for the STTR) and the multilateral instrument (for the GloBE Rules).

Challenges:

a. Market Jurisdictions:

- For a number of market jurisdictions (such as India), the domestic ETR for most incorporated entities is in any case above 15%. In such circumstances, the GloBE Rules offer fewer advantages to such market jurisdictions (when compared to the significant administrative cost and burden that will be required for its implementation). Similarly, for a number of other developing countries, the primary advantage from Pillar Two is likely to flow from the introduction of the STTR (which gives the first right of taxation to source countries). However, given that the introduction of the STTR will depend on bilateral negotiations, (primarily) between economically stronger resident jurisdictions, and economically weaker developing market jurisdictions, the extent to which political consensus is achieved, and the STTR becomes an effective international tax tool, is yet to be seen.
- Additionally, there is likely to be significant conflict between source and resident jurisdictions as to which kinds of payments should be covered within the purview of the STTR (as this still remains undecided at the level of the OECD IF). For example, in the case of India, payments for software products made to a non-resident are not subject to royalty taxation in India.¹⁷ In case these payments are made to a jurisdiction with a patent box regime, the consolidated ETR (i.e., the total tax on such payments in the source and resident jurisdictions) is likely to be less than 9%. As such, bringing software payments within the ambit of the STTR would benefit India by allowing India to withhold taxes on such outbound software payments (which are otherwise not taxable under the ITA).

b. Resident Jurisdictions:

- As opposed to developing countries, developed nations that seek to gain more from Pillar Two may be relatively eager for its implementation. A number of European countries have confronted delays in the implementation of Pillar Two. The European Union ("EU") held an Economic and Financial Affairs Council (ECOFIN) meeting to address the draft European Directive on Pillar 2. The Council released a directive stating that the provisions will apply for fiscal years starting on or after 31st December, 2023.¹⁸ Recently, five EU nations – France, Germany, Italy, Netherlands and Spain have released a joint statement reaffirming their "strengthened commitment" towards the implementation of Pillar Two. The countries signalled the opting of a less organised option to unilaterally implement the rules of Pillar Two in their legal system, if no consensus is reached¹⁹.
- The US, on the other hand, has stalled its position for implementation of Pillar Two as no proposed changes, in line with Pillar Two rules, have been made to the existing domestic US - Global Intangible Low-Taxed Income ("GILTI") rules²⁰. These changes were left out of the recently enacted tax reconciliation bill – "Inflation Reduction Act"²¹. Though the Biden government has shown full support towards the agreement, the outcome for enactment of international legislation in the near term is ambiguous. In this context, while the OECD Statement of October 2021 (i.e., on agreement to adopt Two Pillar Solution) stated that the draft GloBE Rules will address the co-existence of GILTI and the GloBE Rules,²² the same has not been provided for within the model rules as of yet. This is likely to be another roadblock to attaining consensus on the final form of the draft rules.

CONCLUSION

The design of Pillar One rules has seen an evolution from an 'activity test' based criteria focused to target businesses that are able to have significant and sustained interactions with customers in a market jurisdiction, to a 'threshold test' intended to not ring-fence digital economy and minimise compliance costs. While discussions on Pillar One have been ongoing since 2019, it is clear that implementation of a new tax system to transform the global tax infrastructure will require (a) political consensus on a number of key provisions within the Amount A mechanism, and (b) alignment on tax policy aspects between perspectives of predominantly resident and market jurisdictions (with inherent differences in their economic power and outlooks). Consequently, on account of the innate uncertainties, this is likely to be a laborious task.

With respect to the GloBE Rules, while public consultations on key provisions have taken place through the course of 2022, finalization of numerous technical aspects is still ongoing. As such, countries are still negotiating at the level of the IF on the operability of the draft provisions; and are in the process of analysing the impact of the GloBE Rules. Consequently, the final version of the GloBE Rules would be required for countries to be able to determine the extent to which they may incorporate the same within their domestic legislation.

The STTR, on the other hand, is likely to come forth as the key benefit for developing nations. As such, given that the model framework for its implementation, and the technical provisions for its operation have not yet been released, market jurisdictions will need to wait in order to determine the overall revenue benefit which may accrue to them on account of Pillar Two.

Ultimately, both pillars will need to be analysed holistically to ascertain the net revenue gain that countries might receive from the Two-pillar Solution. Thus, while there definitely may be light at the end of the tunnel, there still seems to be significant distance to cover before the end is near.

– Arijit Ghosh & Ipsita Agarwalla

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You can direct your queries or comments to the authors

¹ Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 2021; available at: <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf>

² Progress Report on Amount A of Pillar One, Two-Pillar Solution to the Tax Challenges of the Digitalisation of the Economy, July to August 2021; available at: [progress-report-on-amount-a-of-pillar-one-july-2022.pdf](https://www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf) (oecd.org)

³ Public consultation document: Progress Report on the Administration and Tax Certainty Aspects of Amount A of Pillar One, October to November 2022; available at: [Public consultation document: Progress Report on the Administration and Tax Certainty Aspects of Amount A of Pillar One](https://www.oecd.org/tax/beps/public-consultation-document-progress-report-on-the-administration-and-tax-certainty-aspects-of-amount-a-of-pillar-one) (oecd.org)

⁴ Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy FAQs, July 2022; available at: <https://www.oecd.org/tax/beps/faqs-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2022.pdf>

⁵ Pillar one Amount A: rules too complex, say corporations; available at: <https://www.internationaltaxreview.com/article/2akge5nn7bl8q6kg8nu2o/pillar-one-amount-a-rules-too-complex-say-corporations/00000182-f91c-d6b1-a7b2-dffe2750000>

⁶ Comments of the G-241 on the Progress Report on Amount A of Pillar One, August 2022; available at: <https://www.g24.org/wp-content/uploads/2022/08/Comments-of-the-G-24-on-the-Progress-Report-on-Amount-A-of-Pillar-One.pdf>

⁷ OECD/G20 BEPS Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 2021; available at: <https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf>

⁸ The purpose behind this provision could be to avoid double counting i.e. a situation where the market jurisdiction is able to levy tax on the same income twice, once under the existing tax regime (tax treaty based) and then on Amount A

⁹ Tax Foundation Response to OECD Consultation on Amount A of Pillar One, August 2022; available at: <https://taxfoundation.org/oecd-pillar-one-amount-a-consultation/>

¹⁰ Global Tax Deal Threatened as US Senate Dysfunction Delays Vote, July 2022; available at: <https://www.bloomberg.com/news/articles/2022-07-15/global-tax-deal-threatened-as-us-senate-dysfunction-delays-vote>; Yellen's Grand Global Corporate Tax Plan Risks Congress Flop (1), May 2022; available at: <https://news.bloombergtax.com/daily-tax-report/yellens-grand-global-corporate-tax-plan-risks-flop-in-congress>

¹¹ The Latest on the Global Tax Agreement, September 2022; available at: <https://taxfoundation.org/global-tax-agreement/>

¹² Secretary of the Treasury Letter to Senator, June 2022, available at: https://mnetax.com/wp-content/uploads/2021/06/Yellen_letter_to_Crapo_on_OECD_tax_negotiations920.pdf

¹³ Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two), December 2021; available at: <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf>

¹⁴ Note that as of date, there is no guidance or global consensus on which other kinds of payments are envisaged to be incorporated within the scope of the STTR.

¹⁵ Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October, 2021; available at <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf>

¹⁶ Press Release, Pillar Two model rules for domestic implementation of 15% global minimum tax; December 2021; available at: <https://www.oecd.org/tax/beps/oecd-releases-pillar-two-model-rules-for-domestic-implementation-of-15-percent-global-minimum-tax.htm>

¹⁷ Engineering Analysis Centre of Excellence Private Limited v. Commissioner of Income Tax & Another [(2022) 3 SCC 321]

¹⁸ Draft Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union - Compromise text, March 2022; available at: <https://data.consilium.europa.eu/doc/document/ST-6975-2022-INIT/en/pdf>

¹⁹ 5 EU Members jointly commit to Global Minimum Tax 'by any possible legal means', September 2022; available at: <https://www.taxsutra.com/news/5-eu-members-jointly-commit-global-minimum-tax-any-possible-legal-means>

²⁰ Key updates on the global implementation of Pillar 2, September 2022; available at: [https://www.granthornton.global/en/insights/articles/implications-of-pillar-2#:~:text=United%20States%20\(US\),the%20%E2%80%9Cinflation%20Reduction%20Act.%E2%80%9D](https://www.granthornton.global/en/insights/articles/implications-of-pillar-2#:~:text=United%20States%20(US),the%20%E2%80%9Cinflation%20Reduction%20Act.%E2%80%9D)

²¹ Inflation Reduction Act, 2022; available at: <https://www.democrats.senate.gov/inflation-reduction-act-of-2022>

²² Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October, 2021; available at: <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf>

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