Advance Refresher Course on International Taxation

Overview and Impact analysis of Pillar 1 and Pillar 2

10 September 2022

CA Saurabh Shah

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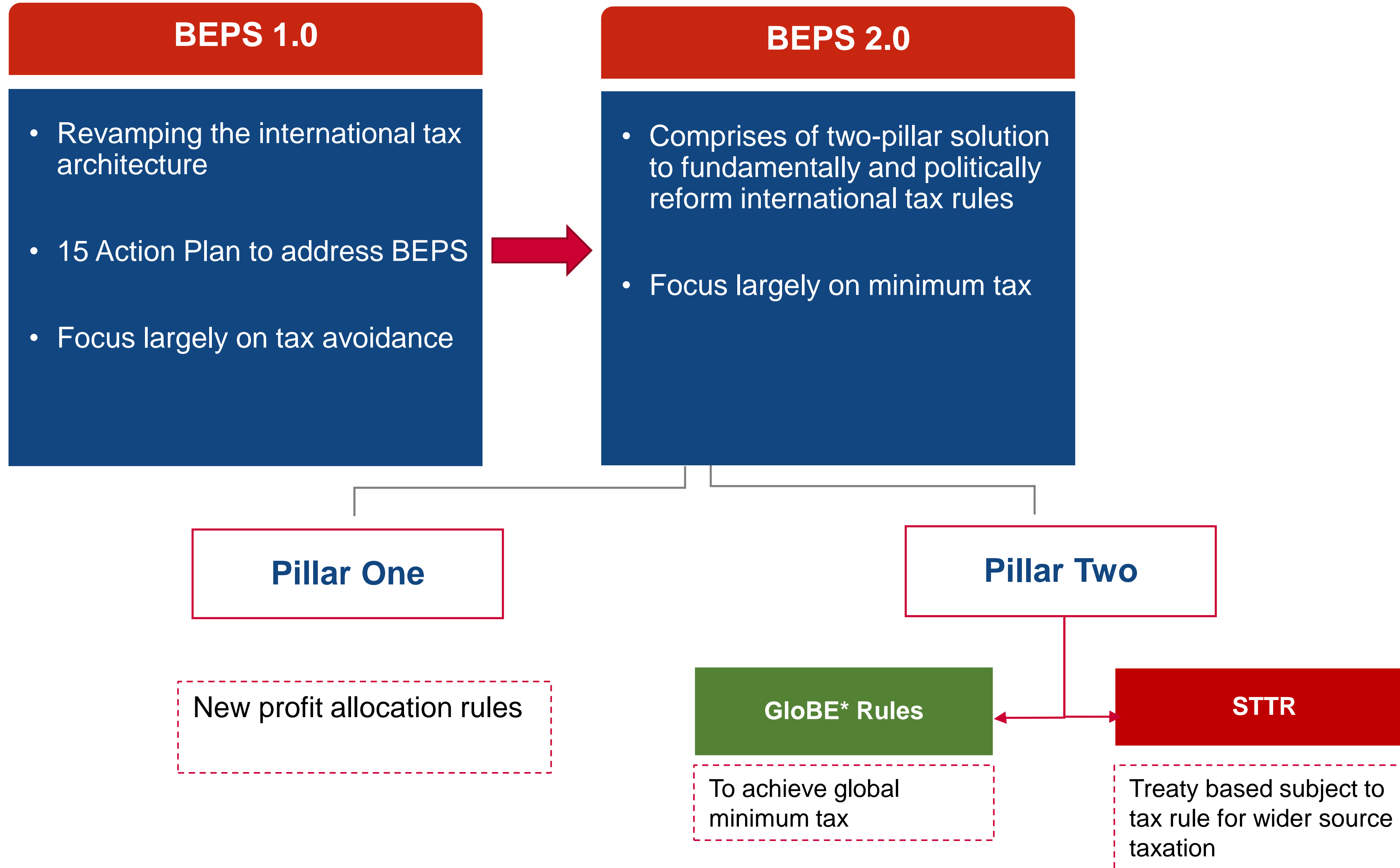
Journey from BEPS 1.0 to BEPS 2.0



** Global Anti-Base Erosion Rules*

GloBE Model Rules

Preamble:

“The GloBE rules provide for a **coordinated system of taxation** intended to ensure large MNE Groups pay a **minimum level of tax** on the income arising in each of the jurisdiction where they operate. It does so **by imposing a top-up tax** whenever the **Effective Tax Rate,** determined on a **jurisdictional basis**, is below the minimum rate”

(Executive summary to Model Rules)

Pillar 2 – Policy objectives

- Pillar 2 aims to end “race to bottom” in corporate taxation
- Reduce pressure on developing countries to offer wasteful tax incentives
- Ensure that decisions on investments and effective capital allocation are based on non-tax factors such as infrastructure, skilled workforce, or labour costs
- Trigger minimum tax in each jurisdiction in respect of profits in excess of routine returns related to real substance i.e. related to average net book value of tangible assets and payroll cost
- Restore public finances post COVID by increase in corporate tax revenue globally, meet Environmental, Social, and Governance (ESG) transformation cost

- Model rules reflect common approach but optional measure i.e. countries may opt out at their discretion but will agree to implementation by others - if implemented, need to adhere to common template
- Rules are fairly complex; couched in highly technical language adding several new concepts beyond the Blueprint

Timelines

Oct 2020 — Release of blueprints of Pillar 1 & 2

July 2021 — Conceptual agreement of G20/OECD Inclusive Framework on BEPS (“IF”) with respect to BEPS 2.0 Project

Oct 2021 — 137 out of 141 members of BEPS IF reach consensus on key design parameters of BEPS 2.0

Dec 2021 — Release of the Model Rules on Pillar 2 as approved by BEPS IF

Mar 2022 — Release of Commentary and illustrative examples on Model Rules on Pillar 2. Initiated public consultation on aspects to be covered by Implementation Framework

End of 2022 — Pillar 2 to be brought into law

2023 — IIR to be brought into effect

Is Pillar 2 on track?

1

EU ECOFIN Meeting (5 April 2022)
Most likely, the Income Inclusion Rule will effectively enter into effect in the EU in 2024. The Undertaxed Profit Rule will likely enter into effect in 2025. Small Member States will be allowed to delay the introduction of the rules

2

EU Parliament Panel (28 April 22)
EU countries should press Pillar 2 more quickly than currently envisaged timeline and should be ready to implement it by 31 December 2022"

3

US Treasury Secretary (13 April 2022)
Our corporations will no longer be based in the only country on earth that requires them to pay a minimum tax on their foreign earnings. This **level playing field will enhance their competitiveness relative to foreign corporations**

4

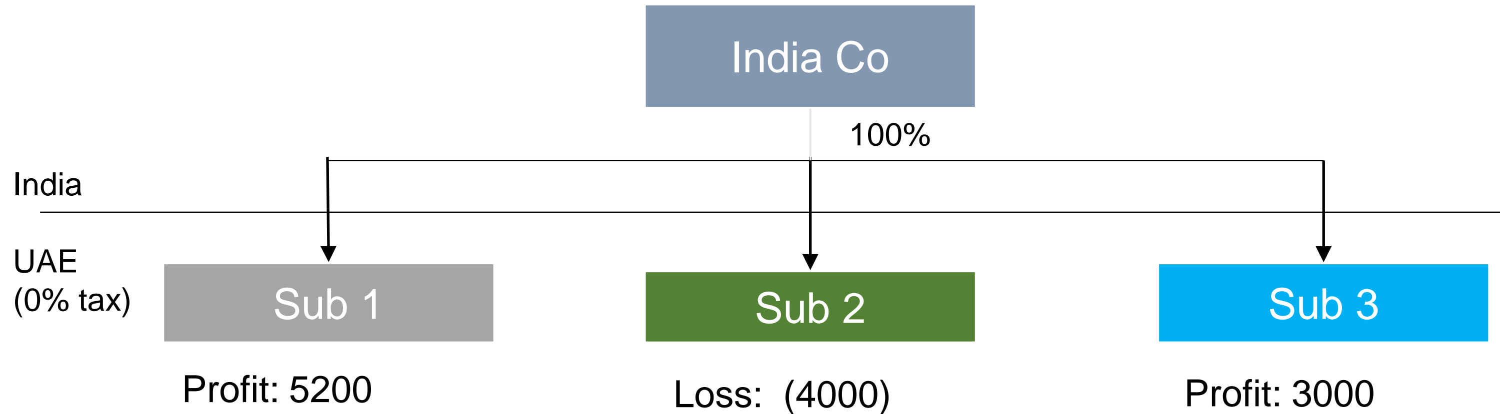
US Senate Finance Committee (Republicans) (22 Dec 2021 / 16 Feb 2022)
As **Pillar Two does not require other countries to adopt a global minimum tax**, we are not confident that our biggest foreign competitors, like China, will enact and implement a global minimum tax on the same terms or on the timeline agreed to at the OECD…

…**foreign countries could effectively capture the benefit of congressionally-provided tax credits and deductions** targeted at domestic innovation, investment, and job creation…

5

UK (27 April 2022)
The Chartered Institute of Taxation (CIOT) urges UK **not to rush into the implementation** ahead of its competitors as **quick adoption is not as important as implementing it with right policy aims**

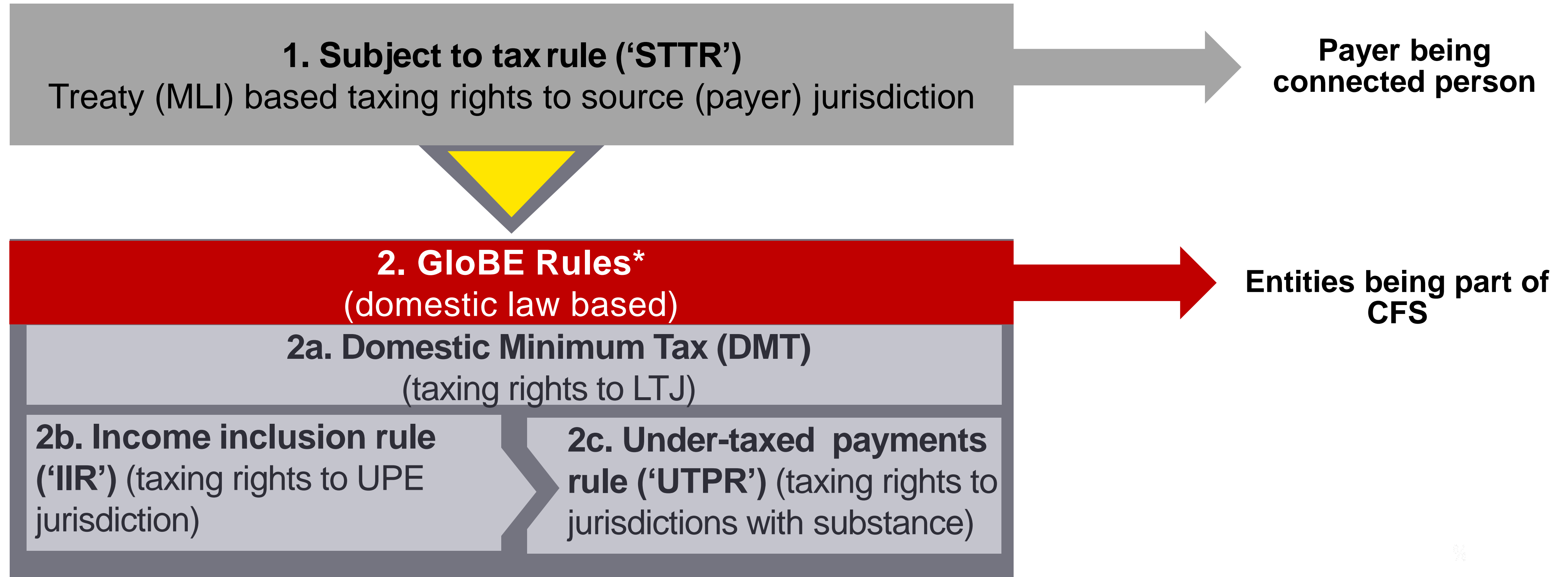
Impact of jurisdictional blending



Illustrating GloBE top-up tax & Jurisdictional Blending		Amount
Aggregate book profits	A	4200
Current tax including DTL	B	NIL
ETR	C	0%
Shortfall (15% - 0%)	D	15%
Substance based exclusion* of profits	E	(200)*
Excess income (A-E)	F	4000
Top Up Tax (D x F) (15% of 4000)		600

*Reflects normatively calculated “routine profits” linked to tangible assets / payroll cost in UAE

How to achieve Global Minimum Tax?



Pillar 2 measures are in addition to existing SAARs including POEM, ALP, GAAR, PPT

Situations where Pillar 2 is NOT relevant from India perspective

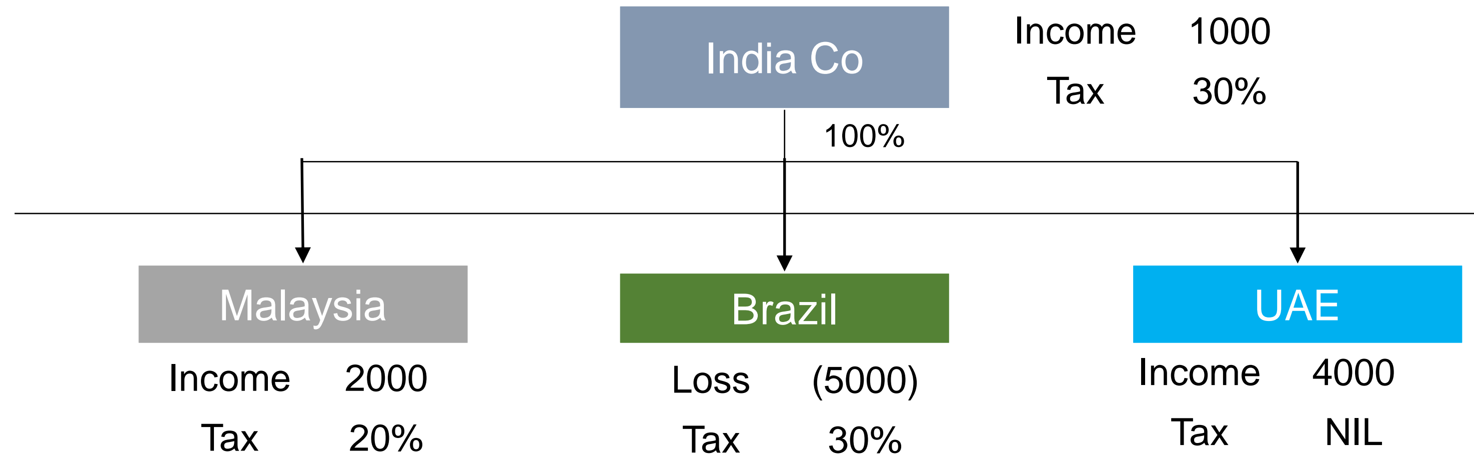
- MNEs which have revenue of < €750 mn as per CFS
- At level of individuals owning wealth through different companies/ entities
- Any Indian enterprise which has income from exports but has no PE in other jurisdictions
- If income as earned in a jurisdiction is less than 'moderate' profit due to meaningful substance
- Entity in LTJ is investment holding company and its income comprises of dividend or capital gains income or profit on fair valuation of its holdings
  - Holding can either be within group, JV, or associates, or other investments provided it is ≥ 10%
  - Holding of < 10% is considered portfolio investments and its dividend* or gain subjected to GloBE
- If some entity in overseas LTJ is considered POEM resident of India, it is regarded as located in India for GloBE rules, and will cease to be low taxed constituent entity (LTCE)
- De-minimis exclusion: If LTJ as a whole has 3 year average GloBE revenue of < € 10 mn (Rs. 85 cr) and GloBE profit of < € 1 mn (Rs 8.5 cr) as calculated by applying GloBE rules (on a jurisdictional basis)
- Losses incurred in pre-GloBE years can be captured through DTA mechanism
- Sector carve out: Income from international shipping and specified ancillary activities
- Excluded Entities : Government, non-profit organisations, pension fund, investment fund, etc.

Natural persons/individuals are outside of GloBE, though trusts, partnerships are in scope

Situations where Pillar 2 is likely to impact

- Every meaningful MNE to bear minimum 15% tax on its “excess” profit from each jurisdiction (including HQ jurisdiction)
  - Ensure jurisdictional blending by aggregating “adjusted book profit” of all entities in a jurisdiction
  - At group level, MNE may have incurred loss as per CFS, but there are some low tax jurisdictions which have reported profit
  - ETR of MNE group as per CFS could be far in excess of 15%
- MNEs are expected to bear 15% tax in each jurisdiction– regardless of tax policy, treaty relief or any other reason whatsoever
- Interlocking and rule order ensure that if jurisdiction of shortfall fails to recover, some other jurisdiction can benefit by recovering the shortfall
- Every jurisdiction is within GloBE even if:-
  - Income is of active nature but profit earned is more than “moderate profit”. To recollect: calculation of moderate profit is as prescribed w.r.t. eligible tangible assets and eligible payroll cost
  - Business presence is in high tax jurisdiction, but tax is relieved due to economic incentive under its domestic laws, or is non chargeable due to territorial taxation norms adopted in domestic laws

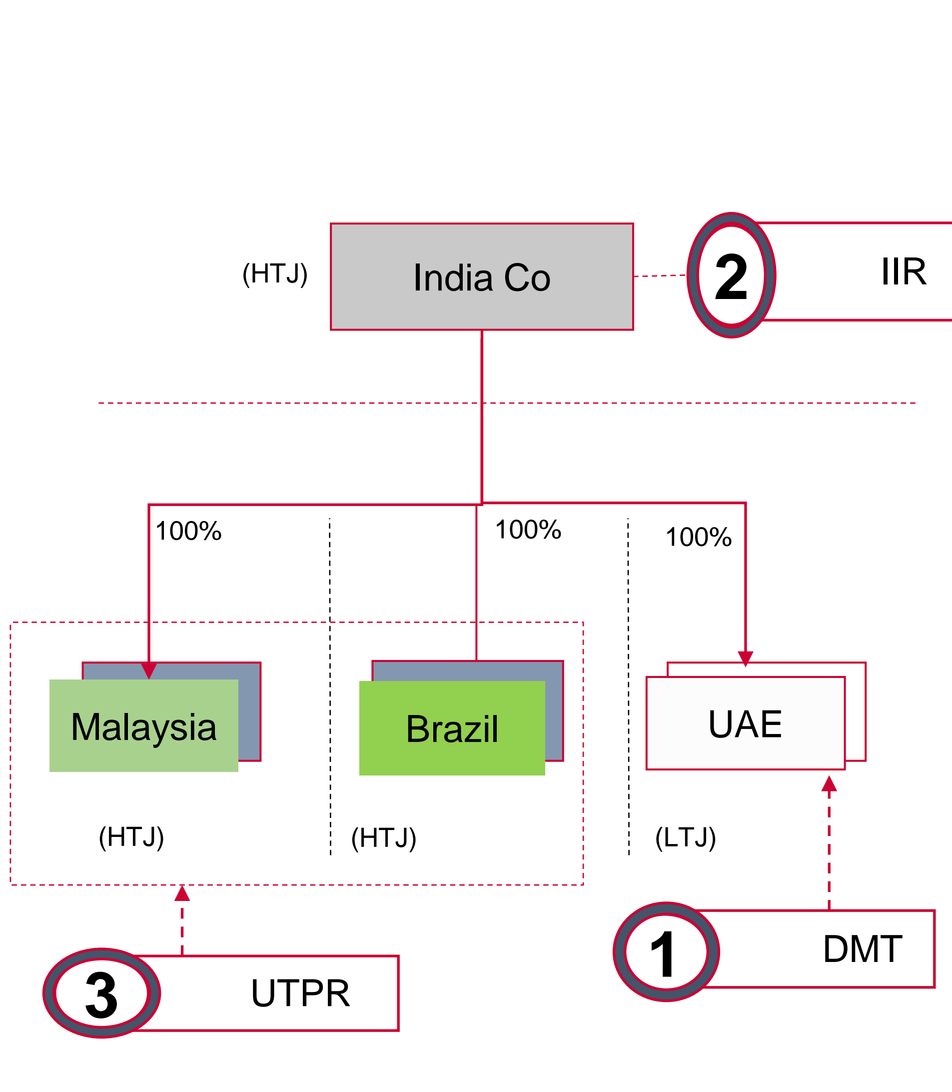
Worldwide ETR > 15%: Does Pillar 2 apply?



Jurisdiction	Profit / (Loss) as per CFS	Tax rate	Tax (Pre GloBE)	GloBE tax impact	Total tax (Post GloBE)
India	1,000	30%	300	NIL	300
Malaysia	2,000	20%	400	NIL	400
Brazil	(5,000)	30%	NIL	NIL	NIL
UAE	4,000	NIL	NIL	**600**	600
Total	**2,000**		**700**	**600**	**1,300**
ETR			**35%**		**65%**

Worldwide ETR of 15% does not save you from GloBE rules

Pillar 2 - A skeletal overview of Rule Order



1 DMT

- UAE can implement qualified domestic minimum top-up tax of 600

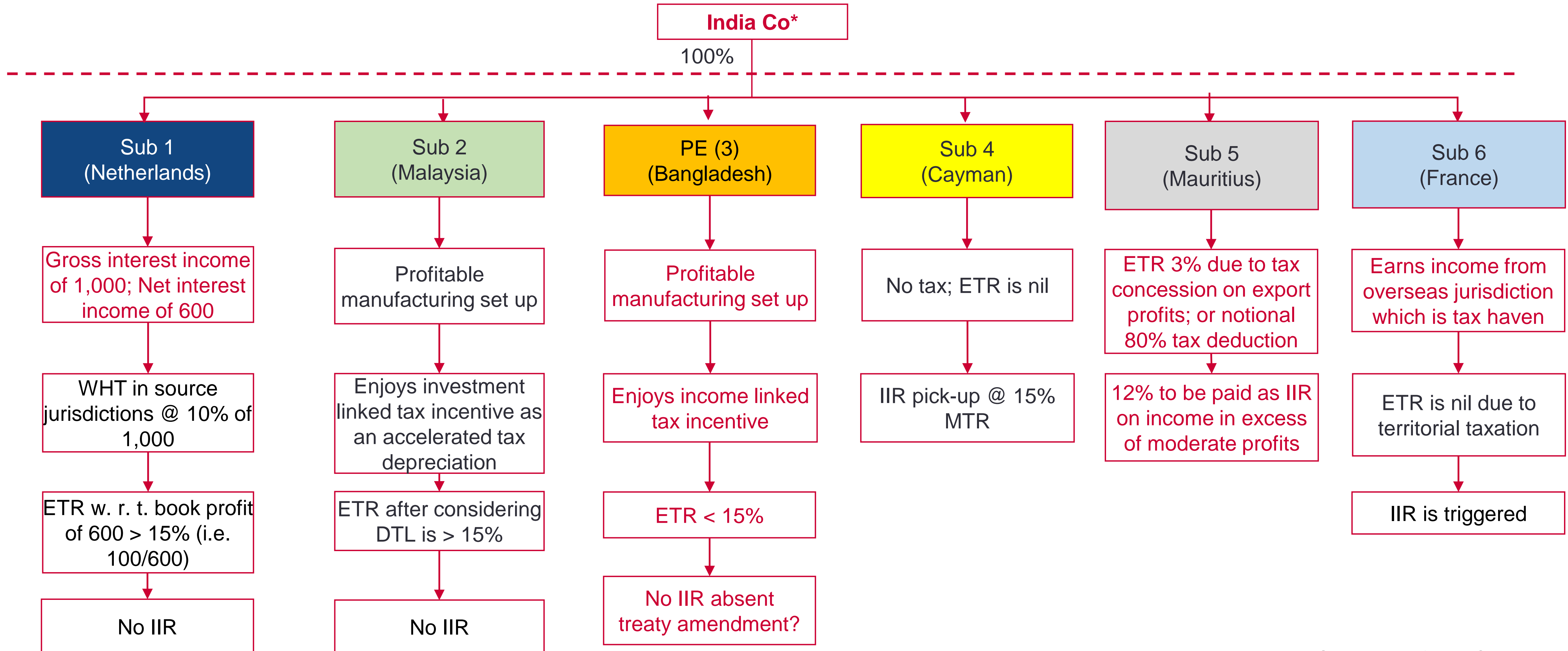
2 IIR

- If UAE does not recover DMT, India can implement GloBE rules and recover 600 as per IIR

3 UTPR

- If India does not recover IIR, Malaysia and Brazil can implement GloBE rules and recover UTPR in ratio of allocation keys (viz. number of employees and value of tangible assets)
- If Brazil alone implements GloBE, UTPR of 600 goes to Brazil alone

Illustrations: GloBE impact



** India headline tax rate is 25% and Global ETR of India Co is > 15%*

To recollect: CFS reflecting global ETR > 15% does not preclude GloBE trigger!

How big companies are reacting to Pillar 2?

Netflix

"I can tell you, that with Pillar 2, we will have to hire an army of accountants just to guarantee that there will be consistency in complying with Pillar 2 and calculate the ETR across the 170 jurisdictions that we are in…"

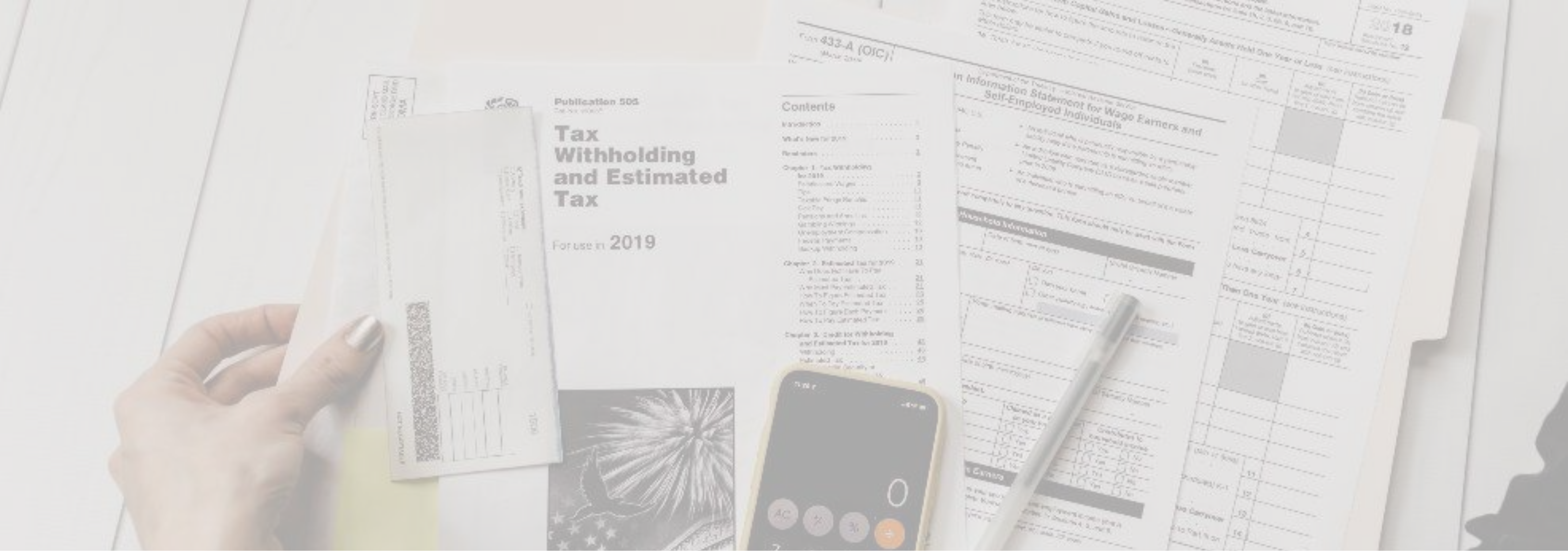
- Dr. Giammarco Cottani Director, Global Tax Policy, Netflix, at IFA International Tax Conference - "Emerging International Taxation Landscape post the Pandemic 2022" held on April 29 & 30, 2022a

Google

"Global tax deal will make "no difference" to Alphabet Google's operations in Ireland as the company remains committed to investing and adding staff to its European hub there.

…. Ireland is a unique place. It gives us a chance to attract the best talent in the industry."

- Sundar Pichai, Google CEO, Economic times, 28 April 2022



India and GlobE – Is India a safe harbour jurisdiction?

Is India a safe harbour jurisdiction?

- India has phased out incentives
- Entities are subject to MAT/AMT
- CTR also triggers tax @ 25%/17%
- Permanent disallowances (e.g. 14A) will only enhance ETR
- Investment linked incentive deduction results in timing difference. GloBE addresses timing mismatches through DTA/DTL
- Past losses will be available through DTA
- Incentives under S.80JJAA or concession under Patent Box Regime (PBR) 'may' potentially trigger GloBE – though, relevant only if profits breach moderate levels
- Companies enjoying exemption in respect of agricultural income (say, tea manufacturing company) can trigger top up levy - though, state income tax paid if any will be reckoned to determine short fall
- Jurisdictional blending will require aggregation of all Indian operations (i.e. PE taxation @40%; presumptive tax cases; S.10AA incentivised units, etc.)

However, devil is in details. A typical mismatch in GloBE basis and domestic tax law could potentially make CEs in India LTCE

Situation 1 – Impact of Excluded Loss

Particulars	Local tax computation (MAT)	GloBE computation
Operating profit	1,000	1,000
Loss on sale of shares	(600)	-
Income (a)	400	1,000
Current tax (@17%)	68	68
MAT credit	(68)	?
DTA @ 20% on 600	(120)	-
Tax (b)		68
ETR (a/b)		6.8%
Shortfall (TUT)		8.2%

- I Co enjoys 100% income linked incentive deduction in respect of its operating profit
- I Co is subject to MAT
- For year under reference, I Co has operating profit of 1,000 and loss on transfer of shares of one of the WOS of 600
- I Co's book profit for MAT purposes is 400 and tax liability @ 17% is 68
- GloBE income of I Co is 1,000
  - Loss on sale of shares of WOS is ignored and excluded
- Covered tax of I Co is 68
  - DTA qua capital loss of 120 (600 @ 20%) is ignored due to co-relative adjustment
- ETR of I Co for GloBE is 68/1,000 = 6.8% ~ 7%
- There is shortfall compared to MTR of 8% (15 – 7%)
- **Open Issue:** Does MAT credit entitlement reduce ETR?

Situation 2 – Impact of super deductions and recast of DTL

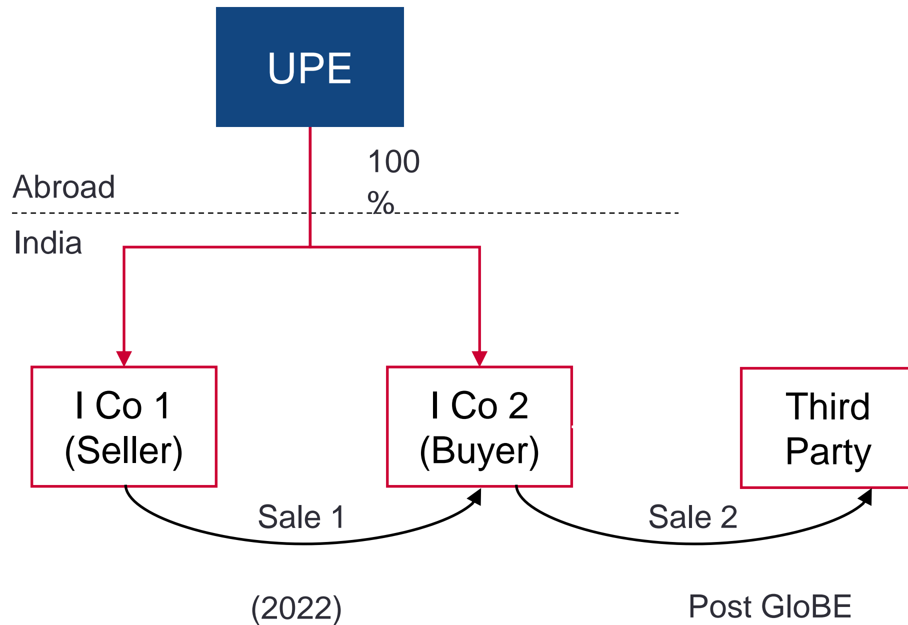
I Co (operating company)

Tax rate: 25%

Particulars		Local tax computation (Normal)	GloBE Computation
Operating profit		1,000	1,000
Accelerated depreciation		(800)	-
S.80JJAA deduction		(200)	-
Income	(a)	Nil	1,000
DTL @ 25% of 800		200	-
DTL for GloBE (recast @ 15% of 800)			120
Tax	(b)		120
ETR	(a/b)		12%
Shortfall (TUT)			3%

- I Co has book profit of 1,000 (post book depreciation) but taxable income as per domestic law of nil on account of following two deductions:
  - Accelerated depreciation of 800 (over and above book depreciation)
  - Weighted deduction u/s. 80JJAA for employment cost of 200
- Tax payable by I Co @ 25% is nil
- In books, DTL of 200 is provided in respect of additional depreciation of 800 (25% of 800)
- GloBE income of I Co is 1,000
- Covered tax of I Co is 120 (actual tax of nil plus DTL of 120 post re-casting @ 15%)
- ETR in the facts of the case is 12% (120 / 1,000) resulting in shortfall of 3% (i.e. 15%-12%)
- TUT will be 3% of excess profit (i.e. profit over routine profits excluded based on substance)

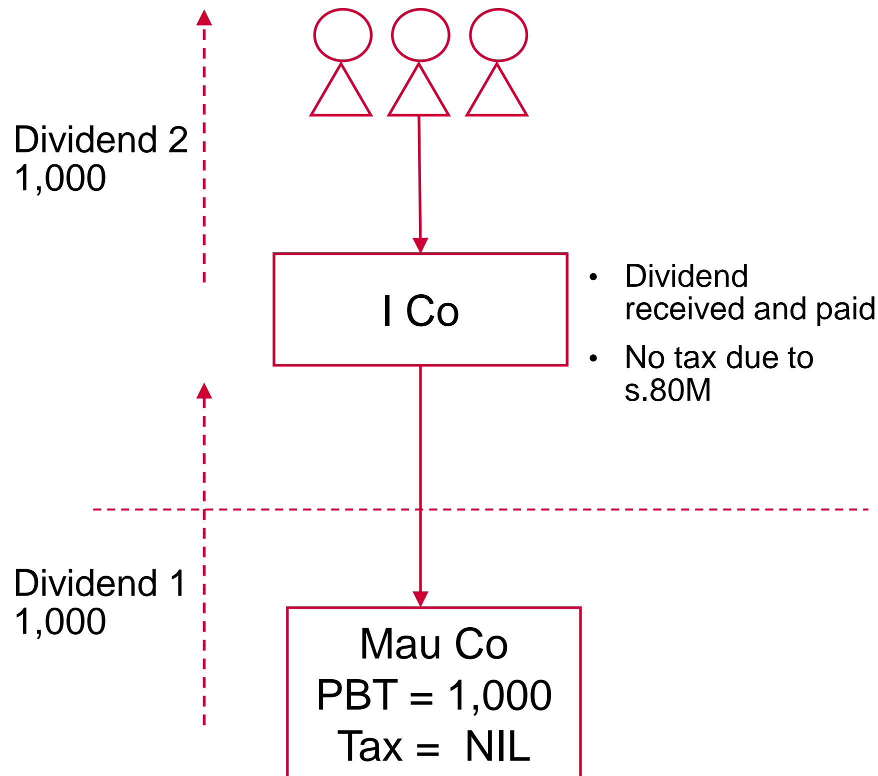
Situation 3 – No cost step up for intra-group asset transfers



ICo1's carrying value	1,000
Sale 1 Transfer price	10,000
Sale 2 Transfer price	10,000

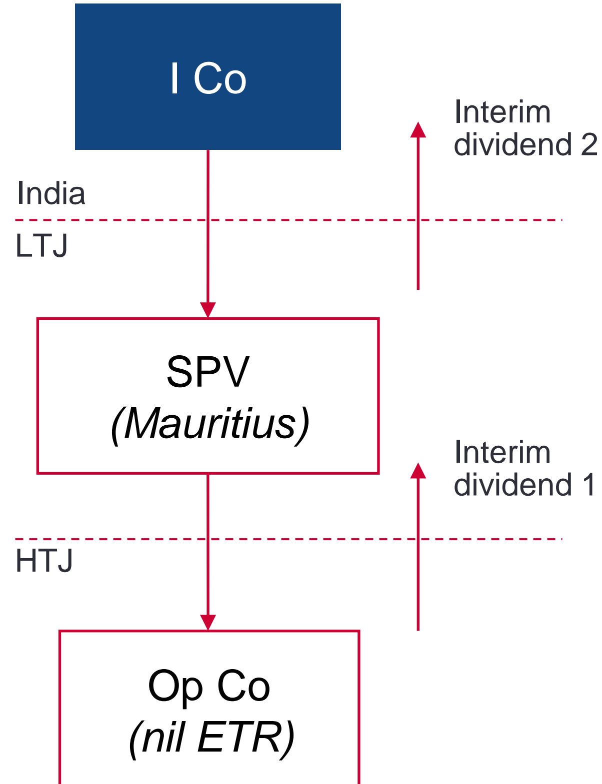
- UPE has 2 subsidiaries in India, I Co 1 and I Co 2
- I Co 1 owns asset that has book value/cost of 1,000 and fair value of 10,000
- In 2022 (pre-GloBE)(and after 30 Nov 2021), I Co 1 transfers the asset to I Co 2 for fair value of 10,000. ICo1 pays capital gains tax @ 20% = 1,800
- In (say) 2029 (post GloBE), I Co 2 transfers such IP to third party for fair value of 10,000
- Book profit of ICo2 is NIL
- Taxable income is NIL
- GloBE income however is 9000 (i.e. fictionally ICo2's cost for GloBE is equal to carrying value of ICo1)
- Potential GloBE TUT = 15% of 9000 = 1350

IIR tax: Cross border reallocation of dividend tax and impact of section 80M



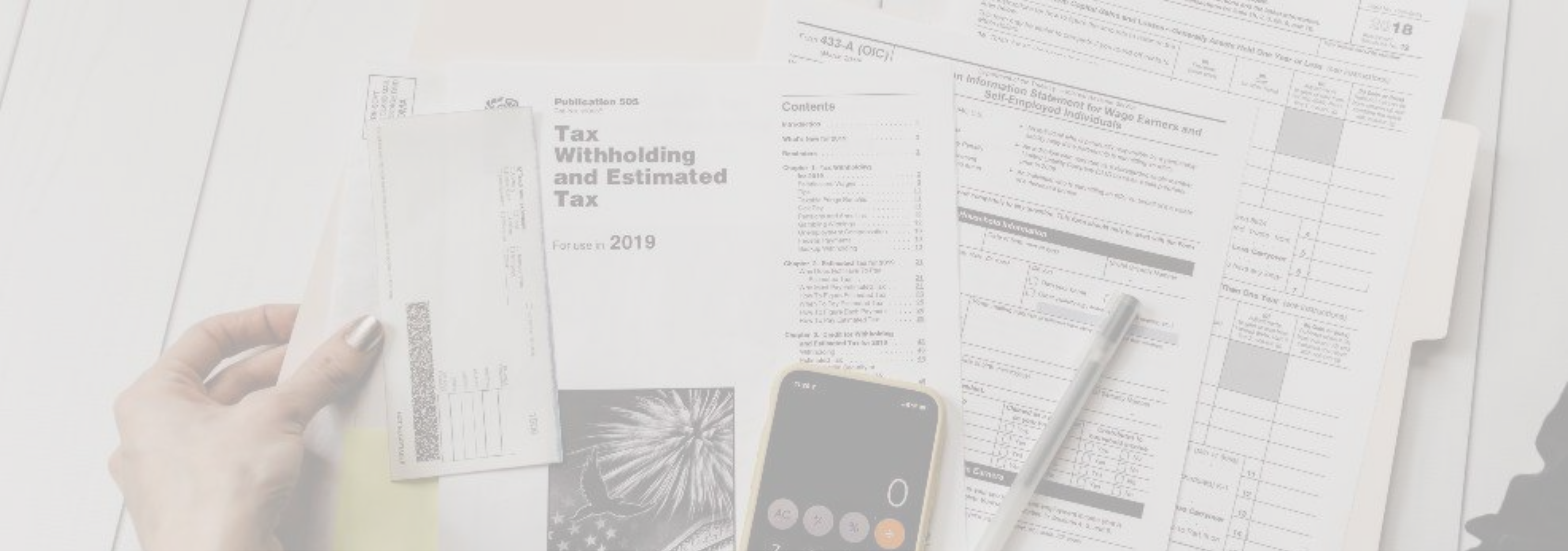
- ICo is UPE and has 100% subsidiary in Mauritius
- Mau Co earns 1,000 in calendar year 1
- Mau Co pays no local tax
- **Situation 1:**
  - Mau Co declares interim dividend to I Co (in year 1)
  - I Co does not claim s.80M deduction and pays tax @ 34% on such interim dividend
  - Dividend tax is assigned to Mauritius under GloBE rules
    - Such allocation happens only on incurrence of actual tax liability by I Co
  - No IIR tax for I Co as ETR > MTR (i.e. 34% > 15%)
- **Situation 2:**
  - Mau Co declares interim dividend to I Co (in year 1)
  - I Co in turn distributes dividend to I Co's shareholders and claims s.80M deduction
  - Shareholders of I Co pay tax @ >15% in same year
    - Shareholder's tax cannot be attributed to Mau Co (individuals are out of GloBE). Tax paid in Mauritius is Nil
    - IIR tax still applies in such year as I Co has not paid dividend tax
  - Mauritius may levy tax by introducing DMT. If not, I Co pays tax of 150 to Indian Tax Authority – it is additional tax

IIR tax: Cross border reallocation of dividend tax – need to eliminate SPVs?



- Op Co is an operating entity in HTJ but enjoys well-meaning tax holiday
- Op Co's ETR is NIL
- Op Co's GloBE income is calculated @ 10,000
- Op Co pays interim dividend of 10,000 to SPV (dividend 1), SPV in turn pays interim dividend to I Co (dividend 2) in same fiscal year
- SPV pays no local tax on dividend income
  - SPV's dividend income is also excluded from GloBE income due to specific exclusion
- I Co pays tax of 34% on dividend 2
  - I Co's tax is allocated to SPV but not to Op Co
- I Co will therefore need to pay IIR to Indian Tax Authority on Op Co's GloBE income @15%
  - This tax of 1500 is additional tax. It cannot be adjusted or set off in any tax computation
- **Had I Co held Op Co directly, tax on dividend could get attributed to Op Co - leading to ETR of Op Co being > MTR**

Highlights the need to revisit presence of intermediate SPV in LTJ



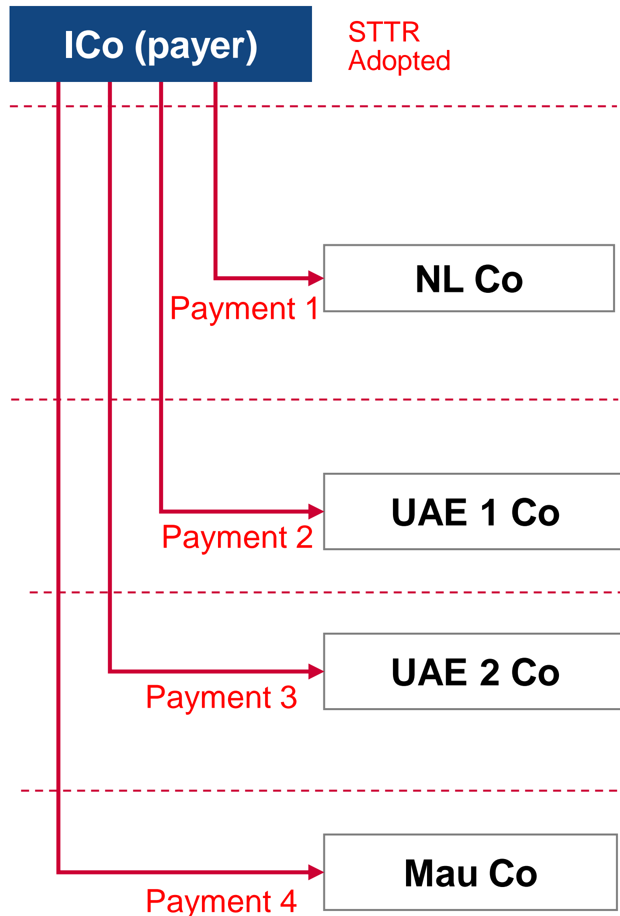
Subject to tax Rule (‘STTR’)

STTR – An overview

- STTR complements GloBE – works in priority to GloBE (i.e. IIR and UTPR)
- Implementation of STTR to be pursuant to a treaty like instrument in the nature of MLI
  - To recollect, OECD to publish model rules and multilateral instrument “in the coming months”
  - MLI will override existing treaty benefits and provide for additional/higher source taxation rights provided headline rate <9%
- STTR to grant taxation rights to payer jurisdiction when connected recipient’s nominal rate of taxation for the transaction is < 9%
  - Headline rate to be adjusted for standard rebate / deductions, incentives, grant of exemption, etc. to test 9% threshold
- STTR to grant source taxation at a rate higher of (i) 9% on gross basis; or (ii) existing treaty rate
  - Applicability expected to be tested on a transaction to transaction basis
- STTR applies only to “Covered Payments” made to “Connected Persons”
- Connected persons is defined widely and can extend to entities beyond CFS
  - In any case, unlike IIR/UTPR, STTR is not restricted to CEs which are part of CFS

Right to adopt STTR can be exercised by a developing country (i.e. country with per capita income of < $ 12,535; Ex: India, China, Brazil, Mexico) at its option, and the counter party (whether a developing or a developed country) ‘to’ accept request

Case study – STTR on India outbound payments

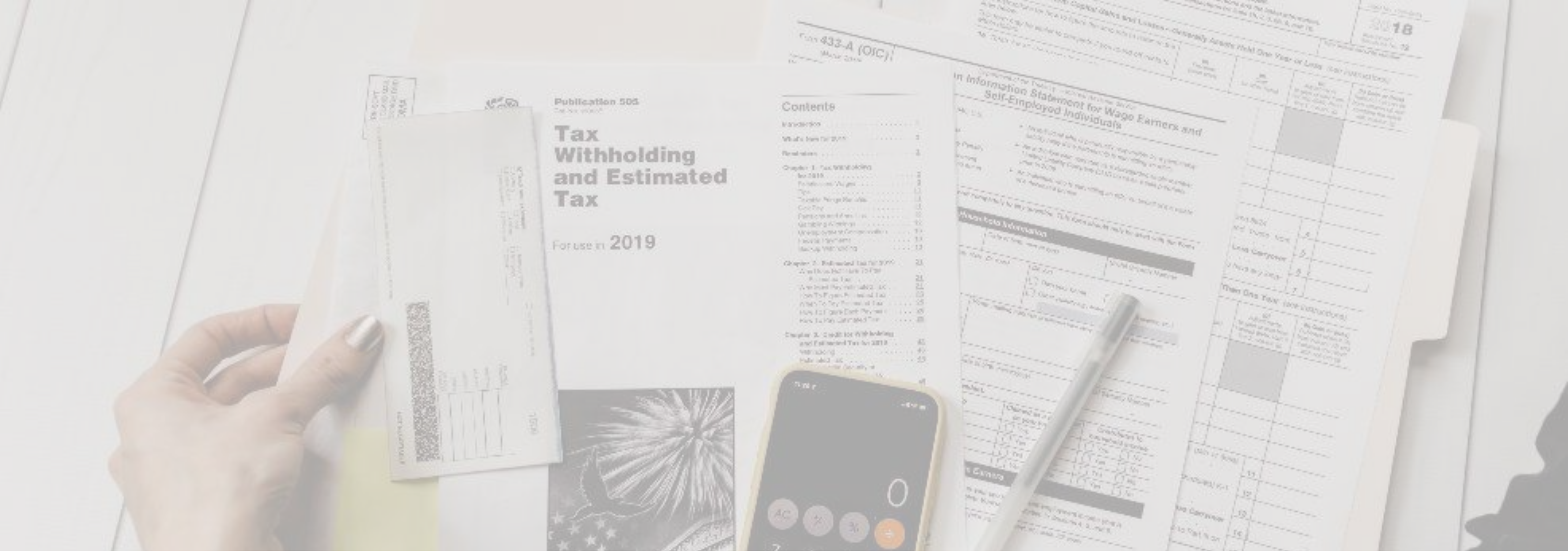


- I Co makes payments to various group entities (not necessarily its subsidiaries)
- **Payment 1** - Equipment royalty/FTS of 1,000 paid to NL Co
  - No taxation in India as per Article 12 of India-Netherlands treaty due to restricted source rule which grants taxation of Equipment royalty/FTS not meeting make-available test to Residence State
  - Taxed in NL at headline rate of 25% - since tax in residence state > 9%, no STTR impact
- **Payment 2 -** Marketing and Procurement Support Fee of 1,000 to UAE 1 Co
  - Market and procurement service is driven by proprietary list possessed by UAE 1 Co
  - Considered as covered payment, with nil tax liability; income liable to tax of 9% as STTR
- **Payment 3 -** Interest of 1,000 paid to UAE 2 Co subject to preferential tax under s.194LC of ITA
  - Differential STTR of 4% may or may not be levied by India at its discretion
- **Payment 4 -** Interest of 1,000 on CCD debt availed from Mau Co
  - Taxation in India at 7.5% as per Article 11(2) of the India-Mauritius treaty; tax in Mauritius effectively @ 3% under a preferential regime of 80% deemed credit
  - Under STTR, Mauritius will restrict foreign tax credit to 1.5%
  - In aggregate, tax paid will be 9% with no additional tax in India – but Mauritius will restrict tax credit to 1.5%

Exclusions from STTR

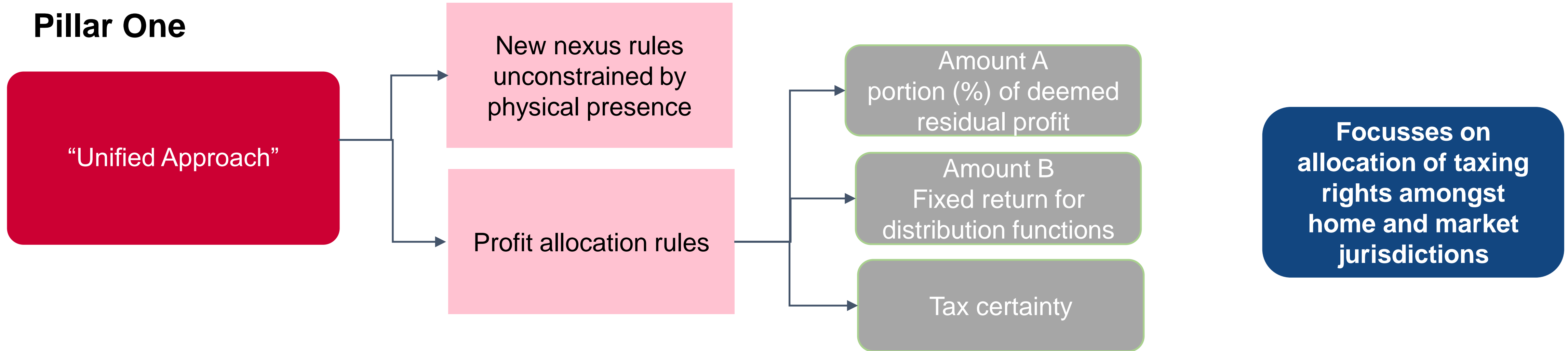
- Cost of goods (including embedded royalty)
- Dividends (since not base eroding)*
- Payments made to individuals including KMPs
- Payments forming part of PE in payer country (as the payer jurisdiction already has full taxation right)
- Payments to investment funds, pension funds, government entities (including sovereign wealth funds), international organisations and non-profit organisations
- Low-return payments - e.g. cost plus payments – subject to safe-harbour margin [not supported by G24 developing countries (including India)]
- Payments up to materiality threshold (to be determined by BEPS IF) [not supported by G24 developing countries (including India)]

**Indian Revenue Secretary Mr. Tarun Bajaj has indicated that India is negotiating to include dividends within scope of STTR*

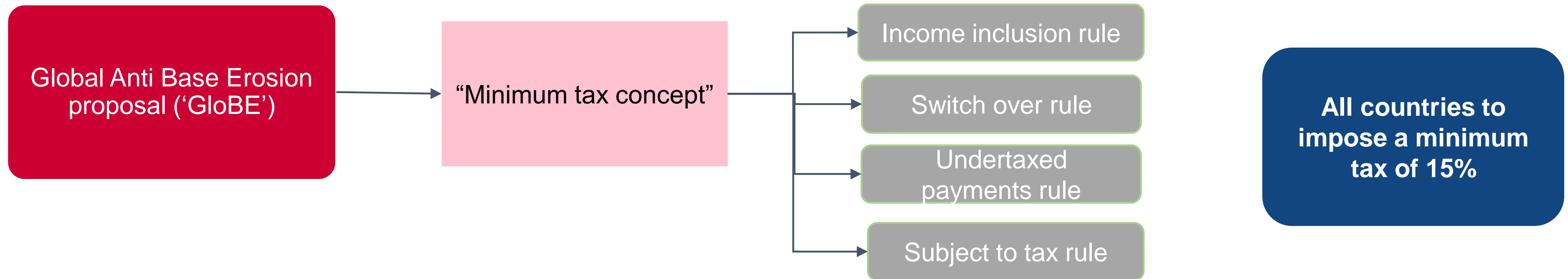


Pillar One proposals

Comparison – Pillar 1 vs. Pillar 2



Focusses on allocation of taxing rights amongst home and market jurisdictions



All countries to impose a minimum tax of 15%

Pillar One* - Illustration

What does the market jurisdiction get to tax?

Step 1: Identify residual profits
Routine profits based on fixed PBT to Revenue threshold % age - yet to be determined (10% threshold floated)

Step 2: Allocate residual profits to market jurisdictions
Apply a reallocation % age to identify the share of residual profits to allocate to market jurisdictions (25% of residual profit floated)

Step 3: Allocate Amount A among market jurisdictions
Pro-rata allocation based on Revenue earned in each market jurisdictions

Worldwide Revenue	(A)	25,000

Total Profits	(B)	6,500

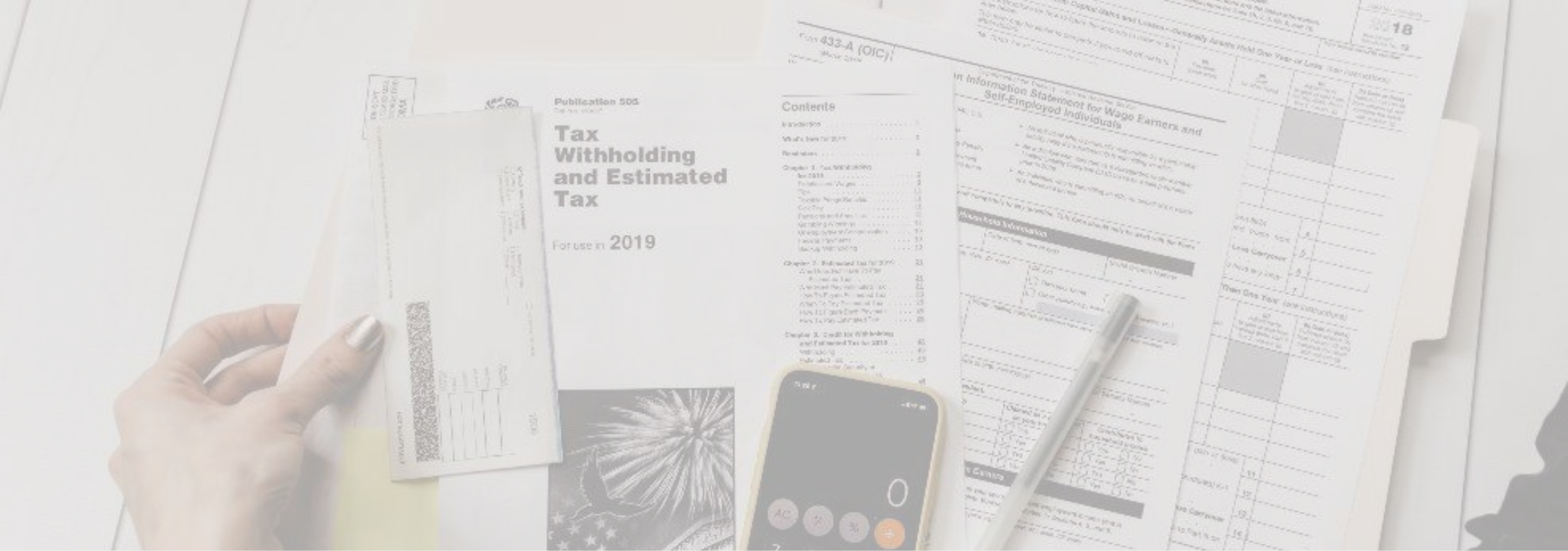
Step 1: Identify Residual Profits		
Identify routine profits with 10% threshold	(C) = (A) x 10%	2500
Identify residual profits	(D) = (B)–(C)	4000

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

*Applicable to MNEs having turnover exceeding 20 billion Euros and profitability in excess of 10%



Concluding thoughts

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- Model Rules a common ‘template’: domestic law variations not ruled out
- Complex set of rules; many clarifications sought!!
- Rules contemplates domestic application based on agreed implementation framework/guidelines which are under debate
- Significance of commentary, implementation framework
- Compliance burden: Use of technology tools inevitable
  - Significant representations to ease the burden and provide strong dispute resolutions
- Impact on treaty obligations
- Impact of domestic GAAR: Is GloBE a SAAR and hence subject to domestic GAAR?
- Likewise, Rule order / priority of tax in TUT reckoning likely to create new form of “tax competition”!

Thank you!

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