

OECD issues consultation document on technical design aspects of Pillar Two

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Executive summary

On 8 November 2019, the Organisation for Economic Co-operation and Development (OECD) released a public consultation document on the Global Anti-Base Erosion (GloBE) proposal under Pillar Two of the ongoing project titled "Addressing the Tax Challenges of the Digitalisation of the Economy" (the Consultation Document). The particular design proposals were prepared by the OECD Secretariat and do not represent the consensus view of the countries participating in the project as members of the Inclusive Framework.

For purposes of the consultation, the OECD welcomes comments on all aspects of the Workplan on Pillar Two, but specifically requests comments on three technical design aspects of the GloBE proposal:

1. The use of financial accounts as a starting point for determining the tax base under the GloBE proposal as well as different mechanisms to address timing differences.
2. The extent to which a group can combine high-tax and low-tax income from different sources taking into account the relevant taxes on such income in determining the effective tax rate on such income.
3. The stakeholders' experience with, and views on, carve-outs and thresholds that may be considered as part of the GloBE proposal.

Interested parties are invited to submit written comments on the Consultation Document no later than 2 December 2019. The OECD will hold a consultation meeting on 9 December 2019 to give stakeholders an opportunity to discuss their comments with the Inclusive Framework jurisdictions.

Detailed discussion

Background

In October 2015, the OECD released the Final Report on Action 1 (the Action 1 Final Report), *Addressing the Tax Challenges of the Digital Economy*, together with the final reports on the other 14 elements of the BEPS Action Plan. The Action 1 Final Report provides the OECD conclusions regarding the digital economy and recommended next steps to address the tax challenges presented by its evolution. The Action 1 Final Report states that special rules designed exclusively for the digital economy would prove unworkable, broadly stating that the digital economy cannot be ring-fenced because it “is increasingly becoming the economy itself,” and summarizes key features of evolving digital business models that the OECD considers relevant for the overall BEPS analysis. In addition, the Action 1 Final Report considers broader direct and indirect tax challenges raised by the digital economy and evaluates options to address those challenges. However, the Action 1 Final Report does not recommend any of the options analyzed and leaves it up to individual countries to introduce any of them as additional safeguards against BEPS.¹

In March 2018, the OECD released a document “Tax Challenges Arising from Digitalisation – Interim Report 2018” (the Interim Report) as a follow up to BEPS Action 1. The Interim Report sets out the Inclusive Framework jurisdictions’ agreed direction of work on digitalization and the international tax rules through 2020. The Interim Report does not make any specific recommendations to countries, indicating instead that further work will need to be carried out to understand the various business models operated by enterprises offering digital goods and services, as well as digitalization more broadly. However, despite the technical complexity and the diverse positions, the Inclusive Framework jurisdictions agreed to undertake a coherent and concurrent review of the rules and achieve a consensus-based solution by 2020.²

In January 2019, the OECD released a Policy Note communicating that the renewed international discussions were going to focus on two central pillars: one pillar addressing the broader challenges of the digitalization of the economy

and focusing on the allocation of taxing rights, and a second pillar addressing remaining BEPS concerns.³ Following the Policy Note, the OECD released a Public Consultation Document⁴ describing the two pillar proposals at a high level in February 2019, received extensive comments from stakeholders, and held a public consultation in March 2019.⁵

Following the public consultation, in May 2019, the OECD released the “Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy” (the Workplan).⁶ The Programme of Work is divided into two pillars:

- ▶ Pillar One is described as addressing the allocation of taxing rights between jurisdictions and considers various proposals for new profit allocation and nexus rules.
- ▶ Pillar Two is the GloBE proposal, which is described as involving the development of a coordinated set of rules to address ongoing risks from structures that are viewed as allowing multinational enterprises to shift profit to jurisdictions where they are subject to no or very low taxation.

On 9 October 2019, the OECD released a public consultation document on an OECD Secretariat proposal for a “unified approach” under Pillar One and invited interested parties to submit comments no later than 12 November 2019.⁷ The OECD will hold a consultation meeting in Paris on 21 and 22 November 2019 to give stakeholders an opportunity to discuss their comments with the Inclusive Framework jurisdictions.⁸

On 8 November 2019, the OECD released this Consultation Document on the GloBE proposal.

The GloBe proposal

Pillar Two of the Workplan seeks to develop an integrated set of global minimum tax rules to ensure that the profits of internationally operating businesses are subject to at least a minimum rate of tax. The OECD has indicated that the level at which the minimum tax rate will be set is to be discussed by the participating jurisdictions once other key design elements of the proposal are fully developed.

The four components of the GloBE proposal set out in the Programme of Work are:

- a) An income inclusion rule that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate.

- b) An undertaxed payments rule that would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at or above a minimum rate.
- c) A switch-over rule to be introduced into tax treaties that would permit a residence jurisdiction to switch from an exemption to a credit method where the profits attributable to a permanent establishment (PE) or derived from immovable property (which is not part of a PE) are subject to an effective rate below the minimum rate.
- d) A subject to tax rule that would complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source and adjusting eligibility for treaty.

The GloBE proposal would also incorporate an ordering rule to avoid the risk of double taxation.

The Consultation Document

The Consultation Document invites comments on all aspects of the Workplan on Pillar Two, but in particular requests input on the following three technical design aspects of the GloBE proposal:

- ▶ Tax base determination: considering the implications of using financial accounts as a possible simplification for determining the tax base and approaches to neutralizing differences between financial accounts and taxable income.
- ▶ Blending: considering the extent to which low-tax and high-tax income within the same entity or across different entities within the same group should be combined for purposes of determining the effective tax rate.
- ▶ Carve-outs and thresholds: considering possible approaches for restricting the application of the GloBE proposal.

The Consultation Document also includes an annex that sets out several simplified examples illustrating the approaches for addressing temporary differences in the measurement of tax and accounting income. The facts of the examples are based on the potential application of the income inclusion rule. However, the Consultation Document indicates that the examples are not intended to suggest that these approaches are any less feasible for addressing temporary differences on the applicability of other elements of the GloBE proposal.

Tax base determination

The Consultation Document notes the importance of using a consistent tax base for the GloBE proposal. The Workplan had called for the exploration of possible simplifications to help address compliance and administrability issues for both taxpayers and tax authorities, and to neutralize possible structural differences in the calculation of the tax base in the parent and subsidiary jurisdictions.

Use of financial accounts to determine income

One of the simplification options identified in the Workplan was the use of financial accounting rules, subject to agreed adjustments to align the income calculated for accounting purposes with an appropriate measure of taxable income.

According to the Consultation Document, consideration must be given to the choice of accounting standard to be used for purposes of GloBE calculations if financial accounting were to be used as a starting point for determining a common tax base under the GloBE proposal. A first question is whether to use the accounting standard applicable to, or used by, the parent entity or the accounting standard applicable to, or used by, the subsidiary for local reporting purposes. Another item that needs to be agreed on is which financial accounting standards would be acceptable for purposes of the GloBE proposal.

The Consultation Document states that using the accounting standard of the ultimate parent entity when it prepares its consolidated financial statements would address some of the concerns raised by using the accounting standards of the subsidiaries, offering more transparency and ensuring that differences among the various subsidiaries' accounting standards do not produce distortions. However, the Consultation Document notes that these consolidated financial accounts would need to be prepared under an acceptable set of financial accounting standards (e.g., International Financial Reporting Standards (IFRS), United States Generally Accepted Accounting Principles (GAAP) or Japanese GAAP).

As the Consultation Document notes, such an approach may lead to different results based on where the ultimate parent entity of a group is located.

Other options will also need to be considered for multinational enterprises (MNEs) that have no obligation to prepare consolidated statements.

Adjustments

While using unadjusted financial figures would be the simplest approach to determine the GloBE tax base, the Consultation Document suggests that this may lead to an understatement or overstatement of net profit when compared to the amount reported for tax purposes. Adjustments could be made to take into account certain permanent and temporary differences between financial accounting and tax accounting.

Permanent differences

Permanent differences are differences between the income as reported for financial accounting purposes and the income reported for tax purposes that are not expected to reverse in the future.

The Consultation Document identifies a few types of permanent differences (e.g., dividends, treatment of corporate acquisitions, other types of disallowed expenses), noting that they arise for a variety of reasons and stating that the need to adjust for them may depend upon the level of blending ultimately adopted.

Temporary differences

Temporary differences are differences between the income as reported for financial accounting purposes and the income reported for tax purposes that are expected to reverse in the future.

The Consultation Document discusses three basic approaches for addressing temporary differences:

- ▶ Carry-forward of excess taxes and tax attributes: similar to a tax loss carry-forward rule, this approach could address the effects of temporary differences with three rules:
 - Taxes paid by a subsidiary in excess of the minimum tax rate in a year would be carried forward and treated as tax paid in a subsequent year in which the local tax paid by the subsidiary falls below the minimum tax rate.
 - Taxes paid by a parent entity under the income inclusion rule with respect to a subsidiary's income would be refunded or credited against another tax liability of the parent entity when the subsidiary pays taxes in its jurisdiction in excess of the minimum tax rate.
 - Operating losses of a subsidiary would be carried forward and used to reduce the financial accounting income of the subsidiary.

- ▶ Deferred tax accounting: under deferred tax accounting, the tax expense of a period is based on the financial income of that period, regardless of the tax due in that period:

- When the actual tax due is lower than the tax expense shown in the financial accounts, a deferred tax liability is recorded.
- When the actual tax due is higher than the tax expense shown in the financial accounts, a deferred tax asset is recorded.

The Consultation Document notes that this approach could eliminate variation in the effective tax rate caused by temporary differences. Moreover, taxpayers that prepare their financial statements under IFRS and other commonly used financial accounting standards already use deferred tax accounting. The Consultation Document also states that another benefit of this approach is that tax assets and liabilities are already computed on an entity-per-entity basis and generally are netted only based on the tax expense of that same entity. Thus, the Consultation Document indicates that this approach is expected to reduce the additional compliance burden of the MNEs that prepare their financial statements under IFRS and other commonly used accounting standards.

- ▶ A multi-year average effective tax rate: this approach would compute the annual effective tax rate based on the total taxes paid and total income of the relevant subsidiaries over a multi-year period that includes the current year and a specified number of preceding years. A multi-year averaging approach is expected to have the benefit of simplicity as it would not necessarily require the development of separate rules for the carry-forward of losses, excess taxes and other tax attributes.

The Consultation Document indicates that a number of compliance, administration, and tax policy considerations need to be considered in the design of the rules for addressing temporary differences under the GloBE proposal. For example, whether to impose a time limitation on the above three approaches, treatment of changes in the tax rate in a subsidiary jurisdiction, recordkeeping considerations, whether and to what extent credits should be eligible to be carried forward when there is a change in ownership of the subsidiary, and possible transition rules for disposition and acquisition subsidiaries.

Blending principles

The Workplan called for the exploration of different blending options, including blending at the entity level, at a jurisdictional level and at global group level as follows:

- ▶ Worldwide blending approach: would require the group to aggregate its total foreign income and the total foreign tax on that income.
- ▶ Jurisdictional blending approach: would require the group to apportion its foreign income between different taxing jurisdictions, aggregating the income and tax paid by all the entities of an MNE group resident in that jurisdiction and the income and tax paid by any branch in that jurisdiction.
- ▶ Entity blending approach: would require the group to determine the income and taxes of each entity in the group, and the income of domestic entities that is attributable to a foreign branch.

The Consultation Document acknowledges that the three approaches to blending pose different challenges and have different compliance cost implications.

The Consultation Document further explores these challenges and puts forward questions for consultation on each of these items:

- ▶ Effect of blending on volatility - temporary differences may give rise to volatility in effective tax rates that blending may partially mitigate.
- ▶ Use of consolidated financial accounting information - if consolidated financial accounts were to be used as starting point to calculate the tax base for purposes of the GloBE proposal, further breakdown of income and foreign taxes would be required for blending purposes, either between domestic and foreign operations (global blending) or at the jurisdictional or entity level (for jurisdictional and entity level blending).
- ▶ Allocating income between branch and head office - under each of the blending approaches, an agreed approach to income (and tax) allocation between branch and head office will be required.
- ▶ Allocating income of tax transparent entity - under each of the blending approaches, an agreed approach to income (and tax) allocation to tax transparent entities (e.g., partnerships) will be required.
- ▶ Crediting taxes that arise in another jurisdiction - depending on the blending approach agreed upon, taking into account CFC and similar taxes levied under the laws

of a third jurisdiction, it may be necessary to align income and taxes paid on that income to avoid understating or overstating taxes paid in a jurisdiction.

- ▶ Treatment of dividends and other distributions - if consolidated financial accounts were to be used as the starting point for calculating the tax base for purposes of the GloBE proposal, this consolidation would disregard the effect of intra-group transactions, including dividends. Adjustments may be required under jurisdictional or entity blending approach.

Carve-outs and thresholds

The Workplan called for the exploration of options and issues in connection with the design of thresholds and carve-outs to restrict application of the rules under the GloBE proposal, including the following:

- ▶ Regimes compliant with BEPS Action 5 on harmful tax practices, and other substance-based carve-outs
- ▶ A return on tangible assets
- ▶ Controlled corporations with related-party transactions below a certain threshold
- ▶ Thresholds based on annual turnover or other indications of the size of the group
- ▶ A *de minimis* threshold to exclude transactions or entities with small amounts of profit or related-party transactions
- ▶ Carve-outs for specific sectors or industries

The Consultation Document recognizes that the existence and design of any carve-outs or thresholds are mainly policy questions. However, such rules also would impact compliance and administration costs for MNEs and tax administrations, as well as the neutrality of the tax system and activities generating positive or negative externalities. The Consultation Document notes that any carve-out and threshold should also take into account existing international obligations, including the European Union fundamental freedoms.

The Consultation Document provides that a carve-out can apply on a qualitative basis (facts and circumstances) or an objective basis (formulaic). Both these approaches could be tailored in multiple different ways depending on what is sought to be achieved. For example, carve-outs based on facts and circumstances could target specific situations intended to be covered and may be more resistant to abuse, but they also would be more difficult to design and would increase complexity. Conversely, carve-outs based on objective criteria (e.g., asset values) would be simpler

to apply and administer, but could result in additional compliance costs if taxpayers were required to produce and maintain documentation to prove they qualify for the exclusion. The Consultation Document suggests that these formulaic criteria may be easier to manipulate and thus they would require further anti-abuse rules (which themselves could be based on facts and circumstances tests).

On thresholds, the Consultation Document notes that broad-criteria thresholds (e.g., total revenue or profit) may be easier to administer and comply with compared to a specific carve-out. However, such thresholds could create volatility for taxpayers that operate near the amount set by the threshold.

Examples

Finally, the Consultation Document contains a series of examples, illustrating the application of the carry-forward of excess taxes and tax attributes and the application of deferred tax accounting.

These simplified examples are intended to illustrate the workings of some of these rules, but they also illustrate the complexities that could arise from the adoption of some of the proposals currently being discussed.

Next steps

The Consultation Document includes 38 questions for comments. Interested parties are invited to submit written comments on all of the Programme of Work on Pillar Two, and on specific questions on the three technical design aspects in particular, no later than 2 December 2019. The OECD will hold a consultation meeting on 9 December 2019 to give stakeholders an opportunity to discuss their comments with the Inclusive Framework jurisdictions.

Implications

The Consultation Document does not represent the consensus views of the jurisdictions participating in the Inclusive Framework. However, the OECD Secretariat prepared the Consultation Document to focus on specific technical issues in respect of the GloBE proposal where input from stakeholders would be valuable in continuing the work on the project.

There are additional technical and design aspects of the GloBE proposal that depend on policy choices that will need to be agreed within the Inclusive Framework, including, for example, the minimum tax rate, the mechanics and operation of the undertaxed payment rule, and the nature and scope of the subject to tax rule.

As the Consultation Document expressly states, the proposals under Pillar Two represent a substantial change to the tax architecture and go well beyond digital businesses or digital business models. These proposals could lead to significant changes to the overall international tax rules under which multinational businesses operate. It is important for businesses to follow these developments closely in the coming months as work continues on key technical, design, and policy aspects of the GloBE proposal and to consider engaging with the OECD and policymakers at both national and multilateral levels on the business implications of these proposals. Companies should also begin to evaluate the potential impact of these changes on their business models.

Endnotes

1. EY Global Tax Alert, [OECD issues final report on the tax challenges of the digital economy under Action 1](#), dated 23 October 2015.
2. EY Global Tax Alert, [The OECD's interim report on tax challenges arising from digitalisation: An overview](#), dated 20 March 2018.
3. EY Global Tax Alert, [OECD's new insights describe growing support on comprehensive changes to international tax policy, beyond digital](#), dated 29 January 2019.
4. EY Global Tax Alert, [OECD opens public consultation on addressing tax challenges arising from digitalization of the economy: time-sensitive issue impacting all multinational enterprises](#), dated 14 February 2019.
5. EY Global Tax Alert, [OECD hosts public consultation on document proposing significant changes to the international tax system](#), dated 18 March 2019.
6. EY Global Tax Alert, [OECD workplan envisions global agreement on new rules for taxing multinational enterprises](#), dated 3 June 2019.
7. EY Global Tax Alert, [The OECD takes next step on BEPS 2.0 - Proposal for a "unified approach" for additional market country tax](#), dated 10 October 2019.
8. Ibid.

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