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ECD/G20 Inclusive Framework provides roadmap for the two-pillar solution on international tax reforms

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Summary

As part of the ongoing OECD/G20 Inclusive Framework (IF) on Base Erosion and Profit Shifting (BEPS), the OECD had released a statement on 1 July 2021 (July Statement). This statement indicated that 130 member countries had agreed to a framework for the two-pillar solution, along with the key components of each pillar. In this solution, Pillar One provides taxing right to market jurisdictions and Pillar Two provides for a global minimum tax. Together, these two pillars, lay down the foundation of international tax rules which are more in-tune with the needs of the 21st Century.

On 8 October 2021, OECD has issued another statement (October Statement) reflecting further progress on this front. The October statement indicates that now 136 member countries (out of 140 countries), representing more than 90% of the global GDP, have agreed to the two-pillar solution. Apart from certain changes in the broad framework of the two pillars, the October statement also provides a detailed implementation plan.

It is expected that under Pillar One, taxing rights on over USD 125 billion of profit will be reallocated to market jurisdictions every year. As far as Pillar Two is concerned, it is estimated that the global minimum tax rate of 15% will generate around USD 150 billion new tax revenues globally every year.[1]

The October statement reflects that significant consensus has been achieved on some key aspects of the two-pillar solution. The broad framework of the two-pillar solution, as it stands after the October statement, is provided below:

Pillar One

Scope

- The October statement confirms that Pillar One will apply to multinational enterprises (MNEs) with global turnover above €20 billion and profitability above 10% (profit before tax / revenue), which will be calculated using an averaging mechanism. Further details about this averaging mechanism are not available yet.
- Turnover threshold is to be reduced to €10 billion[2] on successful implementation.

[1] OECD/G20 Base Erosion and Profit Shifting Project Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 2021

[2] Review will begin after 7 years from time the agreement comes into force and shall be completed in maximum one year.

- The same exclusions as provided in the July statement, i.e., for ‘extractives’ and ‘regulated financial services’ are also included in the October statement.

Special purpose nexus rule

- There is no change in the nexus rule in the October 2021 statement.
- The market jurisdiction is eligible for Amount A allocation, under Pillar One, when the MNE derives at least Euro 1 million in revenue from that jurisdiction. For smaller jurisdictions[3], the revenue threshold will be set at Euro 250,000.

Quantum and cap on marketing and distribution profits

- The October statement provides that for in-scope MNEs, 25% of **residual profit** (in excess of 10% of revenue) will be re-allocated to market jurisdictions using a **revenue-based allocation key**. The July statement had provided a range of 20-30% of the residual profit.
- Where the residual profits of an in-scope MNE are already taxed in a market jurisdiction, a marketing and distribution profits safe harbour will cap the residual profits allocated to the market jurisdiction through Amount A. Further work on this safe harbour is to be carried out.

Revenue sourcing and tax base determination

- Revenue will be sourced to the end market jurisdictions where goods or services are used or consumed.
- The base for determining profit or loss shall be financial accounting income with certain adjustments. Losses will be carried forward.

Dispute resolution and elimination of double taxation

- Elimination of double taxation to happen using either the exemption or credit method. Further, the entities that bear the tax liability with be drawn from those that earn residual profits.
- The October Statement confirms that in-scope MNEs will benefit from dispute prevention and resolution mechanisms, which will avoid double taxation for Amount A and issues related to it (e.g. transfer pricing and business profits disputes), in a mandatory and binding manner.
- Elective binding dispute resolution mechanism for issues related to Amount A will be available only for developing economies in certain cases[4]. Eligibility will

[3] With GDP lower than €40 billion

[4] Countries that are eligible for deferral of BEPS Action 14 peer review (conditions provided in paragraph 7 of the current Action 14 Assessment

be reviewed regularly and ineligible jurisdictions (post-review) will remain ineligible in all subsequent years.

Other aspects

- **Unilateral measures:** Multilateral Convention (MLC), in this regard, will require all parties to remove all Digital Services Taxes and other relevant similar measures and to commit not to introduce such measures in the future.

  Also, there shall be no newly enacted Digital Services Taxes or other relevant similar measures will be imposed **on any company** from 8 October 2021 till 31 December 2023 or till the MLC comes into force. The modalities are being finalised. Details on what would be construed as "relevant similar measures" is also not yet available.

- **Amount B:** The application of arm's length principle to in-country baseline marketing and distribution activities will be simplified with particular focus on needs of low capacity countries. This exercise will be completed by the end of 2022.
- **Segmentation:** Segmentation will occur only in exceptional circumstances where, based on the segments disclosed in the financial accounts, a segment meets the scope rules.

Implementation

- The MLC through which Amount A is implemented will be developed and opened for signature in 2022, with Amount A coming into effect in 2023.

Pillar Two

Pillar two consists of:

- Two interlocking domestic rules (together termed as the Global anti-Base Erosion Rules (GloBE) rules):
  - **Income Inclusion Rule (IIR)** imposes top-up tax on a parent entity in respect of the low-taxed income of a constituent entity.
  - **Undertaxed Payment Rule (UTPR)** denies deductions or requires an equivalent adjustment to the extent the low tax income of a constituent entity is not subject to tax under an IIR.
- A **Subject to Tax Rule (STTR)**, which is a treaty-based rule, allows source jurisdictions to impose limited source taxation on certain low taxed related party

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Methodology published as part of the Action 14 peer review documents) and have no or low levels of Mutual Agreement Procedure (MAP) disputes.

payments. The STTR will be creditable as a covered tax under the GloBE rules.

- Adoption of GloBE rules is not mandatory, however, if an IF member adopts these rules it would need to be consistent with the outcomes provided for, under Pillar Two[5] and accept the application of these rules by other IF members[6].

Scope and carve-outs

- The turnover threshold for GloBE rules has not changed i.e. it will apply to MNEs that meet the Euro 750 million threshold[7]. Countries are free to apply the IIR to MNEs headquartered in their country even if threshold is not met.
- GloBE rules shall not apply to government entities, international organisations, non-profit organisations, pension funds or Investment funds that are Ultimate Parent Entities (UPE) of an MNE Group or any holding vehicles used by such entities, organisations or funds. Further, international shipping income shall also be excluded.
- The October 2021 statement provides a de minimis exclusion in GloBE rules, for those jurisdictions where the MNE has revenue less than € 10 million and profit less than € 1 million. Further, a formulaic substance carve-out will also be given.

Minimum tax rate and rule design

- The minimum tax rate used for purposes of the IIR and UTPR will be **15%.** The July statement indicated that the rate would be at least 15%).
- The IIR allocates top-up tax based on a **top-down approach** subject to a split-ownership rule for shareholdings below 80%. The UTPR allocates top-up tax from low-tax constituent entities including those located in the UPE jurisdiction.
- Exclusion from UTPR[8] is provided for MNEs in the initial phase of their international activity, having a maximum of Euro 50 million tangible assets abroad which operate in up to 5 other jurisdictions. This exclusion was not there in the July statement.

Subject to tax rule

- IF members that apply nominal corporate income tax rates below the STTR minimum rate to covered payments such as interest, royalties and a defined set of other payments, would implement STTR into their bilateral treaties with developing IF members, when requested to do so.

[5] Including in light of model rules and guidance agreed to by the IF
[6] Including agreement of rule order and application of any agreed safe harbours
[7] As determined under BEPS Action 13 (country by country reporting)
[8] Exclusion is for 5 years after the MNE comes into the scope of the GloBE rules for the first time

- The taxing right in such cases will be limited to the difference between the minimum rate and the tax rate on the payment. **The minimum rate for the STTR will be 9%.** The July statement provided a range of 7.5% - 9%.

Implementation

Pillar Two should be brought into law in 2022, to be effective in 2023, with the UTPR coming into effect in 2024.

The detailed implementation plan in the October Statement sets out a timeline, including the key milestones for the IF going forward. Technical assistance will be available to developing countries to support all aspects of implementation.

The detailed implementation plan is tabulated hereunder

Pillar 1	• Amount A will be **implemented through a MLC and changes to the domestic law** (where necessary) and is expected to come into effect in 2023. MLC shall contain the rules necessary to ensure consistency and certainty in the application of Amount A and eliminate double taxation and provide for: - Simplified administration process - Exchange of information process - Processes for dispute prevention and resolution in a mandatory and binding manner between all jurisdictions • The MLC will be supplemented by an Explanatory Statement that describes the purpose and operation of the rules and processes. • MLC will address any inconsistencies with the solution with respect to Amount A, however, existing tax treaties will remain in force and continue to govern cross-border taxation outside Amount A. It will also address interactions between the MLC and future tax treaties. • Whether there is no tax treaty, MLC will create the relationship necessary to ensure the effective implementation of all aspects of Amount A. • The IF has mandated the **Task Force on the Digital Economy (TFDE)** to define and clarify the features of Amount A and develop the MLC and negotiate its content, so as to conclude MLC and Explanatory

	Statement by early 2022. In order to give effect to Amount A, TFDE will develop model rules (supplemented by commentary) for domestic legislation by early 2022. • MLC will **open to signature by mid-2022** and enter into force once a critical mass of jurisdictions has ratified it. MLC shall **enter into force and will be effective in 2023**. • **Amount B is targeted to be finalised by end of 2022**. Technical work will start by defining the in-country baseline marketing and distribution activities in scope of Amount B and developing the balance components.
Pillar 2	• **Model rules to give effect to the GloBE rules** will be **developed by the end of November 2021**.Model rules will include the rules for: - Determining the ETR on a jurisdictional basis - Relevant exclusions, such as the formulaic substance-based carve-out. - Administrative provisions that address MNE's filing obligations and the use of any administrative safe-harbours. - Transition rules. • The **model rules will be supplemented by commentary** explaining the purpose and operation of the rules and addresses the need for a switch-over rule in certain treaties • A **model treaty provision to give effect to the STTR will be developed by end of November 2021**. Further, a **multilateral instrument will be developed by mid-2022** to facilitate the swift and consistent implementation of the STTR in relevant bilateral treaties. • **By the end of 2022, an implementation framework will be developed** to facilitate the coordinated implementation of the GloBE rules. **IF members will consider an MLC** to ensure coordination and consistent implementation of the GloBE rules.

Our comments

Significant consensus seems to have been developed on certain important aspects of the two- pillar solution, particularly the rates of taxes. 136 countries that have agreed to the changes to the two-pillar solution now include countries[9] which had earlier expressed reservations in accepting this framework. This is a step forward in formalising this framework.

While detailed implementation plan has been released, considering that several important technical details are yet to be finalised and ironed out, it remains to be seen to what extent the timelines are met.

Further, the October statement requires member countries to withdraw any digital services taxes and other similar measures in their domestic tax laws, with respect to all companies. It indicates transitional arrangements and modalities are being discussed. The outcome of these discussions would impact the timing and extent of withdrawal of equalisation levy provisions in India. In addition, it would be interesting to see if the 'other similar measures' could take within its ambit Significant Economic Presence (SEP) provisions under the domestic tax laws.

[9] Ireland, Hungary, Estonia, Barbados and Peru

Contact us

To know more, please visit **www.grantthornton.in** or contact any of our offices as mentioned below:

NEW DELHI
National Office,
Outer Circle, L 41,
Connaught Circus,
New Delhi - 110001
T +91 11 4278 7070

NEW DELHI
6th Floor, Worldmark 2,
Aerocity,
New Delhi - 110037
T +91 11 4952 7400

BENGALURU
5th Floor, 65/2,
Block A,
Bagmane Tridib,
Bagmane Tech Park,
CV Raman Nagar,
Bengaluru - 560093
T+91 80 4243 0700

CHANDIGARH
B-406A, 4th Floor,
L&T Elante Office Building,
Industrial Area Phase I,
Chandigarh - 160002
T +91 172 4338 000

CHENNAI
9th Floor, A Wing,
Prestige Polygon,
471 Anna Salai,
Mylapore Division,
Teynampet,
Chennai – 600035
T +91 44 4294 0000

DEHRADUN
Suite No 2211, 2nd Floor,
Building 2000,
Michigan Avenue,
Doon Express Business
Park, Subhash Nagar,
Dehradun - 248002
T +91 135 2646 500

GURGAON
21st Floor,
DLF Square,
Jacaranda Marg,
DLF Phase II,
Gurgaon - 122002
T +91 124 462 8000

HYDERABAD
7th Floor, Block III,
White House,
Kundan Bagh,
Begumpet,
Hyderabad - 500016
T +91 40 6630 8200

KOCHI
6th Floor,
Modayil Centre Point,
Warriam Road Junction,
MG Road
Kochi - 682016
T +91 484 406 4541

KOLKATA
10C Hungerford Street,
5th Floor,
Kolkata - 700017
T +91 33 4050 8000

MUMBAI
11th Floor, Tower II,
One International Center,
SB Marg Prabhadevi (W),
Mumbai - 400013
T +91 22 6626 2600

MUMBAI
Kaledonia, 1st Floor,
C Wing,
(Opposite J&J Office),
Sahar Road,
Andheri East,
Mumbai - 400 069

NOIDA
Plot No 19A, 2nd Floor,
Sector - 16A,
Noida - 201301
T +91 120 485 5900

PUNE
3rd Floor,
Unit No 309-312,
West Wing, Nyati Unitree,
Nagar Road, Yerwada
Pune - 411006
T +91 20 6744 8800

For more information or for any queries, write to us at **gtbharat@in.gt.com**

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