The OECD's Base Erosion & Profit Shifting Pillar One & Two

Presentation to the Association of International Business Lawyers 24 September 2021

Today’s speakers

Introduction – BEPS Action Plan

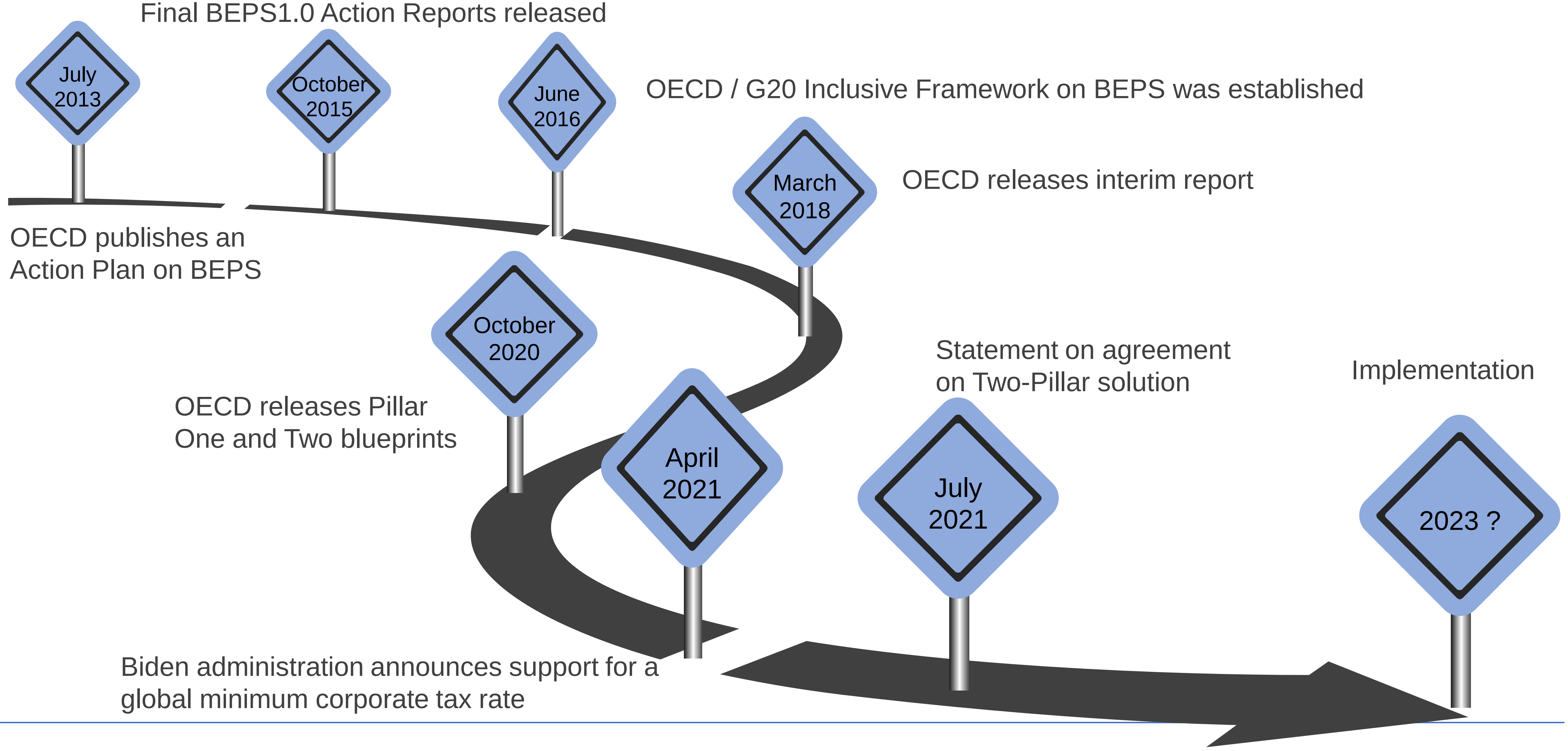
BEPS 1.0

Action item	
1	Tax Challenges arising from the Digitalisation of the Economy
2,3,4,6,7 & 15	International Anti-Avoidance Rules
5 & 12	Abolition of Harmful Tax Regimes, Tax Transparency and Disclosures
8-10, 13 & 14	Transfer Pricing Alignment, Transfer Pricing Documentation and Making Dispute Resolution Mechanisms More Effective
11	Measuring and Monitoring BEPS

BEPS 2.0

- Pillar One: Unified Approach
- Pillar Two: Global Anti-Base Erosion Approach

History



July 2013
OECD publishes an Action Plan on BEPS
October 2015
Final BEPS1.0 Action Reports released
June 2016
OECD / G20 Inclusive Framework on BEPS was established
March 2018
OECD releases interim report
October 2020
OECD releases Pillar One and Two blueprints
April 2021
Biden administration announces support for a global minimum corporate tax rate
July 2021
Statement on agreement on Two-Pillar solution
2023 ?
Implementation

Pillar One

- The goal of Pillar One is to ensure a fairer distribution of profits and taxing rights.
- Pillar One offers market jurisdictions new taxing rights of multinational groups, whether there is a physical presence in the market country or not.
- The key elements of Pillar One can be grouped into three components:
  1. A new taxing right for market jurisdictions over a share of residual profit calculated at an MNE group level (Amount A)
  2. A fixed return for certain baseline marketing and distribution activities taking place physically in a market jurisdiction, in line with the arm's length principle (Amount B)
  3. Processes to improve tax certainty through effective dispute prevention and resolution mechanisms.

Groups in-scope of Pillar One

October 2020 blueprint

Primary activity test:

- Automated Digital Services
- Consumer Facing Business

Consolidated global revenue > EUR 750m

Impact ca. 2,300 groups

July 2021 statement

Carve out for:

- Extractive industries
- Regulated Financial Services

Consolidated global revenue > EUR 20b

Profit before tax margin > 10%

Impact ca. 100 groups

Amount A

- 20%-30% of the profit before tax exceeding 10% of revenue
- Allocated to “market jurisdictions” using market revenue as an allocation key
- To be an eligible market
  - Market must generate at least EUR 1 million in revenue; or
  - EUR 250,000 where country market has GDP < EUR 40 billion
- Detailed “revenue sourcing” rules to be developed
- Amount A will be subject to a cap to avoid double taxation

Amount B

- Amount B is a standardized arm's length return for baseline marketing and distribution activities.
- To qualify the distributor must:
  - Buy from related parties and resell to unrelated parties
  - Have a routine distributor functionality profile
- Postive and negative list to determine characterisation of distibutor
- Expectation is the baseline return will vary by industry and geographic region
- Work to be completed by end of 2022

Example - Determination of Amount A

Group	EUR million
Revenue (R)	25’000
Profit before tax (P)	6’500
PBT margin (P/R)	26%

Residual profit margin = 16% (26% - 10%)

Residual profit = 4’000 (25’000*16%)

Profit for reallocation = 800 (4’000*20%)

EUR million	Local revenue	Market presence
Market 1	2’000	Local company
Market 2	18’000	Remote activity
Market 3	5’000	Remote activity
Total	25’000	

EUR million	Reallocated profit	Allocation key
Market 2	576	800*(18’000/25’000)
Market 3	160	800*(5’000/25’000)
Total	736	

Example – M&D Profit Safe Harbour

	IP Owner	Distributor 1	Distributor 2	Distributor 3	Distributor 4	Consolidated
Revenue	5’000	7’000	5’000	6’000	4’000	22’000
Third party revenue	-	7’000	5’000	6’000	4’000	
Intragroup revenue	5’000	-	-	-	-	
Profit before tax	1’750	532	160	-60	712	3’094
Profit margin	35%	7.6%	3.2%	-1.0%	17.8%	14.1%

- Calculation of Amount A is not shown in this example. It is assumed to be a return on sales of 1.2%
- Amount B, the the fixed return for marketing and distribution activities is assumed to be 2.3%
- The cap for allocating Amount A is therefore 3.5%
- Distribution 1 and 2 would receive an allocation of Amount A
- IP Owner is likely to be identified as the paying entity and hence its tax jurisdiction would be required to provide double tax relief

Identifying the paying entities

Process will potentially contain four steps:

1. Activity test

"the member or members of an MNE group (or segment) that perform functions, use or own assets and/or assume risks that are economically significant, for which they are allocated residual profits relevant to Amount A"

2. Profitability test

To ensure paying entities have the capacity to bear Amount A

3. Connectivity to the market test

For each market jurisdiction allocated Amount A, a taxpayer will be required to determine which (if any) of the potential paying entities identified have a sufficient connection to be identified as a paying entity for that market jurisdiction

4. Pro-rata allocation test

If the paying entities connected to a market do not have sufficient profits to bear the full Amount A tax liability, then as a "back-stop" any outstanding liability will be apportioned between all other potential paying entities within a segment.

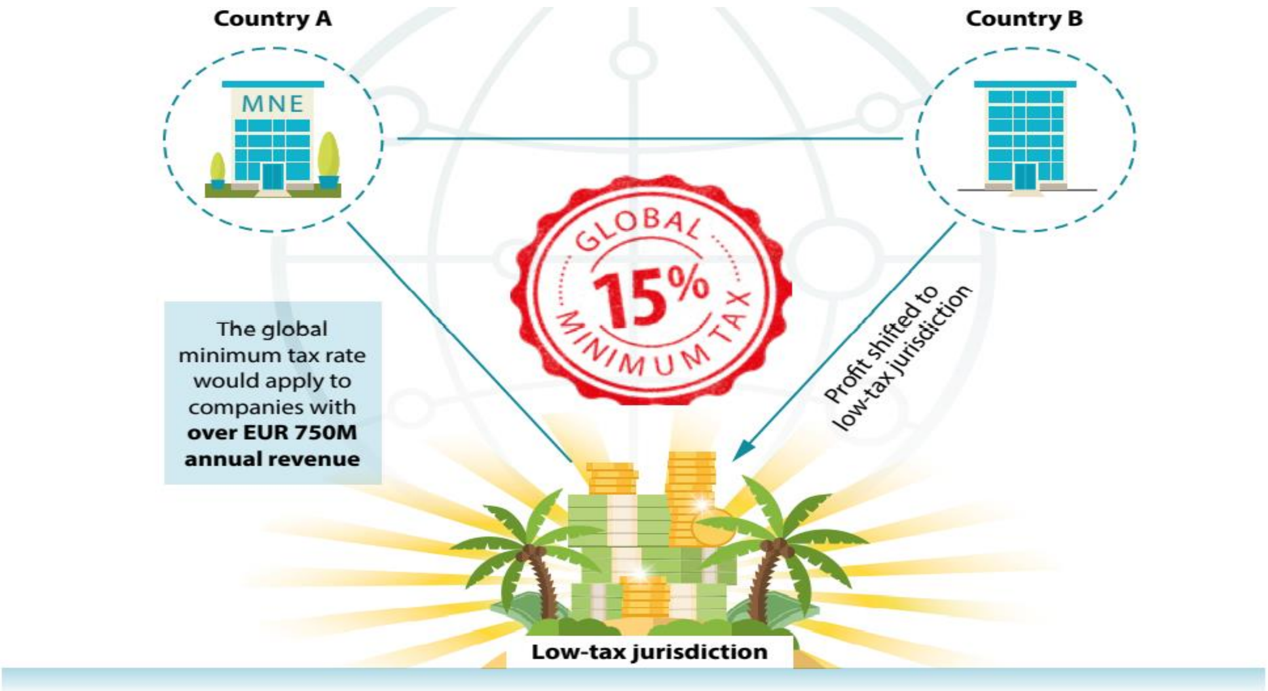
Implementation

- A standardised Amount A self-assessment return and documentation package will be developed, for use in all jurisdictions
- Filing in a single tax jurisdiction, which in the majority of cases will be the jurisdiction of the Ultimate Parent Entity
- Panel review of self-assement return to try and achieve tax certainty
- A new multilateral convention would be developed to implement the solution, as it is believed this offers the best and most efficient way of implementing Pillar One.
- New instrument is scheduled to be signed during 2022 with entry into force in 2023.

Impact for Switzerland

- The OECD estimates that taxing rights on more than USD 100 billion in profits are expected to be reallocated to market jurisdictions.
- High revenue and profit threshold, plus carve out for regulated financial services and extractive industries means application to Swiss headquartered multinationals is limited to a handful of groups.
- Expect Switzerland to be a net loser as taxable profit reallocated from Swiss principal models and centralised IP structures of foreign headquartered groups to market countries

Pillar Two – in one picture



Under Pillar Two, the global minimum tax, with **a rate of at least 15%**, is expected to generate more than **EUR 150 billion** in new tax revenues globally.

Overall design considerations

Pillar Two addresses remaining BEPS challenges and is designed to ensure that large internationally operating businesses pay a minimum level of tax regardless of where they are headquartered or the jurisdictions they operate in.

It does so via a number of interlocking rules that seek to

(i) ensure minimum taxation while avoiding double taxation or taxation where there is no economic profit,

(ii) cope with different tax system designs by jurisdictions as well as different operating models by businesses,

(iii) ensure transparency and a **level playing field,** and

(iv) minimise administrative and compliance costs.

Overall design considerations

Pillar Two has three new rules granting jurisdictions additional taxing rights:

(i) an **Income Inclusion Rule (IIR),** which imposes top-up tax on a parent entity in respect of subsidiaries' income (including permanent establishments) that is taxed at less than a minimum effective rate (at least 15 percent), and

(ii) a supporting **Undertaxed Payment Rule (UTPR),** which denies deductions or requires an equivalent adjustment to the extent the low-tax income of a constituent entity is not subject to tax under IIR.

(iii) A treaty-based **Subject to Tax Rule (STTR)** which applies a minimum effective rate of between 7.5 percent and 9 percent at source to certain related party payments. The STTR will be creditable as a covered tax under the IIR and UTPR (i.e., the STTR applies first).

Groups in-scope of Pillar Two

- The rules will apply to MNE Groups with a total consolidated group revenue above €750 million. However, countries may apply a lower revenue threshold for the IIR in respect of groups headquartered in their country.
- Investment funds, pension funds, governmental entities, international organizations, and non-profit organizations are excluded entities.
- Also mining and shipping companies. That exception is actually not surprising since the Pilar II aimed initially to target only the digital economy.

Key Take away

- The Pillar Two rules are anticipated to be brought into law in 2022 and take effect beginning in 2023. IF members are not obliged to adopt the IIR and UTPR (the Global Anti-Base Erosion (GloBE) rules) but must accept the application of the rules by other IF member.
- A detailed implementation plan is expected in October 2021. This will include model legislation for the GloBE rules. A multilateral convention may also be drafted.
- The plan will also include an STTR model provision together with an implementing multilateral convention, and possible transitional rules (possibly a deferral of the UTPR).
- A number of uncertainties remain but Pillar Two is likely to be a radical shift in the tax landscape

Swiss position

October 2020 blueprint

- International companies are essentially taxed where added value is generated.
- New taxation rules must not impede growth and innovation.
- Tax competition must continue to be allowed within a fair framework.

July 2021 statement

- Switzerland conditionally supports key parameters for international corporate taxation

Q&A on the OECD IF key parameters

Why did Switzerland not veto the Inclusive Framework decision?

A final decision has not yet been made. The agreement published by the OECD only reflects an interim status.

Switzerland is prepared to continue the work at OECD level for the following reasons:

- A multilateral solution will prevent the emergence of an uncontrolled proliferation of national digital taxes.
- The large companies in Switzerland that are potentially most affected clearly signalled beforehand that a multilateral solution is preferred for legal certainty reasons.
- A multilateral solution will allow Switzerland, with appropriate measures, to remain an internationally competitive location for large multinationals.

Q&A on the OECD IF key parameters

What measures can be considered to strengthen Switzerland's competitiveness as a business location if taxes become less important as a location factor?

- This issue is to be explored by the new project organisation led by the FDF, with the involvement of interested parties, and, depending on the progress of the OECD/G20 work, a coordinated reform plan is to be presented to the Federal Council in the first quarter of 2022.
- It is premature for the authorities to mention concrete measures at this stage, but we welcome the public discussion that is currently taking place on possible measures and want to use the new project organisation to steer them in the right direction.

Q&A on the OECD IF key parameters

What are other countries doing to make their locations more attractive?

- Many countries support companies with favourably priced infrastructure, loans or subsidies, contributions for research and development, support for sustainable business management and tax advantages that are internationally compatible.
- Location factors such as security (legal, political), stability, service quality, internationally diversified financial sector, high standard of education and high-quality authorities are important. Switzerland is still very well positioned in these areas

Q&A on the OECD IF key parameters

What impact would the global minimum tax rate have on tax receipts in Switzerland?

- In the short term, it could result in additional receipts.
- But especially if we take a dynamic view, the weakening of the previous argument of attractive corporate taxation is likely to adversely affect Switzerland's appeal as a business location. Companies could move away and the establishment of new companies could decline, causing a loss of tax receipts and jobs.
- For this reason, we need measures that specifically address the partial elimination of global (and national) corporate tax competition and the preservation of Switzerland's appeal as a business location.

My personal opinion

- Countries will start designing their effective tax rates;
- Potential radical change of business models may allow to escape the minimal taxation rule (franchisee model instead of low cost distributors);
- The hierarchy of norms will need to be approved;
- Interaction of the STTR rule and the residual dividend withholding tax;
- An efficient conflict resolution system should be included;

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