KPMG

Tax Alert

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BEPS 2.0 - Pillar One and Pillar Two consultation papers

Perceived gaps in the 2015 base erosion profit shifting (BEPS) programme has led to the next wave of global proposals known as BEPS 2.0, which in part seeks to tackle some of the challenges of an increasingly digital economy. On 9 October 2019, the OECD published a public consultation paper that sets out a "Secretariat Proposal for a Unified Approach under Pillar One". This was followed by the release of a public consultation paper titled Global Anti-Base Erosion Proposal (GloBE) – Pillar Two on 8 November 2019. This Tax Alert provides a summary of the proposals and consultation focus areas, as well as how the proposals might impact Singapore and entities based here.

Background

In May 2019, the OECD/G20 Inclusive Framework on BEPS (Inclusive Framework) agreed a Programme of Work for Addressing the Tax Challenges of the Digitalisation of the Economy. The Programme of Work is divided into two pillars:

- Pillar One addresses the allocation of taxing rights between jurisdictions and considers various proposals for new profit allocation and nexus rules (*transfer pricing focus*);
- Pillar Two (also referred to as the "Global Anti-Base Erosion" or "GloBE" proposal) - provides jurisdictions with a right to tax where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation (*corporate tax focus*)

Despite the programme name, the scope of both Pillar One and Pillar Two is not limited to digitalised businesses (recognising that the difficulties of ring-fencing the digital economy from the rest of the economy for tax purposes).

Pillar One - revised profit allocation and nexus rules

Proposal

The underlying objective of the unified approach is to re-attribute a share of consolidated profits generated by multinational companies (MNCs) from jurisdictions where value is created to jurisdictions where goods or services are being consumed ("market jurisdiction"). We have outlined below the key elements proposed in the Pillar One consultation paper to achieve the foregoing objective:

Scope: The Secretariat's proposal seeks to cover highly digital business models but is more broadly focusing on all types of consumer-facing businesses regardless of whether they are digitalised. Possible carve-outs are also considered, in particular for extractive industries or financial services. In addition, size limitations (e.g. a EUR 750 million revenue threshold in line with Country-by-Country Reporting thresholds) might be introduced so that smaller MNCs are not subject to the additional compliance burden.

Nexus: Since the market jurisdiction would in many cases have limited or no taxing rights under current international tax laws, a new nexus rule which grants taxing rights in the absence of a physical presence would be required. The Secretariat's proposal highlights local sales as a potential trigger to create nexus with the sales threshold likely to be country specific.

Profit Allocation: The Secretariat's proposal is a hybrid between the established and widely accepted arm's length principle which is complemented by a mechanical attribution of profits. The latter in some way resembles features of formulary apportionment which was considered inferior to the arm's length principle in the OECD Transfer Pricing Guidelines. The profit allocation would be based on a three-tier approach, consisting of Amount A, B and C as defined below:

- **Amount A** ("new taxing right") is a portion of an MNC's "deemed residual profit" that would be allocated to the market jurisdiction. It would be determined by deducting a "deemed routine return" from an MNC's consolidated profit.
- **Amount B**, which represents a baseline return for routine marketing and distribution activities undertaken in a market jurisdiction.
- **Amount C**, which represents a potential arm's length return for marketing and distribution in excess of routine marketing and distribution activities.

It is unclear yet how Amounts A, B and C would reconcile in detail under specific circumstances and many practitioners have raised concerns that it could create a potential overlap of taxing rights which ultimately would lead to double taxation.

Insights

Aside from consumer facing businesses, it is still unclear how far reaching the scope of this initiative will be. Adding to the complexity is the fact that often products and services are ultimately consumed by private customers and any line of separation between what constitutes B2B vs. B2C will inevitably contain an element of judgement.

While the basic conceptual framework has been set out in the Secretariat's proposal, there is still considerable uncertainty how certain parameters which are the foundation of the formula-based approach will be set. This includes among other items the deemed routine return and the split of excess profits between market jurisdictions and IP ownership under Amount A as well as the baseline return for routine distribution and marketing activities. How these parameters are set will have critical implications regarding the ultimate profit allocation and which jurisdictions will gain or surrender taxing rights under the Secretariat's proposal.

Given its population size, Singapore represents a relatively small consumer market and is unlikely to be a net beneficiary of this initiative. As an attractive location for intellectual property (IP) related activities, it seems more likely that the implementation of the Secretariat's proposal will in some way reduce Singapore's taxing rights, though the magnitude will depend on how the above parameters are set.

Arguably, Singapore would have an interest for the routine return to be set at a moderate level, so that a reasonable profit remains attributable to IP creating functions after allocation to market jurisdictions. It is therefore not surprising that Singapore is advocating a position which grants taxing rights to jurisdictions where value is created on the basis of existing transfer pricing principles.

The discussions at OECD level have focused on how to split taxing rights between jurisdictions under the implicit assumption of a zero-sum game. It seems that limited consideration has been given to the fact that the design of tax policy itself impacts economic activity and what is commonly referred to as "the size of the pie". Again, a key question will be at which level the deemed routine return and profit allocation to market jurisdictions under Amount A are set. This will impact the residual profit to remunerate IP creating functions and thus incentives for businesses to invest in technology, innovation and productivity growth - all which form a crucial part of Singapore's prosperity.

For Singapore taxpayers who are in scope of this initiative, the partial reliance on a formula-based solution will pose new challenges to generate objectively verifiable data. Accurate P&L information will likely be required on a country and business line basis.

During the consultation process, considerable concern has been expressed that double taxation will likely occur and the unified approach only vaguely addresses potential mechanisms to prevent/resolve double taxation. Given that the additional taxing rights may not be covered under current tax treaties, it remains to be seen what dispute resolution mechanism(s) will finally be designed and adopted as well as their practical implementation.

Pillar Two – global anti-base erosion proposals

Proposal

Under the 'income inclusion rule', the income of a foreign branch or controlled entity can be taxed at the parent company level if that income was subject to tax at an effective tax rate (ETR) below a minimum rate (effectively a "top up" tax to the globally agreed minimum tax rate in the parent company jurisdiction). The paper does not specify what the minimum tax rate will be, instead noting this will form part of later consultation (a rate of 15 per cent is used in the examples, but the paper stresses nothing should be inferred from this).

This income inclusion rule will be supported by:

- a 'tax on base eroding payments' to deny a deduction or impose tax for payments not subject to tax in the recipient jurisdiction at or above the globally agreed minimum rate;
- a 'subject-to-tax rule', designed to ensure that treaty benefits (such as lower withholding tax rates) are only granted if the item of income is subject to tax at or above the globally agreed minimum rate, and
- a 'switch-over rule', designed to ensure that residence countries can elect to use the 'credit method' instead of the 'exemption method' where the profits attributable to a permanent establishment (PE) or income derived from immovable property are subject to tax below the minimum rate.

The Pillar Two consultation paper does not provide much detail, but gives some indication of the preliminary direction of the income inclusion rule, by seeking views on the areas below.

Under the proposal, the ETR is calculated by determining the actual tax paid by a subsidiary entity over a "tax base". This ETR is then compared to the minimum tax rate and to the extent it is below this rate, additional tax may be payable.

- **Calculating the tax base for the purposes of determining the effective tax rate (ETR)** – the paper notes the importance of consistency across jurisdictions to ensure a level playing field, but notes that this must be balanced against compliance and administration burdens. The OECD Secretariat's preference appears to be to use consolidated financial accounts (with some tax adjustments) to determine the tax base of subsidiaries. The question is which accounting standards should be used?
- **Determination of tax adjustments** – the paper acknowledges that temporary differences (and some limited permanent differences) and should be adjusted for in determining the tax base, otherwise there will be volatility in effective tax rates year to year. It explores dealing with temporary differences using (i) Carry forward of excess tax and tax attributes (similar to carry forward tax loss rules); (ii) Deferred tax accounting; or (iii) Multi-year averaging of taxes paid and total income**.** Each method has pros and cons, and compliance simplicity may need to be traded off against a potential higher or earlier tax burden.
- **Blending** – the paper canvasses options for blending high tax and low tax income, either on a stand-alone entity basis, a jurisdictional basis or on a global basis (with the Secretariat appearing to favour the jurisdictional basis).
- **Carve outs** – the paper looks at possible options:
  - A return on tangible assets – similar to that in the US Global Intangible Low-Taxed Income (GILTI) regime
  - Controlled corporations with related party transactions below a certain threshold
  - A carve out for tax incentives that are not harmful tax practices under BEPS Action 5 or a general substance based carve out.
  - Thresholds based on turnover or other sized based measures
  - De minimus thresholds to exclude certain transactions or entities
  - Carve outs for specific sectors or industries

Insights

Our observations of the potential impact of the Pillar Two proposals for Singapore are as follows:

- Importantly for Singapore, the paper discusses a potential carve out for substance based tax incentives that are not harmful tax practices under BEPS Action 5, however, it does note this "would undermine the policy intent and effectiveness of the proposal" which suggests such a carve out could be unlikely. Otherwise, we may see an increased move towards grants instead of incentive rates to encourage businesses to Singapore.
- Jurisdictional or global blending of high tax and low tax entities may enable Singapore to maintain the benefits of its incentive tax rates.
- There is no discussion on how territorial regimes will be treated under the measures, nor whether capital gains would be carved out. Absent any carve out or adjustment mechanism, this could encourage Singapore to move towards to a residence-based taxation regime (rather than let another country exercise taxing rights over income Singapore treats as exempt).
- Depending on the ultimate design of the measures and Singapore's domestic law response, the Pillar Two proposals could give rise to an uneven playing field between low taxed or tax exempt income of Singapore headquartered companies (which at most will be subject to the tax on base eroding payments or subject to tax rules) and that of Singapore subsidiaries of multinationals (which could also be subject to "top up" tax in parent company locations under the income inclusion rules).

KPMG observations

It is clear from the two consultation papers that there are still significant design features that will require resolution within the OECD Inclusive Framework's self-imposed tight deadline. Achieving global consensus is likely to be challenging, with the main battleground likely to be between developing nations seeking to preserve sovereignty over the design of their tax systems and its use in supporting economic growth, and developed nations seeking to prevent the flow of profits or capital to lower tax jurisdictions.

MNCs need to start planning for the flow on impacts of the proposals. As an example, Pillar One could result in the group now having tax filing requirements in market locations, the cost of which could add up to a significant amount.

How we can help

We welcome the opportunity to discuss how the BEPS 2.0 measures may impact your business.

Taxpayers should consider modelling the outcome of the unified approach to evaluate the potential impact on their business and effective tax rate. The modelling exercise could also help to identify some of the practical challenges of applying the proposed approach. KPMG has developed a BEPS 2.0 model to facilitate these discussions between different stakeholders in MNCs.

Although implementation of any final proposals is still some time away, planning for potential outcomes needs to start now.

About Tax Alert

KPMG Tax Alert highlights the latest tax developments, impending change to laws or regulations, current practices and potential problem areas that may impact your company. As certain issues discussed herein are time sensitive it is advisable to make plans accordingly.

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