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International Tax Webinar Series

Taxing the Digital Economy: Pillars One and Two

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Wednesday, 20 October 2021

HWL Ebsworth Lawyers acknowledges the Traditional Owners of Country throughout Australia. We pay our respects to Elders past and present.

International Tax Webinar Series

- Session 1 - Base Erosion and Profit Shifting: Overview and current status of implementation of BEPS measures in Australia (Wednesday, 6 October 2021)
- **Session 2 - Taxing the Digital Economy: Pillars One and Two (Wednesday, 20 October 2021)**
- Session 3 - International tax disputes (Wednesday, 3 November 2021)
- Session 4 - Interpretation of Double Taxation Agreements (Wednesday, 17 November 2021)
- Session 5 - Evidentiary issues and processes in international tax and transfer pricing matters (Wednesday, 1 December 2021)

To hear more about our upcoming sessions, or to register to attend, please email Katarina Szivek, BD Specialist (kszivek@hwle.com.au).

Outline

- Background – the Pillars
- Pillar One
- Pillar Two
- Questions

Background – the Pillars

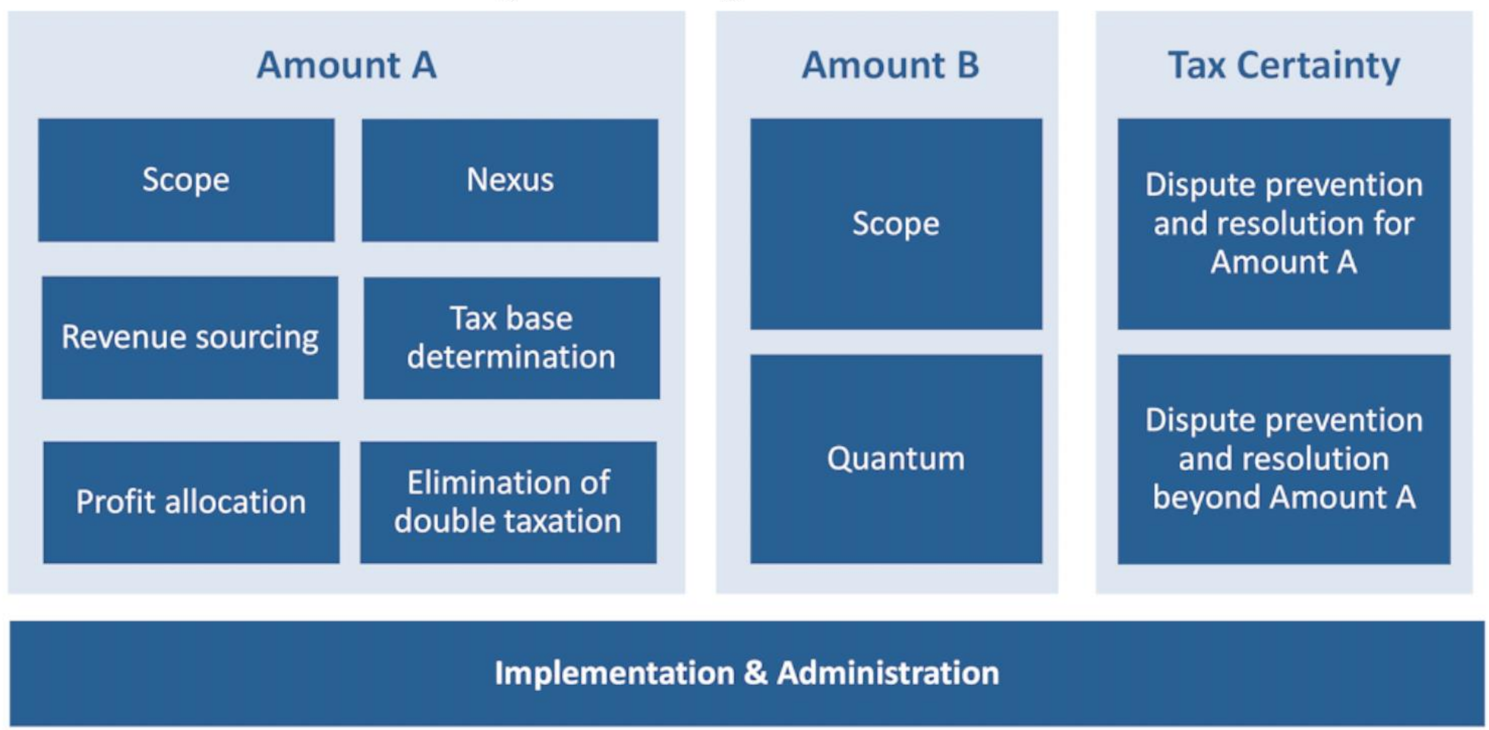
- In January 2019, members of the Inclusive Framework agreed to examine BEPS Action Item 1 in two pillars.
- **Pillar One** is focused on nexus and profit allocation.
- **Pillar Two** is focused on a global minimum tax intended to address remaining BEPS issues.

Pillar One – Intent

- *Pillar One seeks to adapt the international income tax system to new business models through changes to the profit allocation and nexus rules applicable to business profits. Within this context, it expands the taxing rights of market jurisdictions (which, for some business models, are the jurisdictions where the users are located) where there is an active and sustained participation of a business in the economy of that jurisdiction through activities in, or remotely directed at, that jurisdiction.*
- *It also aims to significantly improve tax certainty by introducing innovative dispute prevention and resolution mechanisms. Pillar One seeks to balance the different objectives of Inclusive Framework members and result in the removal of relevant unilateral measures.*
  - OECD Tax *Challenges* Arising from Digitalisation, Report on Pillar One Blueprint at [6].

Pillar One – Building Blocks

Figure 1.1. **Building Blocks of Pillar One**



Amount A – The New Taxing Right

- Overlay to existing nexus and profit allocation rules.
- Key Design Features include:
  - Revenue Thresholds
  - Scoping Rules
  - New Nexus Rule
  - Detailed Sourcing Rules
  - Reallocation of Residual Profit
  - Loss Carry-Forward Regime
  - Marketing and Distribution Profits Safe Harbour
  - Mechanisms to Eliminate Double-Taxation
  - Simplified Administrative Process
  - Domestic Law changes to ensure Amount A taxing right be implement

Amount B – Baseline Marketing and Distribution Activities

- Distribution arrangements continue to be an area of concern for both tax authorities and taxpayers and are identified, by the OECD, as a frequent focus of domestic transfer pricing controversy.
- Aims to simplify administration of transfer pricing rules for tax authorities, reduce compliance burden for taxpayers and enhance tax certainty.
- Implementation to be commenced by end of 2022.
- Key Design Features include:
  - Tax compliance will be streamlined (single entity lodgement)
  - Unilateral measures (removal of some jurisdiction's digital service tax)
  - Implementation (MLI development)

Unresolved Issues – Pillar One

- **Scope:** Narrow group of digital business models vs wider group
- **Quantum:** Amount of profit reallocation
- **Extent of tax certainty:** Differences of view on the scope of mandatory binding dispute resolution beyond Amount A
- **Scope and application of Amount B**

Pillar Two – Intent

- *Pillar Two provides a solid basis for a systemic solution that would address remaining base erosion and profit shifting (**BEPS**) challenges and sets out rules that would provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights, or the payment is otherwise subject to low levels of effective taxation. These rules would ensure that all large internationally operating businesses pay at least a minimum level of tax.*
  - OECD Tax *Challenges* Arising from Digitalisation, Report on Pillar Two Blueprint.
- Pillar Two is also referred to as the Global Anti-Base Erosion (**GloBE**).

Pillar Two – Design Features

- Income Inclusion Rule
  - Similar to CFC rules; the IIR effectively operates by requiring a parent entity to bring into account its share of the income of each Constituent Entity located in a low-tax jurisdiction and taxes that income up to the minimum rate (after crediting any covered taxes on that income). The IIR imposes a top-up tax only on that portion of the low tax income of a foreign Constituent Entity which is beneficially owned (directly or indirectly) by the member of the group that applies the IIR (the Parent).
- Undertaxed Payments Rule
  - Described as a 'backstop' to the IIR; the UTPR is to protect jurisdictions against base erosion through intra-group payments to low-taxed entities while ensuring that, in aggregate, the application of the GloBE rules does not result in the MNE Group being subject to tax on its income in those jurisdictions where it operates in excess of the minimum rate.

Pillar Two – Design Features

- Switch-over Rule
  - The switch-over rule would allow the state of the parent's residence to apply an IIR to tax the income of a PE in those cases where the IIR would apply as a matter of domestic law. The switch-over rule would permit the resident state to tax the low-tax profits of a PE up to the agreed minimum rate.
  - Effectively, permits a residence jurisdiction to 'switch' from an exemption to a credit method where the profits attributable to a PE are subject to an effective rate below the minimum rate.
- Subject to Tax Rule
  - Subjects a payment to withholding or other taxes at source and adjusts eligibility for treaty.
  - The STTR is triggered where a payment is subject to a nominal tax rate in the payee jurisdiction (and below an agreed minimum rate).

Unresolved Issues – Pillar Two

- **Implementation:** the STTR and SOR require changes to bilateral tax treaties.
- **Implementation:** the IIR and UTPR require changes to domestic law.
- **Coordination:** model legislation/guidance required for IIR and UTPR.

Questions?

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