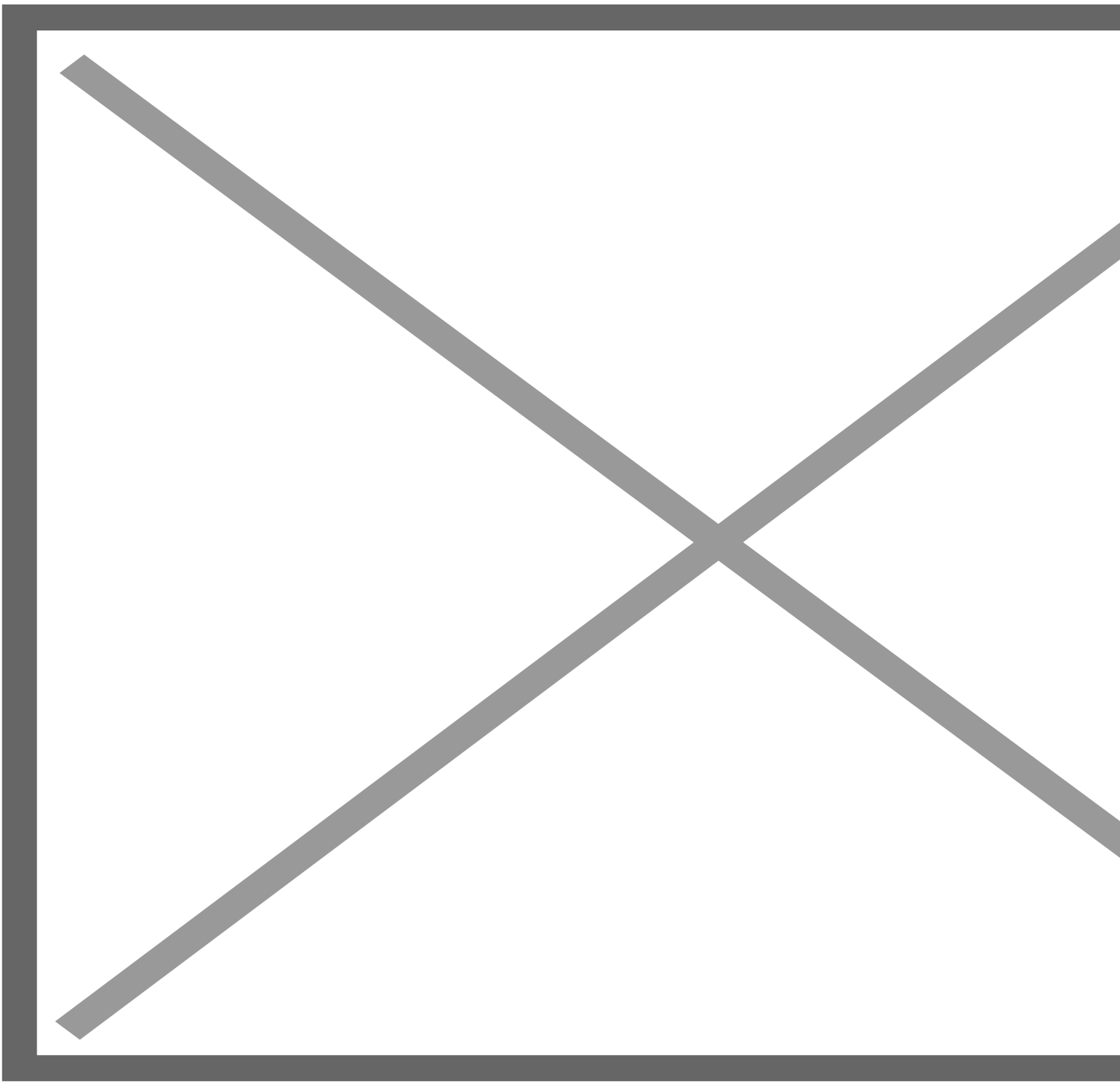
Political cogs are turning

International Tax



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Following the recent G7 agreement, Alison Lobb and Bob Stack consider the key components needed for a working machine

Key Points

What is the issue?

On 5 June 2021, the first announcement of political agreement for multilateral international tax reform came from the G7 largest economies.

What does it mean for me?

The G20 has emphasised the need for a detailed plan for implementation to be agreed by October 2021, alongside addressing the remaining political and technical issues for both pillars.

What can I take away?

At the international level, most countries have committed to make changes but the biggest hurdle to reform may be the complications of the US political system.

Proponents of a coherent, modernised international tax system addressing the tax challenges of the digital economy have been waiting, and hoping, for a long time for governments to agree a way forward.

On 5 June 2021, the first announcement of political agreement came from the G7 largest economies. This significant agreement, described as ‘historic’ by both Janet Yellen, the US Treasury Secretary, and Rishi Sunak, the Chancellor of the Exchequer, indicated that countries were prepared to make changes to allocate a percentage of profits to market (sales) countries and to implement rules requiring a global minimum level of tax on corporate profits. This was expanded a few weeks later by agreement of 132 (out of 139) countries of the OECD Inclusive Framework to key principles, and most recently by the endorsement of the G20.

Although the digital economy was Action 1 of the Base Erosion and Profit Shifting (BEPS) Action Plan in July 2013, it is since 2017 that the 139 member countries of the Inclusive Framework have been jointly developing a ‘two pillar’ approach to address the corporate income tax challenges arising from the digitalisation of the economy. This led to the publication of two detailed ‘Blueprints’ in October 2020 on potential rules for addressing nexus and profit allocation challenges (‘Pillar One’) and for global minimum tax rules (‘Pillar Two’). The Biden Administration put forward proposed changes to update and simplify the proposals in April 2021, and these formed the basis for the political agreement reached recently. The political agreement is, by necessity, high level with limited detail and there are a number of areas where further significant technical work is needed before the regimes are finalised. Many questions remain for businesses.

Nexus and profit allocation rules (Pillar One)

Pillar One’s ‘Amount A’ proposal reallocates taxable profits in favour of market (sales) countries through the creation of a new taxing right. A share of a group’s global residual profit will be reallocated to market countries using a formula. No physical presence is required in a market country to create an Amount A nexus/taxable presence.

Determining the scope of the new taxing right has been the hardest technical and political issue in relation to Pillar One. In line with proposals from the US, countries have agreed that Amount A should apply to the 'largest and most profitable' multinational businesses with global annual turnover exceeding €20 billion and profitability above a 10% margin. Extractive and regulated financial services activities are excluded. The agreement represents a significant move away from, and potential simplification of, the original scope (which had looked at determining profits from automated digital services and consumer facing businesses) but means that business to business activities are no longer out of scope.

The OECD estimates that 'around 100' multinationals will be in scope.

The global annual turnover threshold may be reduced to €10 billion in the future, depending on a successful implementation of the rules, including in respect of tax certainty. A review to determine the success will be undertaken after seven years (so expected to be in 2030).

Rules to look at separate business segments (which had been considered but would add considerable compliance and administration complexity) will apply only in exceptional circumstances where a segment disclosed in a group's consolidated financial statements individually meets the scope (including the turnover threshold) requirements.

A market country will be entitled to tax an allocation of Amount A profits at their domestic rate if revenues of at least €1 million are generated in that country. For small or developing countries with GDP lower than €40 billion, this threshold will be €250,000. Revenues will be sourced to the end market country where goods or services are used or consumed. Detailed sourcing rules will be developed for specific categories of transactions but, in response to concerns raised by businesses, requirements to trace small amounts of sales will be kept to a minimum.

Businesses that are in scope will reallocate between 20% and 30% of their residual profit above a 10% profit level to market countries based on proportion of sales. The 10% profit level is calculated as the ratio of profit before tax to revenue. Profit amounts will be derived from consolidated financial accounts with only a small number of adjustments (largely for share-related items such as dividends and gains or losses on disposal which are not taxable in many jurisdictions). To eliminate double taxation, any Amount A liability will be allocated to companies that earn residual profit and relieved via either exemption or credit. Businesses by and large would have preferred this to be limited to exemption, given the complex interaction with domestic credit systems and the risk that the double tax is not, in fact, relieved.

Further areas of work will include developing a marketing and distribution profits safe harbour to limit the further allocation of profits to market countries where residual profits are already taxed. It will also be necessary to finalise the administration system, keeping it as simple as possible for businesses and allowing compliance through a single entity. Mandatory and binding dispute resolution mechanisms will be available in respect of all issues related to Amount A, including transfer pricing, business profits, and determination of whether an issue falls within the scope of the Amount A dispute resolution mechanism. Some small developing economies that have few or no mutual agreement procedure cases may be considered for an elective (rather than mandatory) dispute resolution process.

Importantly, and a key point in the negotiations for the US, implementation will be coordinated with the removal of all unilateral digital services taxes (DSTs) and other 'relevant similar measures' (to be defined) on all companies.

Alongside the new taxing right, but as a separate workstream, work will be undertaken in respect of 'Amount B' to simplify and streamline the pricing of 'baseline marketing and distribution activities' undertaken by group

distributors in a country. This is likely to focus on limited risk distributors and operate under existing transfer pricing rules in double tax treaties, perhaps as a form of 'safe harbour'. It is focused in particular on developing economies and their needs.

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Global minimum tax (Pillar Two)

Multinational businesses with annual turnover of more than €750 million (as for country by country reporting) will be required to pay a minimum effective rate of tax of at least 15% on profits realised in each country. Countries will not be obliged to adopt the global minimum tax rules, but those that do will apply them in a consistent manner in accordance with the OECD guidance. Countries will respect the application of the rules by others.

The 'main' income inclusion rule will result in additional 'top up' amounts of tax being payable by the ultimate parent company of the group to its tax authority (a UK Plc will pay the top-up tax to HMRC). The undertaxed payment rule will apply as a secondary (backstop) rule where the income inclusion rule has not been applied, although its method for allocating top up taxes, including in respect of low taxed profits in the country of the ultimate parent, remains under discussion.

Countries will be free to apply lower annual turnover thresholds to groups headquartered in their country. Government entities, international organisations, non-profit organisations, pension funds or investment funds, and any holding vehicles used by such entities, will be exempt where they are the ultimate parent entity.

An important consideration for groups with a US parent or non-US parented groups with a US holding company in their structures is how the existing US 'GILTI' regime will interact with Pillar Two. Proposed Budget changes by the Biden Administration would, if agreed by the US Congress, bring the GILTI considerably closer in line with the global Pillar Two rules. The OECD Inclusive Framework has said that consideration will be given to the conditions under which the US GILTI regime will co-exist with the Pillar Two global minimum tax, including being applied on a country by country basis.

Effective tax rate calculations will use a tax base determined by reference to the group's consolidated financial accounts, subject to some adjustments. Mechanisms to address timing differences and losses will also be available, but have not yet been developed. This has been perhaps the most difficult technical area in relation to the minimum tax rules, as the OECD has been reluctant to rely heavily on deferred tax accounting to address timing differences. Considerable work is ongoing in this area, with input from business. Specific issues for the insurance and extractives sectors are also likely to be addressed.

There will be limited exemptions for substantive activities (even where these relate to a regime that has been approved under the BEPS Action 5 Harmful Tax Practices work). These include profits that represent a 5% return on tangible assets and payroll costs (7.5% during a five-year transition period). There will also be a de minimis exclusion, and an exclusion for international shipping income. Further discussions will take place in this area as the Inclusive Framework expressed an ambition for the global minimum tax to have a limited impact on businesses carrying out economic activities with substance (of importance to some countries, in particular in relation to regimes such as R&D incentives), with a final decision to be made by October 2021.

Alongside the income inclusion and undertaxed payment rules, a 'subject to tax' rule will apply for smaller developing economies only. This will allow deductions of tax at source (similar to withholding taxes) on intra-group interest, royalties and a to-be-defined set of other payments. The minimum tax for the subject to tax rule

will be lower (between 7.5% and 9%) to take into account its operation on a gross turnover (rather than profit) basis. The subject to tax rule will be incorporated into bilateral tax treaties with countries that apply nominal rates of tax below a minimum rate to such receipts where requested by defined developing economy countries.

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Next steps

The G20 has emphasised the need for a detailed plan for implementation to be agreed by October 2021, alongside addressing the remaining political and technical issues for both pillars.

The OECD Inclusive Framework has set what looks like an extremely ambitious timeline for implementation largely to be in 2023. This looks challenging, given the need for a number of moving parts to turn and interact smoothly with each other. The new nexus and profit allocation rules (Amount A) will be implemented through a new multilateral instrument to amend double tax treaties which will be available for signature in 2022, with changes scheduled to come into effect in 2023. The global minimum tax rules are also scheduled to come into effect in 2023, although the undertaxed payment rule may be deferred to allow for implementation of the income inclusion rule first. The subject to tax rule will also be implemented by a multilateral instrument to amend applicable double tax treaties. Further technical work on the marketing and distribution function return (Amount B) is scheduled to be completed by the end of 2022, after which implementation is likely to be swift.

Making sense of the evolving political and technical developments

The significant political progress on international tax reform has been made possible by the efforts of the Biden Administration. This has better aligned the US administration's desire for changes to the US tax regime (for both inbound and outbound businesses) with the global minimum tax concept in Pillar Two. At the same time, the Biden administration has been prepared to contemplate the reallocation of some corporate profits to market countries, seen by the large economies in Europe and elsewhere as essential to capture the modern reality of highly digitalised businesses and others that do not need a local physical taxable presence to be successful.

A key point for the US administration has been that the reallocation of profits to market countries by the largest and most profitable companies (a large proportion of which will be US multinationals) will be tempered by the withdrawal of blunt and uncoordinated unilateral measures such as the digital services taxes for all companies, whatever their size. For countries that have implemented digital services taxes, this will also lead to the removal of the tariffs imposed (but suspended) by the United States Trade Representative in response.

One question to debate is what will be needed from here for multilateral international tax reform to finally go ahead? From a big picture perspective, at the international level, most countries have committed to make changes. The handful of countries that have not yet committed to the rules, and that continue to engage in discussions with the OECD, such as Ireland, Hungary, Kenya and Nigeria, may make local implementation more complicated, particularly within the European Union where a Directive to implement the rules was expected.

It seems unlikely, however, that these difficulties would be enough to stop the momentum for changes to be implemented by other countries. The undertaxed payment rule, for example, would, depending on the final design, tax low-taxed profits in other countries even if the income inclusion rule is not adopted in the parent company jurisdiction. There are also questions around the long-term behavioural response of low-tax countries, and whether raising tax rates to the minimum to prevent tax on their profits being collected elsewhere is a feasible or logical step.

The biggest hurdle to reform may be the complications of the US political system. It remains to be seen whether the Biden Administration can persuade the US Congress to approve the changes, especially as the window for action in Washington is later this year, before any global minimum tax is likely to be finalised by the OECD Inclusive Framework countries working on Pillar Two. Slim majorities for the Democratic Party do not make this an easy task, and it is unclear how much – if any – support the Republican Party is willing to give the effort. That will be especially important if some of the changes need to be implemented via treaty changes, which require the support of two-thirds of the Senate. But global tax reform, without the participation of the largest economy in the world, would not be reform at all.