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Navigating the OECD's Two-Pillar Approach

WHAT IS BEPS ACTION PLAN?

The genesis of the Two-Pillar approach lies in the pathbreaking project of the OECD on Base Erosion and Profit Shifting ('BEPS') which was launched in year 2013. The project has captured the center-stage of discussion amongst tax policy makers and all the stakeholders since last several years. BEPS refers to tax planning strategies adopted by multinational enterprises ('MNE') to exploit gaps and mismatches in tax rules of different jurisdictions which has resulted in avoidance of tax and has caused significant loss to the exchequers across the world. Working together within OECD / G20 Inclusive Framework, over 141 jurisdictions have collaborated on the implementation of 15 Action Plans to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment.

With the immense proliferation of digital means of doing business and incoherence of the existing tax systems to deal with digitisation, taxation of digital economy has been a key policy issue of the BEPS framework. Action Plan 1 of the BEPS project addresses the tax challenges arising from digitalisation. The OECD / G20 Inclusive Framework has made major progress in development of Two-Pillar approach for, inter-alia, addressing the tax challenges of the digital economy.

UNTIL END OF NOVEMBER 2021, THE KEY COMPONENTS OF TWO-PILLAR APPROACH HAVE RECEIVED APPROVAL OF 137 MEMBERS JURISDICTIONS, REPRESENTING MORE THAN 90% OF GLOBAL GDP.

WHAT IS THE TWO-PILLAR APPROACH?

There is now a formal recognition by the OECD that the existing global tax architecture suffers from two fundamental infirmities:

1. that digital world does not require existence of a fixed place of business or what is referred to in tax parlance as a Permanent Establishment ('PE'); the trade world has become borderless and not limited by physical boundaries; and
2. profits arise not merely from research, manufacture and production but also from access to markets.

For example, businesses of MNEs such as Google, Amazon, Facebook, etc. do not require a physical presence in the market jurisdiction and thereby under the current tax architecture, such entities are typically not taxed in absence of a taxable presence in the market jurisdiction.

This recognition marks a radical departure in the existing thought process on how MNEs should be taxed. Whilst the OECD was in the process of finalizing on what needed to be done on the BEPS Action Plans, countries started to take unilateral measures to address the gaps in the global tax architecture. For instance, the UK introduced the Digital Services Tax, India introduced Equalization Levy and a host of other countries took different unilateral measures. Given the fact that many of the companies which were impacted were US MNEs, the USA retaliated with trade measures on these countries.

It was therefore only in the fitness of things that the OECD came up with its Two-Pillar approach to address the above two infirmities; the framework was approved in-principle a couple of months back and has now been formalized with 137 (out of 141) world's largest economies agreeing to be a part of the Inclusive Framework and implement the Two-Pillar approach.

The proposed Two-Pillar approach is not only meant to address tax challenges of a digitized business but will also subject thousands of MNE groups across the world to a global minimum tax of atleast 15%. The Two-Pillar approach recognizes the pervasiveness of digital economy and observes significant departure from traditional taxation rules. While Pillar One addresses the broader challenges of the digitalized economy and focuses on allocation of taxing rights amongst home and market jurisdictions, Pillar Two is focused on global minimum tax and addresses remaining issues on account of BEPS. The global minimum tax agreement amongst the jurisdictions does not seek to eliminate tax competition, but puts multilaterally agreed limitations on it.

PILLAR ONE – THE UNIFIED APPROACH

SIMPLY STATED, PILLAR ONE PROVIDES THAT LARGE MNEs (CURRENTLY THOSE HAVING A TURNOVER OF MORE THAN EUROS 20 BILLION) AND HAVING PROFITABILITY IN EXCESS OF 10% WOULD ALLOCATE 25% OF THE EXCESS PROFITS (TECHNICALLY REFERRED TO AS "RESIDUAL PROFITS") TO THE MARKET JURISDICTION WHERE THEY SELL THEIR PRODUCTS IRRESPECTIVE OF THE PHYSICAL PRESENCE.

The monetary threshold would be reviewed and reduced after 7 years. While the number of MNEs impacted at this point of time would be few, Pillar One marks acceptance of a radical proposition viz. attribution of profits to market jurisdiction. India as a developing country has been a consistent advocate of this view and would regard this as a welcome development. As a quid pro quo, countries have agreed to not impose unilateral measures and to reverse the existing unilateral measures by earlier of 31 December 2023 or the coming into force of the Multilateral Convention[1]. The issue as to how will such a withdrawal take place and whether the withdrawal will only be in respect of those MNEs which are covered by Pillar One remains to be seen. The identification of unilateral measures and the methodology of rollback remains an important open issue.

Mechanics of Pillar One – A brief overview

Pillar One – 'Unified Approach' largely focusses on taxation of automated digital services (ADS) and large consumer faced business (CFB). Pillar One expands the taxing rights of market jurisdictions where the businesses have an active and sustained participation without a physical presence.

IT IS PROPOSED THAT PILLAR ONE WILL BE APPLICABLE TO MNEs WITH GLOBAL TURNOVER ABOVE EUROS 20 BILLION AND PROFITABILITY ABOVE 10% (HEREINAFTER REFERRED AS 'SPECIFIED MNEs').

The turnover threshold shall be reduced post implementation review. The nexus rules under Pillar One would apply to market jurisdictions where specified MNEs derive revenues of at least 1 million euros in the market jurisdiction (0.25 million euros in case of smaller jurisdictions).

Under Pillar One, taxable profits allocable to market jurisdictions are based on summation of the following amounts:

Amount A	Portion of MNEs residual / excess profit allocated to market jurisdiction
Amount B	Fixed remuneration for 'baseline' routine marketing and distribution activity in line with Arms Length Price ('ALP')

Amount A

It is proposed that 25% of "residual profit" (profit in excess of 10% of revenue) of MNEs will be allocated to market jurisdictions.

Amount A = (Total profit – 10% of revenue) * 25%

Taxable profits computed as Amount A would be further allocated in market jurisdictions based on application of allocation keys (turnover, etc). 'Total profit' would be determined after few adjustments to financial accounting income. Losses will be carried forward. Segmentations may occur in exceptional circumstances.

Where the residual profits of specified MNE are already taxed in a market jurisdiction, a marketing and distribution profits safe-harbor will cap the residual profits allocated to the market jurisdiction through Amount A. Double taxation of profit allocated to market jurisdictions will be relieved using either the exemption or credit method.

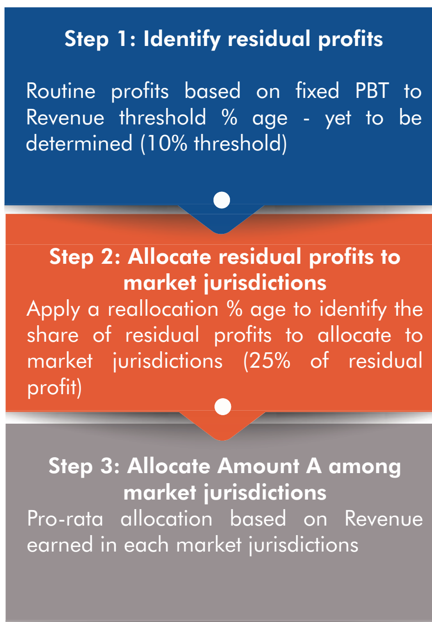
Computation of Amount A could be divided into three steps:

Step 1	Determine profitability threshold based on a PBT to revenue ratio, to isolate residual profit which is the subject matter of reallocation (10% of revenues)
Step 2	Apply the reallocation % to identify the share of residual profits to allocate to market jurisdictions (25% of residual profit floated)
Step 3	Apply allocation key based on locally-sourced in-scope revenues to allocate Amount A among eligible market jurisdictions

This is explained by way of an illustration below:

[1]For example, recently, India and US have reached an agreement on the transitional approach to the treatment of equalisation levy during the interim period till Pillar One rules come into effect. As per the official statement issued by India, it appears that India will not withdraw equalisation levy until Pillar One proposals take effect. Further, India has also agreed to give credit of equalisation levy against the tax liability computed under Pillar One approach for the interim period (i.e. period commencing from 1 April 2022 till implementation of Pillar One or 31 March 2024, whichever is earlier). In lieu of this, the US is expected to terminate its proposed trade actions against India.

What does the market jurisdiction get to tax?



World-wide revenue	(A)	25,000

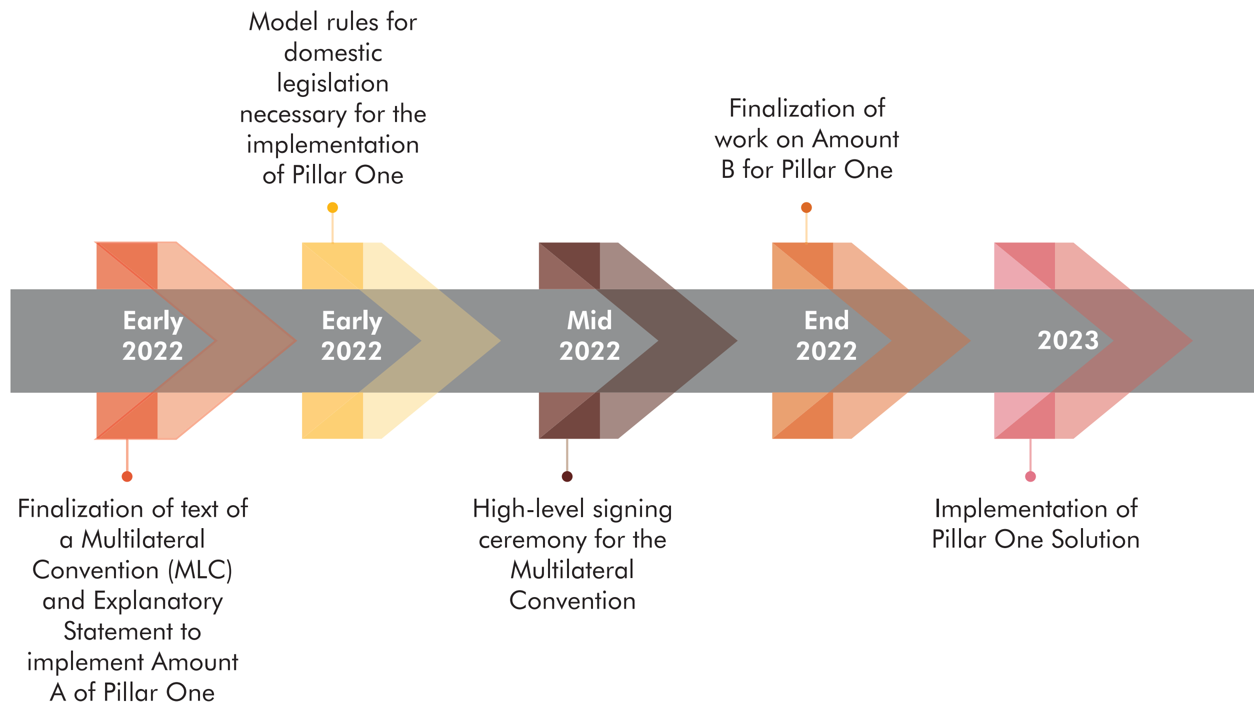
Total profits	(B)	6,500

Step 1: Identify Residual Profits		
Identify routine profits with 10% threshold	(C) = (A) x 10%	2500
Identify residual profits	(D) = (B)–(C)	4000

Step 2: Allocate Residual Profit to Market Jurisdictions		
Residual profits allocable to market jurisdictions – 25%	(D) X 25%	1000

Step 3: Allocate Amount A to each Market Jurisdiction				
	Country X	*Country Y*	*Country Z*	*Total*
Revenue from each country	2,000	18,000	5,000	25,000
Share of residual profits	80	720	200	1000

The timelines by which Pillar One proposals are expected to be implemented are depicted below:



Amount B

Amount B would be determined basis the arm's length principle to in-country baseline marketing and distribution activities. The framework pertaining to mechanics and computation of Amount B will be simplified and streamlined, with a particular focus on the needs of low-capacity countries. This work is expected to be completed by the end of 2022.

MNEs would be allowed tax compliance under Pillar One at a single entity level. The Multilateral Convention ('MLC') will require all parties to withdraw all Digital Services Taxes and other relevant similar measures with respect to all companies, and to commit not to introduce such measures in the future. No newly enacted Digital Services Taxes or other relevant similar measures will be imposed on any company from 8 October 2021 and until the earlier of 31 December 2023 or the coming into force of the MLC. Given the same, it is expected that India would withdraw its Equalisation levy provisions in sync with the commitment agreed to by the members of the Inclusive Framework.

Pillar One also proposes to provide tax certainty through mandatory and binding dispute resolution mechanism. Elective binding dispute resolution mechanism would be allowed to certain developing jurisdictions for issues on Amount A.

PILLAR TWO

PILLAR TWO ALSO REFERRED TO AS 'GLOBAL ANTI-BASE EROSION RULES' (GloBE) PROVIDES THAT ALL COUNTRIES WILL IMPOSE A ***MINIMUM TAX OF 15 % ON CORPORATES.***

This is an important step towards eliminating tax havens and addressing the issue of harmful tax competition. While countries may still choose to not impose a 15% tax, Pillar Two provides that where profits are earned in jurisdictions where the rate of tax is less than 15%, the home jurisdiction or the source jurisdiction can tax those profits by way of application of following rules:

Income Inclusion Rule ('IIR')	Parent company pays **top-up tax**[2] on its proportionate share of income of its group entity located in low-tax jurisdiction
Switch-Over Rule ('SOR')	Compliments the IIR by providing an enabling mechanism to overturn tax treaty obligations.
Undertaxed Payments Rule ('UTPR')	This rule kicks in especially in cases where IIR is inapplicable. As per UTPR, the MNE Group will allocate top-up tax to group entities in the ratio of deductible payments made by such companies to the entity located in low-tax jurisdiction. IIR has priority over UTPR.
Subject to tax Rule ('STTR')	This Rule triggers when the covered payment is subject to nominal rate of tax in payee jurisdiction. For example, if the payment is taxable at 5% in payee jurisdiction, as per STTR, additional withholding tax of 4% will apply in the payer jurisdiction (irrespective of the tax treaty rate).

In order to avoid double non-taxation, it is proposed that where profits are not subjected to tax in the other treaty country, the source country will have a reversionary right to tax such profits.

Presently, the Pillar Two proposals are intended to be made applicable for MNEs having consolidated revenue exceeding 750 million euros. With minimum rate at 15%, these proposals are expected to generate additional global tax revenues around USD 150 billion.

As aforementioned, the GloBE rules will operate to impose a top-up tax using an effective tax rate ('ETR') test that is calculated on a jurisdictional basis.

ETR is computed at the jurisdictional level to determine whether the jurisdiction is, in fact, a "low-tax jurisdiction" (i.e. a jurisdiction where the MNE's jurisdictional ETR is below the agreed minimum rate) and to compute the top-up tax percentage necessary to bring the aggregate amount of tax on the income of that jurisdiction up to the minimum rate. ETR computation requires assignment of the income and taxes amongst jurisdictions in which the MNE operates and to which it pays taxes.

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

Further adjustments for substance carve-outs, carryforward of losses, and excess tax credits are also envisaged.

- Where ETR is lower than the minimum tax rate of 15%, MNE would be liable to pay top-up taxes under IIR or UTPR mechanism. Top-up tax is calculated as difference between agreed minimum tax rate and ETR in each jurisdiction. Refer below example:

Country	Profits	ETR	Top-up rate	Top-up tax
A	125	10%	5% (15%-10%)	5%*125 = 6.25
B	150	18%	N.A.	N.A.
C	200	12%	3% (15%-12%)	3%*200 = 6

The aforesaid Rules are discussed in detail below:

- IIR follows top-down approach, wherein the Ultimate Parent Entity ('UPE') would be liable for payment of top-up tax of its group entities ('constituent entities') located in low tax jurisdictions. However, if the UPE is located in a jurisdiction to which IIR is not applicable, the constituent entity at the top of ownership hierarchy to which IIR is applicable, would pay top-up tax under IIR for constituent entities.
- IIR follows split-ownership rule for shareholding below 80%. Accordingly, where more than 20% equity interest in a constituent entity of MNE group is owned by third party outside MNE group, the obligation to apply IIR would shift to partially owned intermediate parent entity.
- IIR is complimented by treaty-based SOR which would allow the jurisdictions to override exemption method, to the extent it is necessary to apply IIR to the profits of a permanent establishment. The SOR would permit the residence state to tax the low-tax profits of a PE up to the agreed minimum rate, using the same ETR test as the IIR.
- UTPR applies in scenarios wherein the IIR does not apply to the parent entity. UTPR is secondary rule and applies to those constituent entities in MNE group which are not controlled by any entity to which IIR is applicable. The top-up tax is allocated to companies covered by UTPR in ratio of deductible payments made by such companies to the entity located in low-tax jurisdiction.
- The GloBE rules also provide for an exclusion from UTPR for MNEs in the initial phase of their international

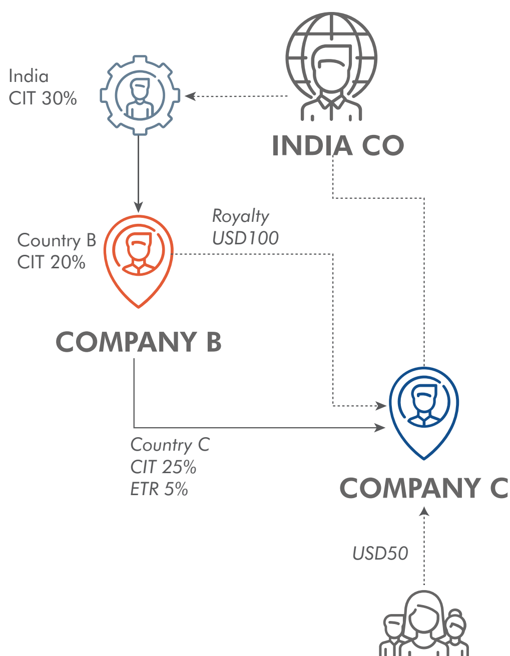
[2]*Amount of tax required to make the Effective Tax Rate ('ETR') at 15%*

activity i.e. MNEs that have a maximum of EUR 50 million tangible assets abroad and that operate in no more than 5 other jurisdictions. This exclusion is limited to a period of 5 years after the MNE comes into the scope of the GloBE rules for the first time.

- STTR, treaty-based rule, targets certain payments which are likely to present risk of BEPS. The STTR will apply where a covered payment is subject to a nominal tax rate in the payee jurisdiction which is below than an agreed minimum rate. The minimum STTR rate is set at 9%. The rule allows the source jurisdiction to tax the gross amount of the payment up to an agreed minimum rate. For example, if the payment is taxable at 5% in payee jurisdiction, as per STTR, additional withholding tax of 4% will apply in the payer jurisdiction (irrespective of the tax treaty rate). This is explained by way of an illustration below:

Assumptions:

- *STTR trigger rate 9%; Global min tax rate 15%*
- *Company C local statutory rate 25%, but special regime reduces tax to 20% of normal rate (i.e. 5%)*
- *Company B ETR 20%*



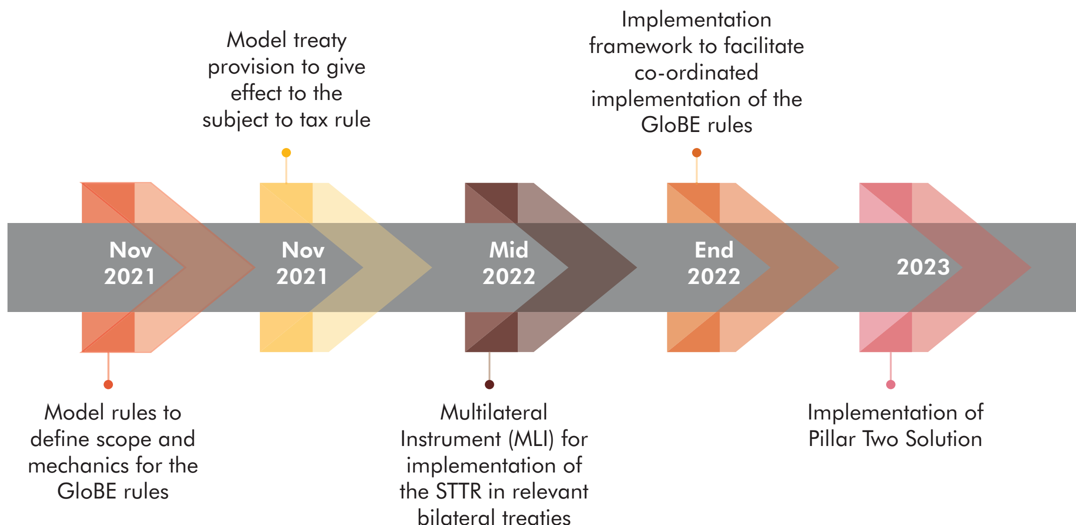
Application of rules		Tax paid in
Step 1: Apply STTR		
Company C: Special regime tax rate	5%<9%	
WHT under STTR	4%*100= 4	Country B
Step 2: Apply IIR (Assuming India introduces IIR)		
Company B ETR	20%>15%, no need to include in IIR	
Company C ETR	(5+4+2.5)/(100 + 50)= 7.67%<15%	
Company C top-up tax	150 * (15%-7.67%) = 11	India
Step 3: Apply UTPR (assuming India does not apply IIR, and country B introduced UTPR)		
Company C top-up tax	11	
Company B denied deduction under UTPR	11/20%=55	Country B

Incremental tax of 15 imposed on undertaxed income of Company C - ETR increases to 15% (15+7.5)/150

THE GloBE RULES PROVIDES FOR A DE MINIMIS EXCLUSION FOR THOSE JURISDICTIONS WHERE THE MNE HAS REVENUES OF LESS THAN EUR 10 MILLION AND PROFITS OF LESS THAN EUR 1 MILLION.

The GloBE rules also provide for a formulaic substance carve-out that will exclude an amount of income that is 5% of the carrying value of tangible assets and payroll. In a transition period of 10 years, the amount of income excluded will be 8% of the carrying value of tangible assets and 10% of payroll.

Introduction of Pillar One and Pillar Two through new multilateral instruments and their interplay with domestic tax law of each jurisdiction would pose new challenges. The timelines by which Pillar Two proposals are expected to be implemented are depicted below:



IMPACT ON BUSINESSES

The application of Two-Pillar approach is expected to bring significant changes in existing tax system. Additional tax burden in market jurisdiction and mechanics for avoidance of double taxation would have significant impact on taxation of MNEs. This would be further complicated by interplay of new taxation rules with existing treaties, domestic tax laws and transfer pricing regulations, application of carve outs and carry forward mechanism, documentation, and compliance requirements, etc.

Incremental tax burden can affect the cash flow and profitability of business. Impact analysis of existing and alternate supply chains and business structures along with realignment of technology to match documentation and compliance requirements would be important action points before implementation of Two-Pillar approach. Training of in-house tax teams would also play important role in smooth transition. **Followings are potential key issues which businesses should be mindful of:**

a. Determination of applicability of Pillar One and Pillar Two to transactions and business segments;

b. Impact analysis of new rules on tax cost, cash flow, profitability, and financial statements;

c. Critical evaluation of existing and alternative supply chains and ownership structures;

d. Understanding of withholding tax requirements;

e. Understanding the documentation and compliance requirements basis the Two-Pillar approach;

f. Upgradation of existing systems and installation of internal checks and controls for smooth documentation and compliance;

g. Training of in-house tax teams on the developments

HOW DHRUVA CAN HELP

At Dhruva, we are well placed and up to speed on the latest developments on the digital tax front and will be happy to partner with clients to help them navigate the new rules with simplicity and ease.

- Advise on applicability and scope of Pillar One and Pillar Two including thresholds, carve-outs, in scope and out of scope activities;
- Assist in quantification of taxes payable in market jurisdiction;
- Advice on application of double tax avoidance treaties and carry forward mechanism;
- Advice on interplay of new rules with domestic tax provisions and treaties;
- Assistance in mandatory and binding dispute resolution process;
- Analysis of withholding tax requirements;
- Modeling of existing and alternative supply chain and ownership structures;
- Restructuring of business operations;
- Assessment of existing transfer pricing policy;
- Documentation and compliance review;
- Representation of industry concerns to policy makers and tax authorities;
- Transition support and training;
- Review of existing systems and support for re-alignment systems and processes

ABOUT DHRUVA ADVISORS

Dhruva Advisors LLP is a tax and regulatory services firm, working with some of the largest multinational and Indian corporate groups. Its brings a unique blend of experience, having worked for the largest investors in India, advising on the largest transactions and on several of the largest litigation cases in the tax space. We also work closely with the Government on policy issues and with our clients on advocacy matters.

Key differentiators:

- Strategic approach to complex problems
- In-depth, specialised and robust advice
- Strong track record of designing and implementing pioneering solutions
- Trailblazers in tax controversy management
- Long history of involvement in policy reform
- Technical depth and quality

We believe in thinking out of the box, handholding our clients in implementing complex solutions and working towards achieving results. We have offices in Mumbai, Ahmedabad, Bengaluru, Delhi, Kolkata, Pune, Dubai and Singapore. We advise clients across multiple sectors including financial services, IT and IT-enabled services (ITES), real estate and infrastructure, telecommunications, oil and gas, pharmaceuticals, chemicals, consumer goods, power, as well as media and entertainment.

Dhruva Advisors is a member of the WTS Alliance, a global network of selected firms represented in more than 100 countries worldwide.

Our recognitions

- Dhruva Advisors has been consistently recognised as the “India Tax Firm of the Year” at the ITR Asia Tax Awards in 2017, 2018, 2019, 2020 and 2021.
- Dhruva Advisors has also been recognised as the “India Disputes and Litigation Firm of the Year” at the ITR Asia Tax Awards 2018 and 2020.
- WTS Dhruva Consultants has been recognised as the “Best Newcomer Firm of the Year” at the ITR European Tax Awards 2020.
- Dhruva Advisors has been recognised as the “Best Newcomer Firm of the Year” at the ITR Asia Tax Awards 2016.
- Dhruva Advisors has been consistently recognised as a Tier 1 firm in India’s ‘General Corporate Tax’ and ‘Indirect Tax’ ranking tables as a part of ITR’s World Tax guide. The firm is also listed as a Tier 1 firm for India’s ‘Transfer Pricing’ ranking table in ITR’s World Transfer Pricing guide.

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