NALSAR

BEPS 2.0 - Pillar 1 and 2

Key highlights

April 2024

By Lakshmana Kumar Devara

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Background

OECD BEPS In a nutshell

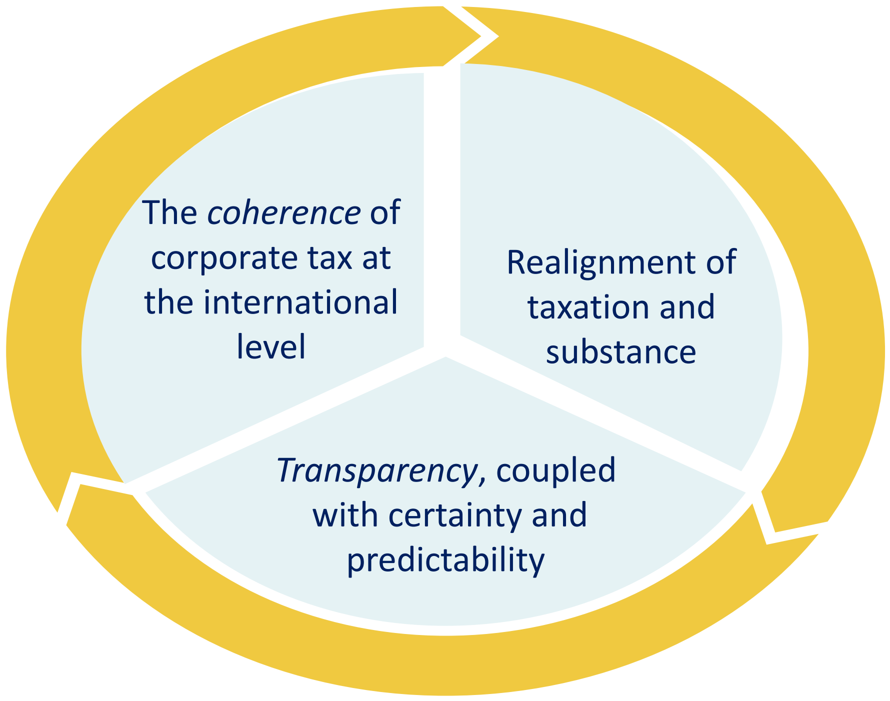
On 19 July 2013 the OECD released an Action Plan on BEPS which was presented to the meeting of G20 Finance Ministers in Moscow

The purpose of the Action Plan is <u>"to prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from activities that generate it.</u>"

<u>The report indicates that "no or low taxation is not per se a cause for concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.</u>"

The Action Plan covered 15 specific Actions which were broadly to be achieved within a two year time frame (i.e. by the end of 2015). On 5 October 2015, OECD released its final set of recommendations on all the 15 Action Points

15 Actions organized around *three* main pillars



Contd..

BEPS 1.0

BEPS 1.0 Action Plan

- Action 15: Development of a multilateral instrument for amending bilateral treaties

- Action 1 : Address the tax challenges of the digital economy

- Action 2: Neutralise the effects of hybrid mismatch arrangements
- Action 3: Strengthen CFC rules
- Action 4: Limit base erosion via interest deductions and other financial payments
- Action 5: Counter harmful tax practices more effectively, taking into account transparency and substance

- Action 11: Establish methodologies to collect and analyse data on BEPS and actions addressing it
- Action 12: require taxpayers to disclose their aggressive tax planning arrangements
- Action 13: Re-examine transfer pricing documentation
- Action 14: Making dispute resolutions more effective

- Action 6: Prevent treaty abuse
- Action 7: Prevent the artificial avoidance of permanent establishment status
- Action 8: Consider transfer pricing for intangibles
- Action 9: Consider transfer pricing for risks and capital
- Action 10: Consider transfer pricing for other high-risk transactions

BEPS Actions covered under MLI

Hybrid Mismatches (Action 2)

Treaty Abuse (Action 6)

Artificial Avoidance of PE (Action 7)

Dispute resolution (Action 14)

Minimum standard (some components)

BEPS 2.0

BEPS 2.0

Virtual PE

Digital Services Tax (Equalisation Levy)

Pillar One and Two

- Linklaters LLP vs DDIT (106 taxmann.com 195) (Mumbai Tribunal)
- ABB FZ LLC (83 taxmann.com 86) (Bangalore Tribunal)
- Clifford Chance Pte Ltd vs ACIT (SA No. 437/Del/2023) (Delhi Tribunal
  - ✓ Taxpayer a resident of Singapore rendered services in FY 2019-20 and 2020-21
  - ✓ FY 2019-20 - [Business development 35 days, Vacation period 36 days, common days 5, Services rendered in India for 44 days.
  - ✓ FY 2020-21 - Services rendered remotely. No employees visited India
  - ✓ Article 5(6) of India-Singapore DTAA provides for a threshold of 90 days (30 days for AEs)
  - ✓ Relied on Apex Court ruling in the case of E-Funds and held that the requirement of Service PE is that services must be rendered in India

<u>01 Apr 2016</u>

EL on Advertisement Services (6%)

<u>01 Apr 2020</u>

EL on E-commerce Transactions (2%)

Objective to allocate share of excess profits to Market jurisdictions and tax thereon

Identifies low tax jurisdictions and ensures a Minimum ETR of 15%

BEPS 2.0

08 Oct 2021

- The OECD & G20 Inclusive Framework (IF)* released an updated statement setting forth key components for an agreement on a two-pillar solution developed as a part of BEPS 2.0 Project.
- The October Statement describes agreed components with respect to both pillars of the project:
  - ✓ Pillar One on revisions to nexus and profit allocation rules
  - ✓ Pillar Two on new global rules that seek to introduce a minimum tax

Notes:

*. The G20 includes the European Union and 19 individual countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, South Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States.

Pillar One

BEPS 2.0 - Pillar 1

Pillar One: Profit allocation and nexus (Contd..)

- Allocation of profits to market jurisdictions irrespective of any physical presence in those jurisdictions. Amount to be taxed in the market jurisdictions = **Amount A** + **Amount B**.

- **Amount A** - Profits to be allocated to market jurisdictions.

  For in-scope MNEs (that derives at least 1 million euros in revenue from that jurisdiction), 25% of residual profit (defined as profit in excess of 10% of revenue) will be allocated to market jurisdictions with nexus using a revenue-based allocation key.

  The excess profits allocated to a market jurisdiction are capped when the market jurisdiction already taxes those profits. This adjustment is referred to as the Marketing and Distribution Safe Harbour Adjustment (MDSH). The MDSH operates generally as a multi-step calculation that identifies the excess profits with reference to a minimum level of profit calculated as the greater of a local jurisdiction RODP based on in-scope MNEs RODP or 3% of the revenue sourced to market jurisdiction.

- **Amount B** - Remuneration for baseline marketing and distribution activities.

  The development of standard remuneration for in-county “baseline” marketing and distribution activities has been deferred pending further technical work.

Note: Determination of Tax base - The relevant measure of profit or loss of the in-scope MNE will be determined by reference to financial accounting income, with a small number of adjustments. Losses will be carried forward.

BEPS 2.0 - Pillar 1 (Amount A)

The text of the MLC as released is not yet open for signature, and the Inclusive Framework did not make any announcement regarding the same.

11 Oct 2023

<table>
<tr><th>#</th><th>Name of the document released by OECD / G20 IF</th><th>Objective of the document</th><th>Details</th></tr>
<tr><td>1</td><td>Text of ‘Amount A’ Multilateral Convention (MLC)</td><td>To crease a co-ordinated agreement to reallocate rights to Market jurisdictions</td><td rowspan="4"><u>Applicability</u>:
• Applies to Groups with an adjusted revenues greater than €20 billion worldwide <u>and</u> a pretax profit margin greater than 10% (PBT/Revenue); Refer Note 1 & 2
• All industries and business models except few regulated financial services (viz., governmental entities, international Orgs, investment funds, not-for-profit Orgs, pension funds and pension services entities)
• MLC would require the countries to repeal existing unilateral Digital services taxes or similar levies. To the extent of conflict with provisions of an existing tax treaty, the provisions of the MLC are to prevail.</td></tr>
<tr><td>2</td><td>Explanatory statement</td><td>To clarify how each provision is intended to apply</td></tr>
<tr><td>3</td><td>Understanding on the Application of Certainty for ‘Amount A’</td><td>Contains further details on how aspects of Amount A will operate in practice</td></tr>
<tr><td>4</td><td>Overview document</td><td>Brief summary of MLC, its layout and select issues</td></tr>
</table>

Notes:

1. Also, a Group would be considered as Qualified Group if the Group has a pretax profit margin greater than 10% in at least two out of the four Periods immediately preceding the Period and (ii) the average of the pretax profit margin for the five-year Period ending with the Period is greater than 10%.

2. Turnover threshold to be reduced to 10 billion euros, contingent on successful implementation including of tax certainty on Amount A, with the relevant review beginning 7 years after the agreement comes into force

BEPS 2.0 - Pillar 1 (Amount A - MLI and its construct)

Pillar One: Profit allocation and nexus (Contd..)

#	Reference	Scope	Relevant Annexures	Remarks
1	Part 1 (Article 1)	Application and Personal Scope	-	
2	Part II (Article 2&3)	General Definitions and Covered Group	Annex B & C	What is a Covered Group ?
3	Part III (Article 4 to 8)	Allocation and Taxation of Profits	Annex D	How does the profit and tax allocation happens ?
4	Part IV (Article 9 to 13)	Elimination of Double Taxation	-	
5	Part V (Article 14 to 37)	Administration and Certainty	Annex E,F & G	
6	Part VI (Article 38 to 40)	Treatment of Specific Measures Enacted by Parties	Annex A & H	Impact on measures already enacted by countries?
7	Part VII (Article 41 to 53)	Final Provisions		

MLI - for Amount A

BEPS 2.0 - Pillar 1 (Amount A) - Covered Group

Article 3 - Covered Group

- A Group is in scope of Amount A if for the Period it has Adjusted Revenues greater than €20 Billion <u>and</u> a pretax profit margin greater than 10%.
- If in the two preceding Periods before the Period, the Group was not a Covered Group (i.e., it did not satisfy the revenue and profit before tax criteria), it will not be considered a Covered Group for the Period unless it satisfies the following additional criteria.
    - (i) <u>Prior Period Test</u> - the Group has a pretax profit margin greater than 10% in at least two out of the four Periods immediately preceding the Period; and
    - (ii) <u>Average Test</u> - the average of the pretax profit margin for the five-year Period ending with the Period is greater than 10%.

Article 2 - Adjusted Revenue (Part of General Definitions)

- "Adjusted Revenues" means the revenues, exclusive of value added taxes, goods and services taxes, sales taxes, or other similar taxes on consumption, that are reported in the Consolidated Financial Statements of a Group for a Period (or that would have been so reported if the Ultimate Parent Entity prepared Consolidated Financial Statements), modified to.
    - include the Group's share of revenue derived from a Joint Operation or a Joint Venture, in the same proportion as the Group's share of profit or loss derived from the Joint Operation or the Joint Venture. No adjustment shall be made if the Joint Venture is the Ultimate Parent Entity of another Covered Group in the Period;

BEPS 2.0 - Pillar 1 (Amount A) - Allocation and Taxation of Profits

Article 2 - Amount A Profit (Part of General Definitions)

- "Amount A Profit" means the amount determined for a Covered Group for a Period by:

  i. subtracting 10 per cent of the Adjusted Revenues of the Covered Group for the Period from the Adjusted Profit Before Tax of the Covered Group for the Period; and

  ii. multiplying the amount calculated in subdivision (i) by 25 per cent;

Article 5 - Allocation of Profits to the Market Jurisdiction

- Profit allocation to a Jurisdiction in which a Covered Group has a nexus shall be determined by:

  a) Amount A Profit X Adjusted Revenue from Source Jurisdiction / Adjusted Revenue of the Covered Group

  b) If the Profits from the Source jurisdiction is > €50 Million, then subtract Marketing and Distribution profits Safe Harbour adjustment (MDSH) from sub-paragraph (a)

Where the market jurisdictions already have existing taxing rights over the Covered Group's residual profits, should not receive a second taxing right of the Covered Group's residual profits

BEPS 2.0 - Pillar 1 (Amount A) - MDSH

Article 5 - Allocation of Profits to Market jurisdiction

- MDSH Shall be the lower of :

  i. Profits allocated to the Jurisdiction under (a) above; and

  ii. the jurisdictional offsetting profits of the Covered Group in the Jurisdiction;

Adjusted jurisdictional excess profits **X** Jurisdictional offset percentage

Normal level of profit
- Local Jurisdictions RODP based on in-scope MNE's RODP; or
- 3% of Revenue of Market jurisdiction

Adjusted elimination profit (or loss) for the Covered Group in the Jurisdiction for the Period*

Less: Higher of:

(a) Jurisdictional Depreciation and Payroll [X] Elimination Threshold RODP* or

(b) 3% of Adjusted revenues of the Jurisdiction

- 90% (low depreciation and payroll jurisdiction)
- 25% (lower income jurisdiction)
- 35% (Other income cases)

Note:

1. Elimination Profit (or Loss) of a Covered Group for a Period in a Jurisdiction is the sum of the entity elimination profit (or loss) of each Group Entity located in that Jurisdiction and the taxable presence elimination profit (or loss) of each Taxable Presence located in that Jurisdiction for the Period, reduced by the relevant elimination net losses in that Jurisdiction
2. *Elimination Threshold RODP of a Covered Group* = Covered Group's Adjusted Revenues for the Period X 10% / Accounting depreciation and Accounting payroll of the Covered Group

BEPS 2.0 - Pillar 1 (Amount A) - Elimination of Double Taxation

Article 9 - Relief for Amount A Taxation

- The fundamental design objectives of Amount A under Pillar One which, unlike Pillar Two, is not primarily designed to give rise to new tax revenues, but rather to seek to reallocate the residual profits of Covered Groups to certain qualifying jurisdictions.
- Therefore, while certain market jurisdictions are expected to gain tax revenues, Relieving Jurisdictions will be obliged to provide relief for Amount A taxation.
- Concept of Specified jurisdiction and Relieving jurisdiction are defined in Article 11.

BEPS 2.0 - Pillar 1 (Amount A) - Allocation and Taxation of Profits - Illustration

Particulars	Reference	Amount (in Euro Billion)	Percentage (%)	Details
Adjusted Revenue of the Covered Group	A	80		
Profit Before Tax	B	15	18.75%	PBT is in excess of 10%
Routine Profits (10% Threshold for applying Pillar 1)	C=A*10%	8	10%	
Excess Profits	D = C-B	7	8.75%	
Amount A Profit = Excess profits *25%	C*25%	1.75		

	Country A	Country B	Country C	Total
Revenue from each country	50	20	10	80
Allocation of share of Residual Profits (or) Excess Profits	1.09	0.44	0.22	1.75

BEPS 2.0 - Pillar 1 (Amount B)

Further work on the interdependence of Amount B and Amount A under Pillar One will be undertaken prior to the signing and entry into force of the Multilateral Convention.

19 Feb 2024

- OECD/G20 Inclusive Framework (IF) on BEPS released the report on Amount B of Pillar One providing a simplified and streamlined approach to the application of the arm's length principle to Baseline marketing and distribution activities, with a particular focus on the needs of low-capacity countries

- Salient features:

  - Unlike other BEPS 2.0 measures, Pillar One Amount B is not subject to a revenue threshold and can be applicable to many multinational businesses.
  - The Report is incorporated into the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022 (OECD TP Guidelines).
  - OECD will publish a list of the jurisdictions that choose to apply Amount B. Amount B will be treated as providing an arm's-length outcome only in jurisdictions that choose to apply the approach. Jurisdictions that choose to apply Amount B, can do so in any of the following ways:
    1. Taxpayer safe harbour: Tested parties resident in the jurisdiction have the option to elect to apply Amount B where they have transactions that meet the scope criteria.
    2. Mandatory: Tested parties and the tax administrations are required to apply Amount B where transactions meet the scope criteria.

Amount B may not be respected or relied upon in counterparty jurisdictions that choose not to adopt Amount B . Thus, a Group could be required to prepare a benchmarking analysis for Jurisdiction X, apply Amount B in Jurisdiction Y and if this results in double taxation, to the extent its available, rely on a MAP to eliminate double taxation.

BEPS 2.0 - Pillar 1 (Amount B)

Transactions in scope (wholesale distribution) Refer Note 1 & 2:

(a) Buy-sell marketing and distribution transactions

(b) Sales agency and commissionaire transactions

TP Method suggested:

(a) TNMM with Return on Sales (RoS) as Profit Level Indicator (PLI); or

(b) CUP method on exception basis

TP Margins suggested:

a) Based on Industry Grouping & Other factors.

b) Margin ranges from 1.50% to 5.50%

Elimination of Double taxation:
Refer Note 3:

Report acknowledges Double taxation upon application of simplified and streamlined approach by one jurisdiction and suggests MAP as a solution.

Notes:

1. Distribution of non-tangible goods and services and marketing, trading, or distribution of commodities are excluded from the scope of Amount B.
2. Also, the tested party should not
   - Make any unique and valuable contributions, should not assume economically significant risks etc.
   - Must not incur annual operating expenses lower than 3% (or) greater than 20-30% of the tested party's annual net revenues
3. In a MAP or resulting arbitration procedure, when one or more of the jurisdictions have not elected to apply or accept Amount B, they must justify their positions on the appropriate corresponding adjustments using the remaining provisions of the OECD TP Guidelines and not the Amount B approach.

Pillar Two

BEPS 2.0 - Pillar 2

14 Dec 2021

Pillar Two: Global Anti-Base Erosion Rules ('Globe Rules')

- Taxpayers that either have no foreign presence or that have less than **EUR 750 million in consolidated revenues** are not in scope of the Model Rules. Also, do not apply to government entities, international organisations and non-profit organisations, pension, investment or real estate funds
- Taxpayers in scope of the rules calculate their effective tax rate for each jurisdiction where they operate, and pay top-up tax for the difference between their effective tax rate per jurisdiction and the 15% minimum rate. Any resulting top-up tax is generally charged in the jurisdiction of the ultimate parent of the MNE. A de-minimis exclusion applies where there is a relatively small amount of revenue and income in a jurisdiction.
- The Pillar Two Model Rules also contemplate the possibility that jurisdictions introduce their own domestic minimum top-up tax based on the GloBE mechanics, which is then fully creditable against any liability under GloBE, thereby preserving a jurisdiction's primary right of taxation over its own income.
- Though more than 140 countries have announced their intent to adopt Pillar 2.0, their timelines for implementation vary

BEPS 2.0 - Pillar 2 (Four measures for global minimum taxation)

The OECD's Model Rules for the GMT include three main rules and a fourth "subject to tax rule" that countries can use when developing tax treaties.

US GILTI is similar to the IIR

Domestic legislation

Income Inclusion Rule (IIR) & Domestic Minimum Tax (DMT)

IIR (Rule 1): Inclusion of the income of a low-taxed constituent entity in the tax base of the ultimate parent entity if that income is not taxed at the minimum 15% ETR.
DMT (Rule 3): Also known as the Qualified Domestic Minimum Top-up Tax (QDMTT). the DMT gives countries the option of collecting and keeping any top-up taxes that would otherwise flow overseas. Countries that implement a DMT are not subject to the measures imposed by the IIR and UTPR.

Undertaxed Payments Rule (UTPR)

UTPR (Rule 2): Secondary rule which is meant as a backstop in case the minimum taxation is not achieved through the IIR. The UTPR is applied by the jurisdiction of the payer. UTPR gives governments the power to deny deductions (for payments to group companies or third parties on items viz., depreciation, interest etc.) or take similar actions to collect taxes that otherwise would not be collected under the IIR.

Tax treaties

Switch-over Rule (SOR)

Ensuring proper application of IIR by allowing a switch from the exemption method to the credit method.

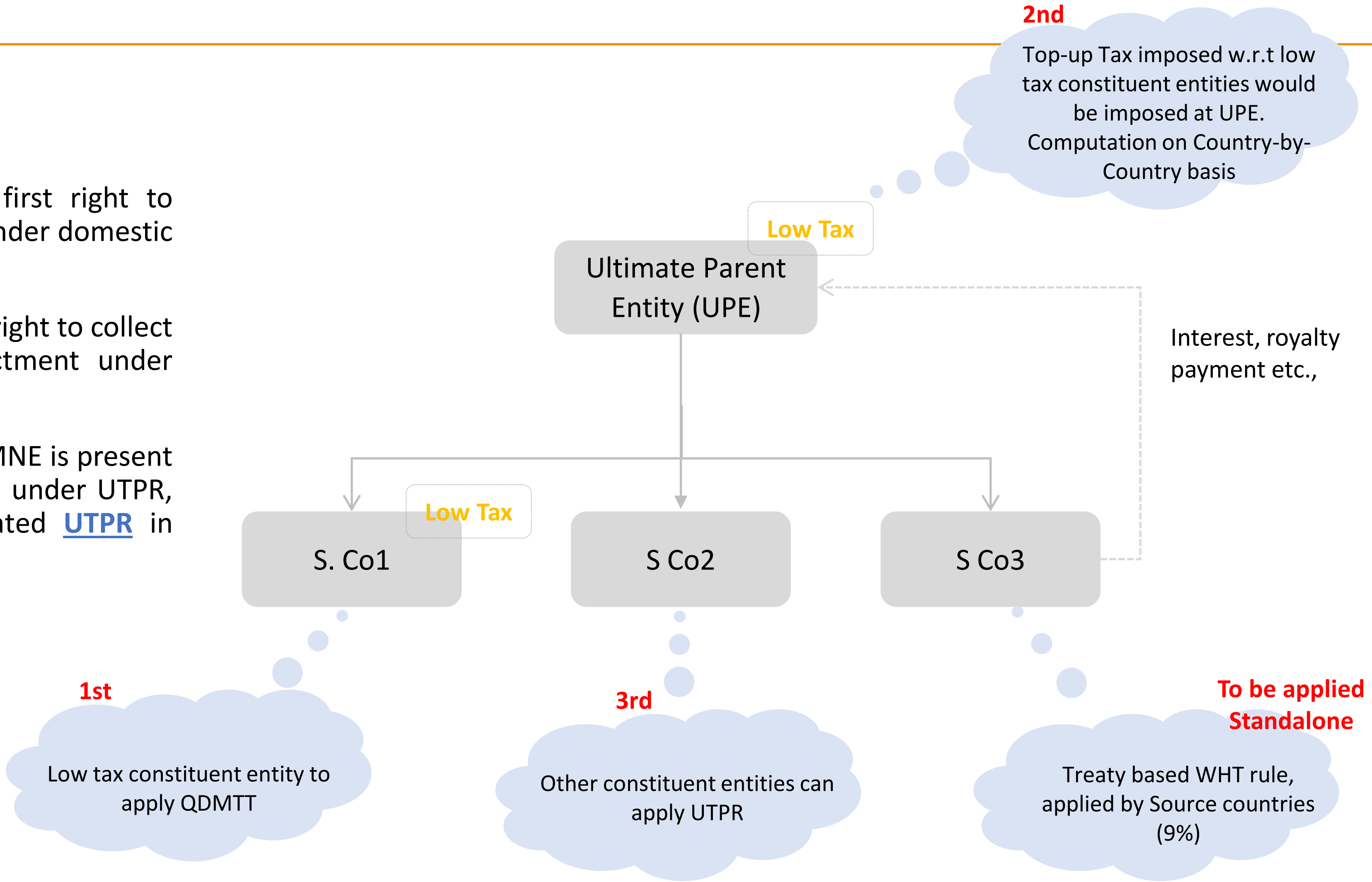
Subject to Tax Rule (STTR)

Rule 4: STTR enables countries to impose additional WHT on certain cross-border payments (viz interest, royalties, services) that are otherwise fully or partially exempt under a tax treaty to bring the total tax cost up to 9%. STTR taxes can be offset against the rest of the Pillar 2 taxes.

BEPS 2.0 - Pillar 2 - Illustration

Points for consideration:

1. Low tax jurisdiction(s) will have the first right to collect **QDMTT** (subject to enactment under domestic law)
2. Else, the UPE jurisdiction shall have the right to collect the taxes under **IIR** (subject to enactment under domestic law). Refer Note
3. Else, the other jurisdictions where the MNE is present shall have the right to collect the taxes under UTPR, provided the jurisdictions have legislated **UTPR** in their jurisdiction



Note: UPE will have the primary responsibility to apply IIR to collect the top-up Tax. If there is a an Intermediary Parent Entity, such IPE may also apply IIR as may be allocable

BEPS 2.0 - Pillar 2 - Illustration for computing QDMTT

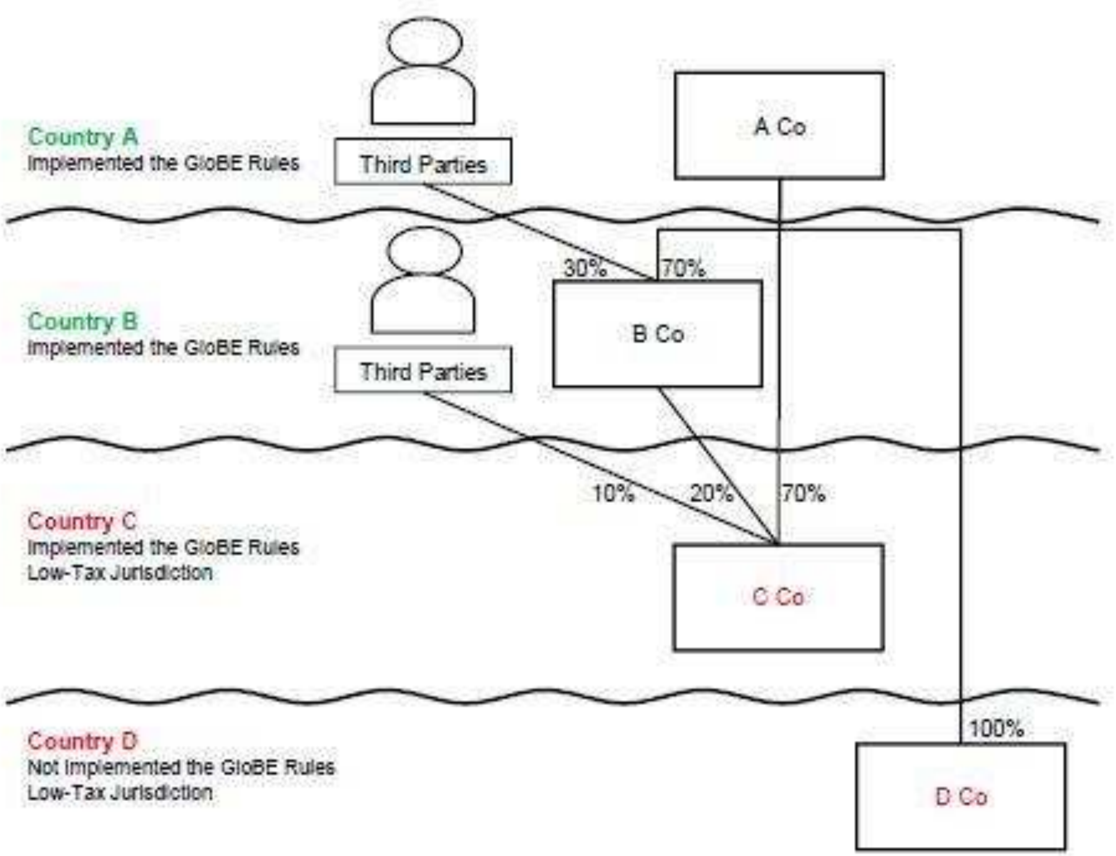
Particulars	Reference	S Co1	S Co2	S Co3
Income computed as per Globe Rules	A	2000	1000	1000
Covered Taxes at respective jurisdictions	B	100	250	200
Jurisdiction level ETR	C=B/A	5%	25%	20%
Top-up tax percentage	D = 15%-C	10%	0%	0%
Tangle Assets & Payroll	E	5000	-	-
Substance based carve out	F=E*5%	250	-	-
Excess profits	G=A-F	1750	-	-
Top-up tax	H=G*D	175	-	-

BEPS 2.0 - Pillar 2 - Illustration for allocation of Top-up Tax under IIR

Facts given:

- The Top-up Tax computed for Country C for the Fiscal Year is 1,000.
- The Top-up Tax computed for Country D for the Fiscal Year is 500.
- The Financial Accounting Net Income of C Co and D Co reflected in the Consolidated Financial Statements of A Co is 18,000 and 0, respectively. C Co's GloBE Income is 20,000 and D Co's GloBE Income is 35,000.
- The difference between C Co's GloBE Income and the income reflected in the Consolidated Financial Statements is attributable to 2,000 of expenses that are not taken into account in computing GloBE Income or Loss. The difference between D Co's GloBE Income and its income reflected in the Consolidated Financial Statements is attributable to the fact that all of its transactions were conducted with Group Entities located outside of Country D.

Entity	Consolidated income	GloBE Income	Difference
C Co	18,000	20,000	2,000
D Co	0	35,000	35,000



Example 2.2.3-1 from the Tax Challenges Arising from the Digitalisation of the Economy - Global Anti-Base Erosion Model Rules (Pillar Two) Examples by OECD

* Assume C Co also has not implemented the Globe Rules.

BEPS 2.0 - Pillar 2 - Illustration for allocation of Top-up Tax under IIR

Allocation of Top-up tax under IIR:

- Assume C Co and D Co have not implemented the Globe Rules. Thus, QDMTT rule does not apply
- A Co and B Co have implemented Globe Rules. Thus, IIR allocation happens at both the Jurisdictions with an offset mechanism.
- Computation involves:
  - ✓ B Co's Allocable Share of the Top-Up Tax of C Co (20%)
  - ✓ A Co's Allocable Share of the Top-Up Tax of C Co (84%)
  - ✓ A Co's Allocable Share of the Top-Up Tax of D Co (100%)

	A Co	B Co	Non-Group	Total
Allocable Share of C Co Top-up Tax	840	200	100	1,140
Article 2.3 Offset	(140)	-	-	(140)
Allocable Share of D Co Top-up Tax	500	-	-	500
Total Top-up Tax allocated	1,200	200	100	1,500

BEPS 2.0 - Pillar 2 - MLI for STTR

15 Sep 2023

- The Multilateral Convention to Facilitate the Implementation of the Pillar Two Subject to Tax Rule was adopted on 15 September 2023 by the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS).
- OECD/G20 Inclusive Framework have also released an explanatory statement on the same

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