KPMG

Tax Alert

ISSUE 15 | **NOVEMBER 2020**

BEPS 2.0 OECD Blueprint on Pillar One and Pillar Two - October 2020

Considerations for Singapore-based taxpayers

Introduction

On 12 October 2020, the Organisation for Economic Co-operation and Development (OECD) in cooperation with the G20 released their latest reports addressing Tax Challenges Arising from Digitalisation as well as a Public Consultation Document calling for submissions by Monday 14 December 2020.

This work follows on the heels of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project and is in some ways a continuation of that work. These blueprints propose details to change existing international tax rules that define where multinational enterprises (MNEs) pay taxes as well as introduce new rules to require a worldwide minimum taxation to be paid by some businesses.

The OECD/G20 policy blueprint

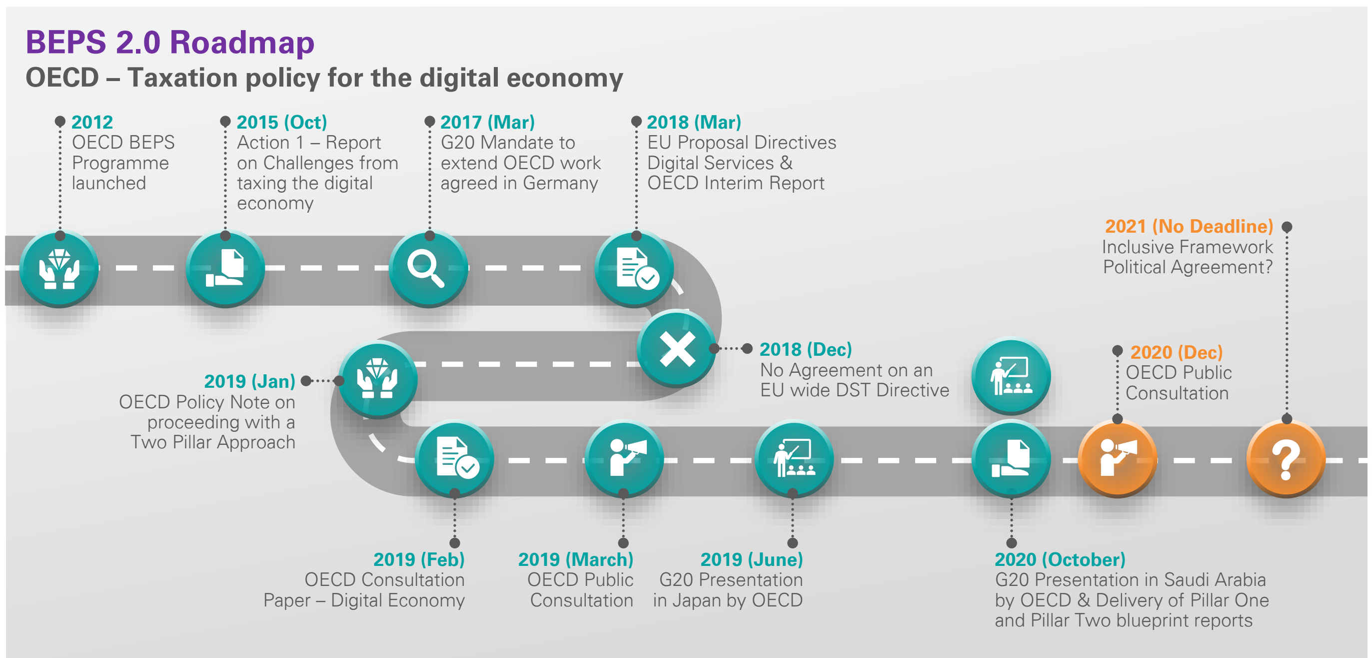
The policy options identified and developed by the OECD/G20 are organised into two separate workstreams commonly referred to as BEPS 2.0. Pillar One addresses taxing rights and nexus rules targeting new and emerging business models (particularly the digital economy), while Pillar Two outlines a global minimum tax and a tax on base-eroding payments which has much broader application to all business models.

It is worth noting that these latest OECD/G20 reports on Pillar One and Pillar Two do not necessarily represent a consensus view of the countries participating within the Inclusive Framework (IF). Building on previous work, these reports seek to outline a general conceptual blueprint for consultation and are a means to facilitate discussion and arrive at a political agreement between participants.

12 October Blueprint

The Report of the Pillar One Blueprint (232 pages) and the Report on the Pillar Two Blueprint (248 pages) were both discussed at the G20 Finance Ministers' meeting in Saudi Arabia in October 2020.

The initial timeline for a contemplated agreement was targeted for the end of 2020, but the stated goal of the IF is now to "bring the process to a successful conclusion by mid-2021."



Pillar One

The Pillar One Blueprint details a proposed methodology on the allocation of taxing rights between jurisdictions. It outlines the existing transfer pricing methodologies for profit allocation but proposes a new nexus rule to expand the taxing rights of Market Jurisdictions as well as outlining considerations for the development of dispute prevention and resolution mechanism.

Simply put, the idea is to develop solutions for the taxation of new business models and expand the taxing rights of Market Jurisdictions where users of Automated Digital Services (ADS) may be located, or where a Consumer Facing Business (CFB) is located. Accordingly, the scope of Pillar One is arguably limited to MNEs operating within the digital economy and using these business models.

For example, ADS is, broadly speaking, defined as the provision of a digital service over the internet or other electronic network with minimal human involvement. The definition of CFB is less developed but is intended to apply to businesses that sell goods or services of a type commonly sold to consumers through a broker, agent, intermediary, or representative. It should also apply to franchising and licensing.

The Pillar One profit allocation amounts are divided into Amount A and Amount B as follows:

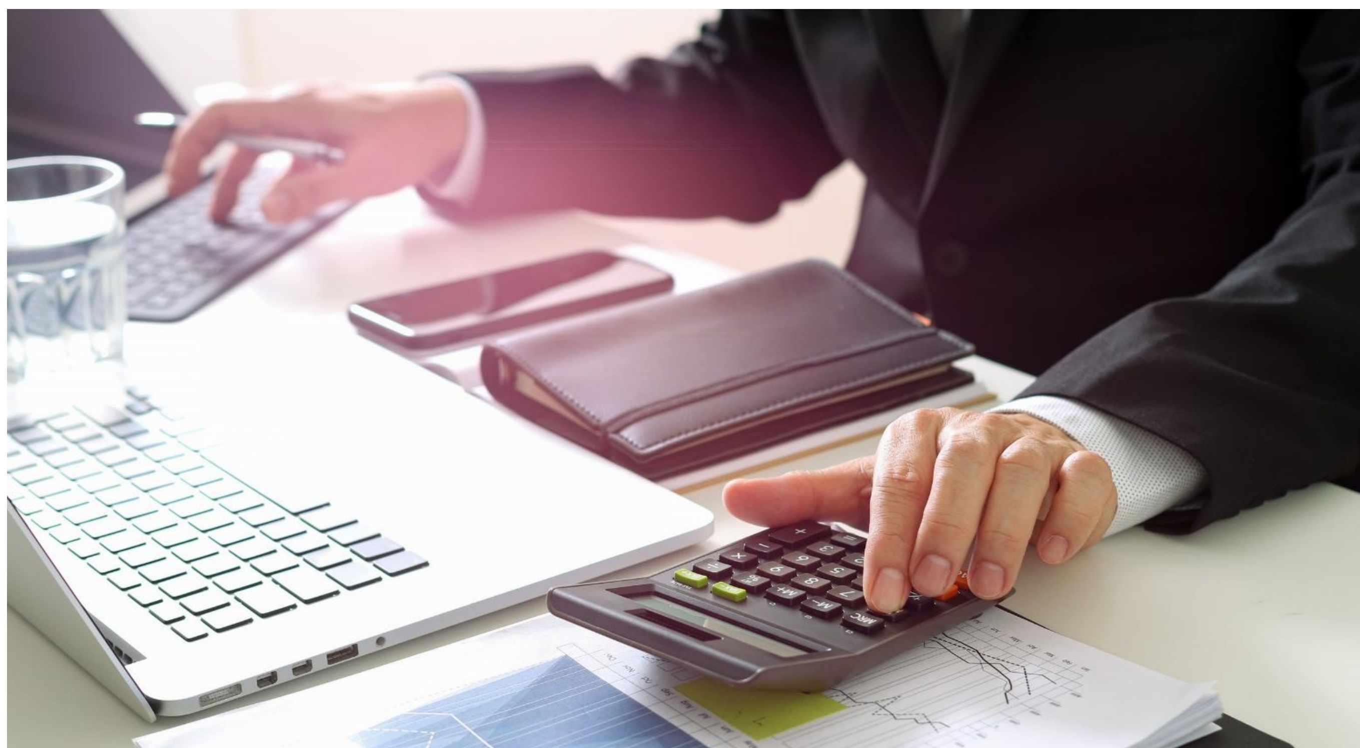
- **Amount A** would apply a formulary approach to allocate a portion of an MNE's deemed residual profits to Market Jurisdictions and provide those jurisdictions with a nexus for taxing that allocation; and

- **Amount B** would provide a fixed return for certain baseline marketing and distribution activities that is intended to be consistent with the arm's length principle.

The key features of the Pillar One Blueprint are highlighted below.

Scope of Amount A: In-scope activities under the Blueprint include both ADS and CFB amounts that exceed certain thresholds, while certain carve-outs are proposed for certain industries such as extractive industries, financial services, infrastructure (including residential real estate), international air and shipping. It is unclear at this stage whether financial technology (Fintech) businesses would fall under the partial financial services exclusion.

The Blueprint proposes a global revenue threshold as well as a separate foreign in-scope revenue threshold to remove MNEs with largely domestic businesses. The quantum for both has not been determined yet. It is expected that the global revenue threshold is at least EUR 750 million which would initially put approximately 2,300 MNEs potentially in scope for Pillar One.



Nexus: It is envisioned that nexus for ADS businesses would be determined solely based on a MNE's revenues in a Market Jurisdiction, which is expected to be below EUR 5 million. Since CFBs are less able to participate remotely in a Market Jurisdiction, the Blueprint indicates that a higher nexus standard could apply to CFBs, possibly by including a "plus factor" such as physical presence. The nexus rules are supported by detailed sourcing rules, which are a critical element to be further developed and agreed. What finally gets agreed will have an important role in determining what is being allocated across the jurisdictions.

Source: The allocation of revenue to Market Jurisdictions is to be underpinned by new revenue source rules. These proposed revenue source rules for ADS will use a range of factors including but not limited to the geolocation of the device used by the viewer, IP addresses, the country code for the phone number associated with a mobile device or user profile data. Relevant factors will be used in a cascading hierarchy of indicators. The proposed source rules for a CFB will use more traditional indicators like the physical location of final delivery.

Determination of Amount A: The Blueprint suggests a three step-approach to quantify Amount A which will be based on a fixed formula rather than the arm's length principle.

STEP 1 Determination of a profitability threshold (e.g. PBT of 10 percent) to isolate residual profits subject to re-allocation.

STEP 2 Application of a reallocation percentage (e.g. 20 percent) to identify the share of profits to allocate to Market Jurisdiction.

STEP 3 Distribution of Amount A among eligible Market Jurisdictions via an allocation key.

All parameters have not been agreed yet and will be subject to further discussions. The tax base for Amount A would be derived from the audited financial accounts prepared under IFRS or GAAP deemed comparable to IFRS, including Singapore GAAP.

Amount B: In addition to Amount A, the Blueprint also proposes to establish a standardized return on sales margin for baseline sales and marketing activities which may vary by industry and region and would be determined based on established transfer pricing principles.

Tax Certainty: The IF acknowledged that the complexity of Pillar One may result in different views between taxpayers and tax authorities. It may also result in double taxation. The IF has therefore agreed to explore mandatory binding arbitration mechanism to resolve double taxation issues, though it remains unclear whether all countries have fully committed to this approach.

Further details on Pillar One measures are included in this KPMG report.

KPMG Observations on Pillar One

There will be winners and losers from this new profit allocation methodology, but given the proposed scope thresholds, the impact may be limited for Singapore, which will remain a regional hub for digital and e-commerce activities. It's also worth highlighting that the rules for allocating these business profits between Amount A and Amount B still require international consensus. Furthermore, the Blueprint raises many questions of administrability, compliance cost, and international cooperation.

Based on the proposed in-scope activities and contemplated thresholds, it is likely that a significant number of Singapore-based companies will be affected by Pillar One. For Singapore-based taxpayers, in particular MNEs with RHQs in Singapore, the following considerations may arise:

- Data Collection and Gathering: The partial reliance on a formula-based approach will require the collection of real-time and objectively verifiable data to determine the source of income and thus the relevant Market Jurisdiction. While it is envisioned to use consolidated information from the audited accounts in most cases, it is unclear at this stage under which circumstances segmented financial accounts can or have to be used. In any case, it would seem prudent for taxpayers to ascertain their ability to segment their accounts which may be a viable option where significant margin disparities between business segments are prevalent.

- Effective Tax Rate: Certain taxpayers may become subject to a higher effective tax rate on allocated profits to Market Jurisdictions. That said, regional corporate income tax rates typically range from 20% to 25% with 20% commonly applied in many jurisdictions in the region.

From a process perspective, given that Amount A would be administered through a self-assessment system in the country where the ultimate parent of the MNE is headquartered, the additional burden on Singapore taxpayers appears to be manageable.

The IF has spent considerable resources on an economic impact analysis which was released together with the Blueprints, distinguishing between high-, middle- and low-income countries as well as investment hubs like Singapore. The IF projects that on average investment hubs would tend to lose tax revenues. It should be noted though that the category "investment hubs" includes a heterogeneous group of countries, ranging from tax havens such as Cayman Islands to countries like Singapore with substance-based and BEPS compliant incentive regimes. It is therefore unclear if this general statement would also apply to Singapore and if so, the magnitude of potential tax revenues surrendered.

While the IF has made important progress in many areas, no consensus has been reached yet on the setting of parameters for the calculation of Amount A which will ultimately drive the profit re-allocation. Based on the scenario analyses published, it seems that a profitability threshold between 10 and 20 percent of PBT and a re-allocation percentage between 10 percent and 30 percent are considered conceivable parameters at this stage. The latter range appears reasonably modest and could help to ensure that a considerable share of non-routine profits would still be allocated to value creating activities which are often performed in investment hub locations like Singapore.

Accordingly, while it was always expected that Singapore would surrender some tax revenue under Pillar One given its small population and thus total consumer spending capacity, it seems possible that the impact would be moderate for Singapore, which is expected to remain a regional hub for digital and e-commerce activities.

Regardless of the ultimate design of Pillar One, the Blueprint has not managed to fully address taxpayers' concerns on tax certainty. While some innovative ideas such as a panel review have been suggested, it remains to be seen what dispute prevention/resolution mechanism(s) will finally be adopted after the political discussions have taken place.

Pillar Two

Pillar Two includes the "GloBE" proposal involving the development of a coordinated set of rules to address ongoing risks from structures that enable MNEs to shift profit to jurisdictions where they are subject to no or low taxation. This has broader application than Pillar One. Specifically the Pillar Two blueprint has introduced four new rules that together would provide jurisdictions with additional taxing rights where other jurisdictions have not exercised their primary taxing rights or the relevant income is otherwise subject to an Effective Tax Rate (ETR) that is below a yet-to-be-agreed global minimum tax rate.

These proposed rules are:
- Income Inclusion Rule (IIR) and Switch-over Rule (SOR)
- Undertaxed Payments Rule (UTPR)
- Subject to Tax Rule (STTR)

Pillar Two proposed rules: Additional tax on otherwise low-taxed income

GloBE Rules (imposition of new taxes)

Income Inclusion Rule (IIR)
Taxes the income (in the hands of the parent) of a foreign branch or controlled entity if that income is subject to tax at an ETR that is below a minimum rate.

Additional "top-up" tax, calculated according to the specific rules, is levied on the parent to bring the total tax up to the agreed minimum rate.

Undertaxed Payments Rule (UTPR)
The UTPR serves as a "backstop" to the IIR, allowing jurisdictions to levy top-up tax on any "undertaxed income" i.e. low-tax income which is not already the subject of the IIR.

It operates when the IIR does not apply by denying a deduction, or requiring an equivalent adjustment, to bring the total tax up to the agreed minimum rate.

Treaty Changes (supporting)

Switch-over Rule (SOR)
Where a parent jurisdiction is required by treaty to exempt the income of a PE in the hands of its resident head office, no additional tax in that jurisdiction would be possible if the PE was low taxed.

To counter this, the SOR permits the parent jurisdiction to switch to a credit method and hence levy additional tax on the PE's income up to the agreed minimum rate.

Subject to Tax Rule (STTR)
Treaty rule to protect a source country's tax base by permitting it to bring back certain taxing rights previously ceded by treaty.

Where interest, royalties or high-risk services payments to related parties are subject to no or low tax in the receiving jurisdiction, the source jurisdiction may apply WHT to bring the total up to the agreed minimum rate.

The IIR and UTPR, which impose new taxes, will need to be implemented by changes to domestic law. To enhance consistency and improve rule co-ordination, model legislation will be developed and will serve as a template for the development of jurisdiction specific domestic legislation.

The STTR and SOR, on the other hand, will require changes to existing international tax treaties which could be concluded through bilateral negotiations. However, the Blueprint for Pillar Two envisages that a Multilateral Instrument would be a more coordinated and efficient approach.

The STTR applies in priority to the IIR and UTPR, although its operation is limited to "covered payments", defined as:
- Interest and royalties;
- A franchise fee or other payment for the use of or right to use intangibles in combination with services;
- Insurance or reinsurance premiums;
- A guarantee, brokerage or financing fee;
- Rent or any other payment for the use of or right to use moveable property; and
- An amount paid or retained by the payee that is consideration for the supply of marketing, procurement, agency or other intermediary services.

Importantly, no minimum ETR has yet been publicly proposed and will likely be an issue of great debate but is expected to be in the range of 10 per cent to 15 per cent. The nominal rate for the STTR will be an even lower rate, as it will be applied to gross payments.

Threshold: The rules apply to MNE groups who are subject to Country by Country Reporting and who have annual revenue of more than EUR 750 million. How this is to be calculated is subject to additionally proposed rules.

Further details on Pillar Two measures are included in this KPMG report.

KPMG Observations on Pillar Two

Taxation Policy: Countries should be aware of the trade-offs that the current project presents. A global approach to corporate income taxation would likely undermine national sovereignty with respect to taxation policy. The removal of this important economic lever would reduce policy options for driving economic growth and economic prosperity. It would, however, minimise the distortionary effects of corporate taxation policy used by some jurisdictions.

For Singapore, it is important to appreciate that incentivised tax rates are only one of many factors which draw MNCs and businesses in general to Singapore. As a freeport with a streamlined and efficient indirect tax regime, a well-established infrastructure, an adaptable business ecosystem and geopolitical neutrality, Singapore is well-positioned to capitalise on any changes which arise from any fallout from the BEPS transition.

Commenting specifically on the impact of the Pillar Two proposals for Singapore, while there is no carve-out for tax incentives such as those enjoyed in Singapore which were found not to be harmful tax practices under BEPS Action 5, there are some other measures which will clearly lessen any impact on Singapore:

- Jurisdictional blending will allow MNEs to blend income and covered taxes of their Singapore entities when applying these rules, such that MNE groups with incentivised and non-incentivised entities may be assessed collectively against the (yet-to-be) established global minimum tax rate. The impact may be diluted further with some ability to share IIR credits globally (at the parent company level);
- The formulaic substance-based exclusion for a fixed return on payroll costs and tangible assets may also reduce the impact for Singapore entities given that Singapore's incentive regimes are based predominately on headcount growth and other quantitative as well as qualitative factors; and
- However, some of the very low tax rate incentives may not be appropriate and may need to be increased or replaced with cash grants, although additional rules contemplated also include grants and tax credits (as income or a reduction in tax liability).

Subject to Tax Rule (STTR): The STTR will be important for Singapore and the region more broadly because this rule is proposed to take precedence over the other rules (i.e., the IIR and UTPR). The STTR can apply even if the parent company applies the IIR.

There is no jurisdictional blending for this rule, so receipts within listed categories (i.e., interest, royalties, lease income and certain high-value services) that fall within an incentive bucket of income need to be reviewed carefully. However, the Pillar Two blueprint specifically notes that, payments made to an entity located in a territorial based tax regime, fall within the scope of this rule. Accordingly, foreign-sourced payments to offshore bank accounts could fall within scope, subject to existing withholding taxes applied and the nominal STTR rate.

Importantly for territorial-based taxation systems like Singapore, the Pillar Two blueprint doesn't appear to have addressed the timing issues that may arise with respect to the taxation and remittance of income. There is no commentary on the consequences should such income be remitted onshore and become subject to tax at a future point in time. This will require further consideration and an appropriate resolution.

The blueprint paper notes that further consideration is being given as to whether the STTR should also apply to gains that would otherwise be taxable in the source state and are shifted into the residence jurisdiction (the paper notes that for capital gains, this may not be dependent on the parties being connected persons).

Income Inclusion Rule (IIR) and Under Taxed Payments Rule (UTPR): For the IIR/UTPR, gains on disposals of stock are excluded from the tax base, but not capital gains more broadly. Likewise, intragroup dividends are excluded, but portfolio dividends remain included for now. This provides some protection for Singapore holding companies and for MNEs with a global or regional hub in Singapore. However, other types of exempt foreign-sourced income and capital gains may still be caught with "top-up tax" applied in the parent company IIR calculation or the UTPR.

KPMG Observations on Pillar Two (continued)

Sector considerations: For industries that underpin the Singapore economy, there is mixed news:

- Unlike for Pillar One, there is no general carve-out for financial services. Banking and insurance entities will need to review the impact, particularly those with enhanced tier incentives.
- The funds management industry has been granted some broad carve-outs, including for investment funds (broadly defined as regulated collective investment vehicles), pension funds and sovereign wealth funds. However, unregulated funds and fund managers may be still be within the scope of the rules.
- Shipping remains an open question, with further work to be done on whether international shipping should be carved out in whole or part.
- Intellectual property heavy entities, marketing hubs and financial services groups will also need to work though the impacts of the STTR given the categories of in-scope payments.

As an overall comment, there are concerns that Pillar Two will result in some activities and transactions being subject to increased levels of taxation in Singapore and this will need to be assessed on a case-by-case basis. However, the rules could also have some beneficial effect, as MNEs seek to simplify their group structures, move further away from very low tax jurisdictions and centralise operations in fewer geographical locations.

Final observations

As can be seen from the above discussion, the OECD/G20 IF has progressed significantly, with the proposed two-pillar approach. That said, this proposed approach does not mean that international consensus has been achieved and much work is still needed to address remaining issues and areas of concern. In any case, final adoption of these measures is likely to be some years away even if an international consensus is ultimately reached in 2021 or beyond.

OECD Public Consultation process

The OECD through their PUBLIC CONSULTATION DOCUMENT has called for comments on the Pillar One and Pillar Two blueprint by **Monday, 14 December 2020**.

KPMG will be making a global submission and is interested in hearing from interested parties who wish to raise issues for further consideration by the OECD/G20 Inclusive Framework process.

If you would like to participate in the KPMG submission, please reach out to your local KPMG representative, or contact one of our specialists listed on the following pages.

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.

Tax Alert is issued exclusively for the information of clients and staff of KPMG Services Pte. Ltd. and should not be used or relied upon as a substitute for detailed advice or a basis for formulating business decisions.

To uncover more insights on the global tax implications of COVID-19, read our COVID-19 Global Tax Developments Summary

Read more of our insights and perspectives at the KPMG in Singapore Webpage

Authors

Dean Rolfe
Partner
Corporate & International Tax
T: +65 6213 3199
E: deanrolfe@kpmg.com.sg

Felicia Chia
Partner
Head of Transfer Pricing Consulting
T: +65 6213 2525
E: fchia@kpmg.com.sg

Contact us

Ajay K Sanganeria
Partner
Head of Tax
T: +65 6213 2292
E: asanganeria@kpmg.com.sg

BANKING & INSURANCE

Alan Lau
Partner
T: +65 6213 2027
E: alanlau@kpmg.com.sg

REAL ESTATE & ASSET MANAGEMENT

Teo Wee Hwee
Partner
T: +65 6213 2166
E: weehweeteo@kpmg.com.sg

Anulekha Samant
Partner
T: +65 6213 3595
E: asamant@kpmg.com.sg

Agnes Lo
Partner
T: +65 6213 2976
E: agneslo1@kpmg.com.sg

Leonard Ong
Partner
T: +65 6213 2038
E: leonardong@kpmg.com.sg

ENERGY, TECHNOLOGY, MEDIA & TELECOMMUNICATION

Gordon Lawson
Partner
T: +65 6213 2864
E: glawson1@kpmg.com.sg

Larry Sim
Partner
T: +65 6213 2261
E: larrysim@kpmg.com.sg

INFRASTRUCTURE, GOVERNMENT & HEALTHCARE

Chiu Wu Hong
Partner
T: +65 6213 2569
E: wchiu@kpmg.com.sg

Toh Boon Ngee
Partner
T: +65 6213 2052
E: btoh@kpmg.com.sg

Dean Rolfe
Partner
T: +65 6213 3199
E: deanrolfe@kpmg.com.sg

CONSUMER & RETAIL

Tan Chee Wei
Partner
T: +65 6213 2470
E: cheeweitan@kpmg.com.sg

Contact us

CORPORATE TAX PLANNING & COMPLIANCE

Mak Oi Leng
Partner
T: +65 6213 7319
E: omak@kpmg.com.sg

Pauline Koh
Partner
T: +65 6213 2815
E: paulinekoh@kpmg.com.sg

PERSONAL TAX & GLOBAL MOBILITY SERVICES

Anna Low
Partner
T: +65 6213 2547
E: alow@kpmg.com.sg

INDIRECT TAX

Lam Kok Shang
Partner
T: +65 6213 2596
E: kokshanglam@kpmg.com.sg

Gan Hwee Leng
Partner
T: +65 6213 2813
E: hweelenggan@kpmg.com.sg

TRANSFER PRICING CONSULTING

Felicia Chia
Partner
T: +65 6213 2525
E: fchia@kpmg.com.sg

Lee Jingyi
Partner
T: +65 6213 3785
E: jingyilee@kpmg.com.sg

PROPERTY TAX & DISPUTE MANAGEMENT

Leung Yew Kwong
Principal Consultant
T: +65 6213 2877
E: yewkwongleung@kpmg.com.sg

R&D & GRANTS CONSULTING

Harvey Koenig
Partner
T: +65 6213 7383
E: harveykoenig@kpmg.com.sg

US TAX SERVICES

Daniel Joe
Partner
T: +65 6213 2626
E: danieljoe@kpmg.com.sg

TAX – DEALS, M&A

Adam Rees
Principal Advisor
T: +65 6213 2961
E: adamrees@kpmg.com.sg

KPMG
16 Raffles Quay #22-00
Hong Leong Building
Singapore 048581
T: +65 6213 3388
F: +65 6220 9419
E: tax@kpmg.com.sg

Singapore Tax Firm of the Year – Asia Tax Awards 2020, *International Tax Review*

Asia Tax Firm of the Year – Asia Tax Awards 2020, *International Tax Review*

Asia Tax Innovator of the Year – Asia Tax Awards 2020, *International Tax Review*

For more information, please view our tax services page.

kpmg.com.sg

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2020 KPMG Services Pte. Ltd. (Registration No: 200003956G), a Singapore incorporated company and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.