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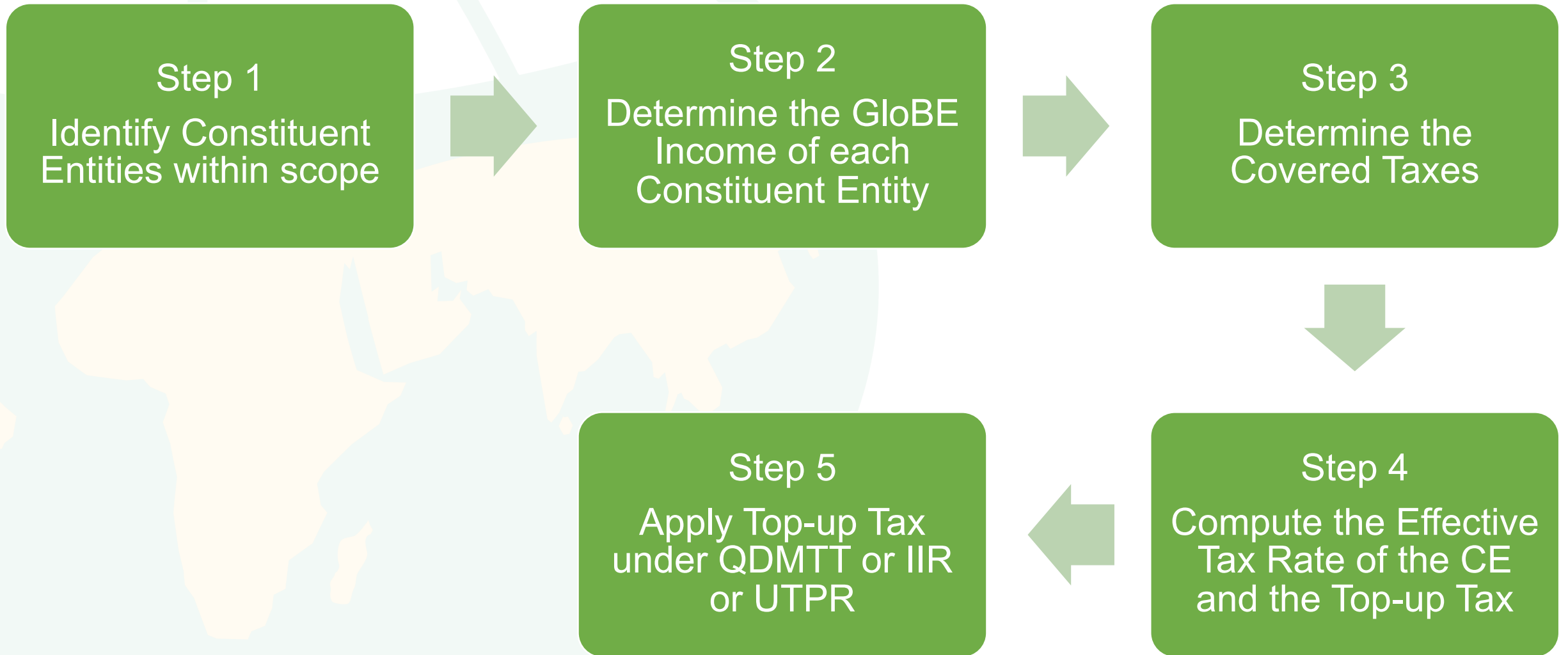
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Pillar Two Model Rules and
Subject to Tax Rule in UN MTC



Steps in determining Top-up Tax liability for an MNE



Steps in determining Top-up Tax Liability for an MNE

Step 1 Identify CE within scope

- Check whether the MNE group is in scope
- Identify Permanent Establishments treated as separate entities
- Remove any excluded entities
- Identify the location of each constituent entity of the Group

Step 2 Determine the GloBE Income of each Constituent Entity

- Calculate the Financial Accounting Net Income (Article 3.1)
- Make the adjustments: inclusion and exclusion (Article 3.2)
- Allocate the Income between Permanent Establishments and main entity (Article 3.5)

Step 3 Determine the Covered Taxes

- Identify the Constituent Entity's current taxes for the Fiscal Year (Article 4.1.2 to Article 4.1.5)
- Apply adjustments as agreed: tax credits – deferred taxes – loss carry-forward (Article 4.4)
- Allocate the Covered Taxes to other Constituent Entities if applicable: CFC taxes – distribution taxes (Article 4.3)
- Include post-filing adjustments if applicable

Steps in determining Top-up Tax liability for an MNE

Step 4

Compute the Effective Tax Rate of the CE and the Top-up Tax

- Compute the jurisdictional Effective Tax Rate (ETR) (Article 5.1)

$$ETR = \frac{\text{Covered Taxes in the jurisdiction}}{\text{GloBE Income in the jurisdiction}}$$

- Compute the jurisdictional Excess Profit (Article 5.2.2 and Article 5.3)

$$\text{Excess Profit} = \text{GloBE Income} - \text{Substance Base Income Exclusion (5\% of tangible assets and payroll)}$$

- Compute the Top-up Tax Rate (Article 5.2.1)

$$\text{Top-up Tax Rate} = \text{Minimum Tax Rate} - ETR$$

- Compute jurisdictional Top-up Tax

$$\text{Top-up Tax} = (\text{Excess Profit} * \text{Top-up Tax Rate}) - \text{Qualified Domestic Minimum Top-up Tax}$$

- Allocate Top-up Tax to the Constituent Entities (Article 5.2.4)

$$\text{Top-up Tax of a CE} = \text{Top-up Tax} * \frac{\text{GloBE Income of the CE}}{\text{Aggregate GloBE Income of all CEs}}$$

- Consider exceptions if applicable (De Minimis Exclusion and Safe Harbour) (Article 5.5 and Article 8.2)

Step 5

Apply Top-up Tax under IIR or UTPR or QDMTT

- Identify Parent Entities liable for Top-up Tax: UPE – Intermediate Parent – Partially Owned Parent (Articles 2.1.1 to 2.1.5)
- Allocate Top-up Tax in proportion of shares under the IIR (Articles 2.2 and 2.3)
- Allocate remaining Top-up to source jurisdiction under UTPR: Value of tangible assets and number of employees (Article 2.4 to 2.6)

Steps in determining Top-up Tax liability for an MNE

- Compute jurisdictional Top-up Tax

$$\text{Top-up Tax} = (\text{Excess Profit} * \text{Top-up Tax Rate})$$

- The jurisdiction decides to apply the QDMTT
- The QDMTT Rate may be equivalent to the Top-up Tax Rate or less

$$\text{QDMTT amount} : \text{Excess Profit} * \text{QDMTT Rate}$$

- Remaining Top-up Tax to be levied under IIR

$$\text{Rem. Top-up Tax} = \text{Top-up Tax} - \text{QDMTT} \quad \text{or} \quad (\text{Top-up Tax Rate} - \text{QDMTT Rate}) * \text{Excess Profit}$$

- All components of Pillar Two: Either IIR or QDMTT or UTPR will decrease tax revenue since Top-up Tax derived from Excess Profit which reduces the tax base because of the substance based carve out
- **It is not clear how the QDMTT will work practically and how source countries can use it**

Qualified Domestic
Minimum Top-up
Tax (QDMTT)

Qualified Domestic
Minimum Top-up
Tax (QDMTT)

Key Limitations of GloBE Rules

Low ETR of 15% detached from developing country realities –average around 25% for G-77+China Member States

Enshrines the principle that all untaxed profits belong to the state of residence through the priority of IIR; sets a negative precedent in international tax law.

Problematic principle pushed by the developed countries to ensure taxing right remains with them.

Under Taxed Payments Rule severely weakened; Pillar Two Model Rules have several provisions which make it easy to be reduced to zero (eg – Sections 2.5.2 and 2.6.3 of Model Rules), giving nothing to the developing countries.

UTPR exemption for MNEs in the “initial phase of activity” – can be easily manipulated by keeping tangible assets below EUR 50 million and their operations limited to 5 jurisdictions.

Key Limitations of GloBE Rules

Qualified Domestic Minimum Top Up Tax (QDMTT) can be used to bring the ETR up to 15%, but applies on a reduced tax base due to substance based carve out

Extremely complex to understand and administer; one commentator said they have “mind-numbing complexity”

Unlikely to be feasible for developing countries; bonanza for tax advisors and lawyers who will benefit from prolonged disputes and confusion.

Unclear if IIR and UTPR can apply with changes to tax treaties.

GloBE Implications

Headquarter jurisdictions and tax havens are rushing to implement GloBE rules (EU, Switzerland, etc) to ensure they don't lose out.

Strongly recommended developing countries introduce minimum taxes otherwise untaxed income will be taken away by the developed countries.

Pillar Two completely optional.

Developing countries have many alternative options, which include Alternative Minimum Taxes

Modified tax base can be calculated in easier ways such as deemed profits, or a % of turnover or assets.

Model Rules – countries free to cherry-pick helpful design elements from GloBE into their domestic minimum tax law – no obligation to stick to Model Rules as they are.

Subject to Tax Rule in Pillar Two: Key Limitations

Has a low rate of 9%, was kept lower than P2 minimum ETR to prevent over-taxation.

Appeasement of European tax havens like Ireland and Hungary meant GloBE and STTR rates were dragged down to the detriment of developing countries.

Applies only to payments between *related parties*

Excludes payments by individuals

Has limited scope (interest, royalties and some service payments)

Service payments presently in-scope:

- a. A franchise fee or other payment for the use of or right to use intangibles in combination with services;
- b. Insurance or reinsurance premium;
- c. A guarantee, brokerage or financing fee;
- d. Rent or any other payment for the use of or the right to use moveable property;
- e. An amount paid to or retained by the payee that is consideration for the supply of marketing, procurement, agency or other intermediary services.

Subject to Tax Rule in Pillar Two: Key Limitations

Limiting scope to connected persons problematic because:

- BEPS can arise from various sources, including unrelated parties; reflected in BEPS Actions themselves and GloBE rules
- IIR taxes income from unrelated parties
- Other BEPS Actions like Action 4 (Thin Capitalization) recognize BEPS risks arise between unrelated parties also
- Administration of 'connected persons' onerous: Pillar Two Blueprint prescribes a) *de facto* control, b) groups of persons and c) deeming rule tests which will be difficult to administer for tax administrations. Will require additional anti-abuse rules which are also resource intensive and increases complexity.

Limiting scope of payments also problematic:

- Base erosion arises when any payment, which reduces the tax base of the source jurisdiction, is not taxed in the jurisdictions where it is received
- Broad scope does not mean reallocating taxing rights; only secondary rights triggered

Subject to Tax Rule in Pillar Two: Key Limitations

Low-return exclusion: Exclusion of payments where the payment generates a “low return”.

P2 Blueprint suggests “low return” be calculated by reference to the costs incurred by the payee in earning the payment or on a cost plus basis, and where the margin is no higher than an agreed percentage. Negotiations ongoing.

Unnecessary restriction of scope of STTR.

Will allow for more manipulation and tax avoidance by MNEs. Challenging for developing country tax administrations to counter such abuse.

Restricted STTR will benefit very small number of developing countries.

Withholding Tax Rate on Interest & Royalties in Tax Treaties: Methodology

Average Tax Rate on Interest for each country (Rates applied with its partners)

Average Tax Rate on Royalties for each country

Average Tax Rate on Interest and Royalties for each country

Average Tax Rate on Interest and Royalties for all SC Members, G-77 +China Members, and the sub-categories. Mean = Average of the group or sub-category.

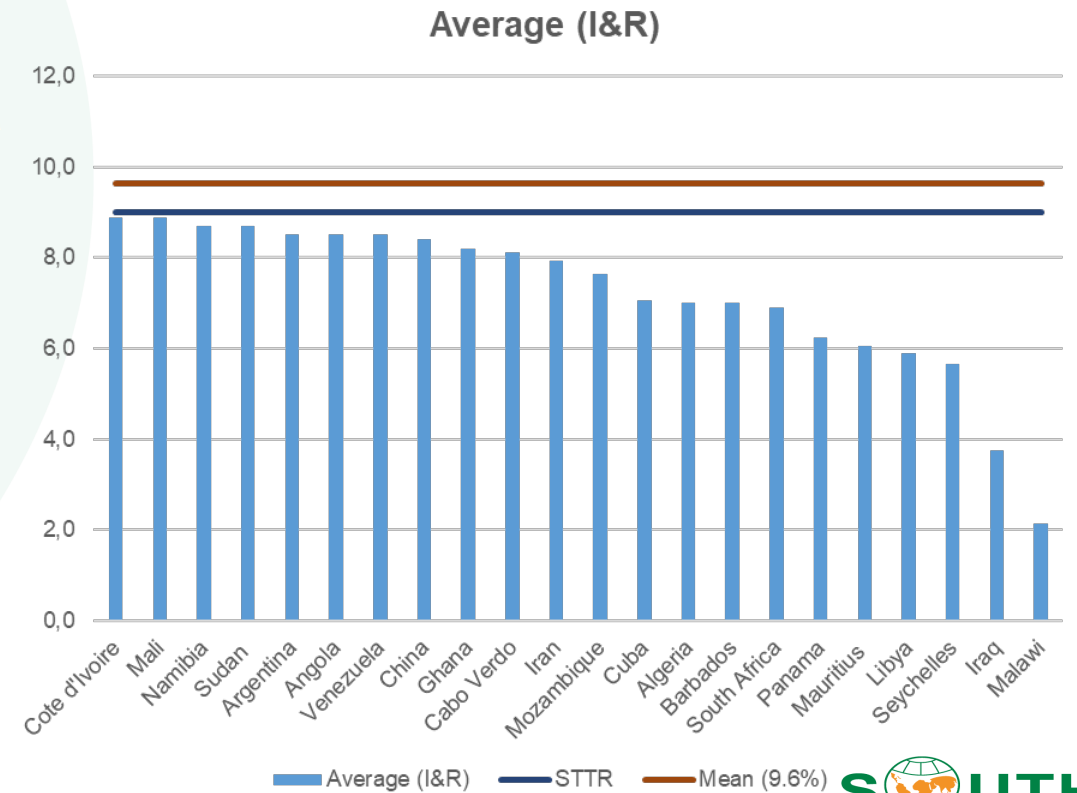
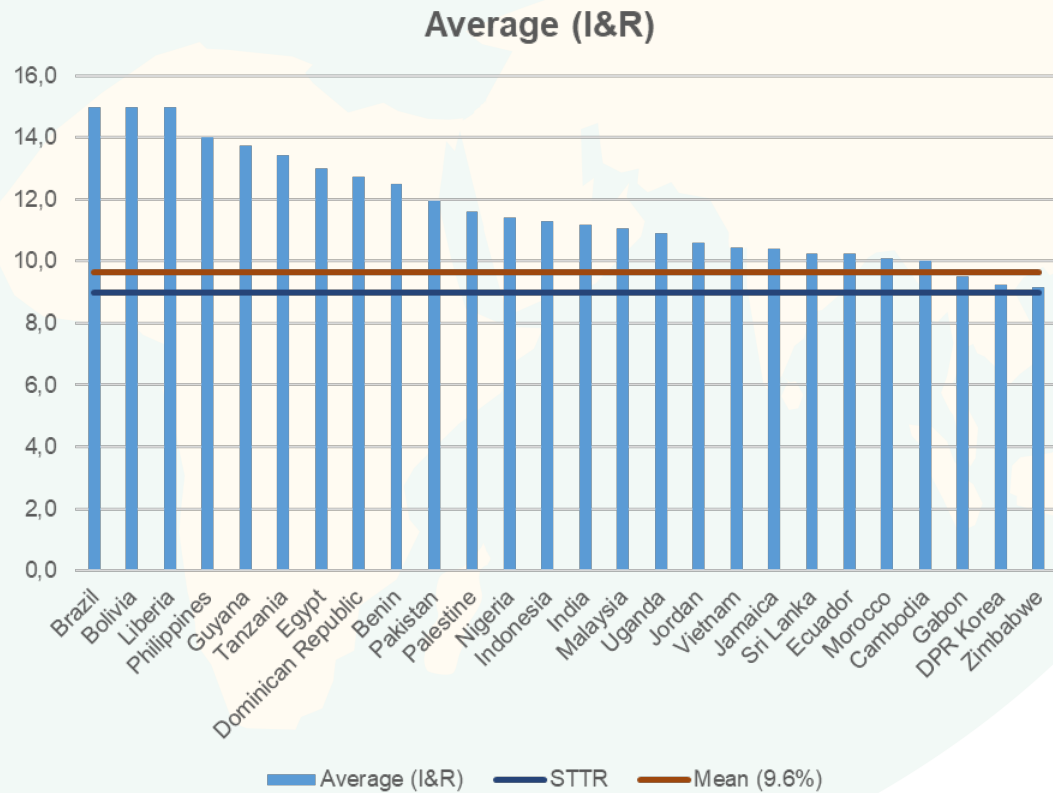
Comparison of the Average Tax Rate on Interest and Royalties for each country with the average of its group and the STTR Rate

Sub-categories:

- Per region
- Per Income group

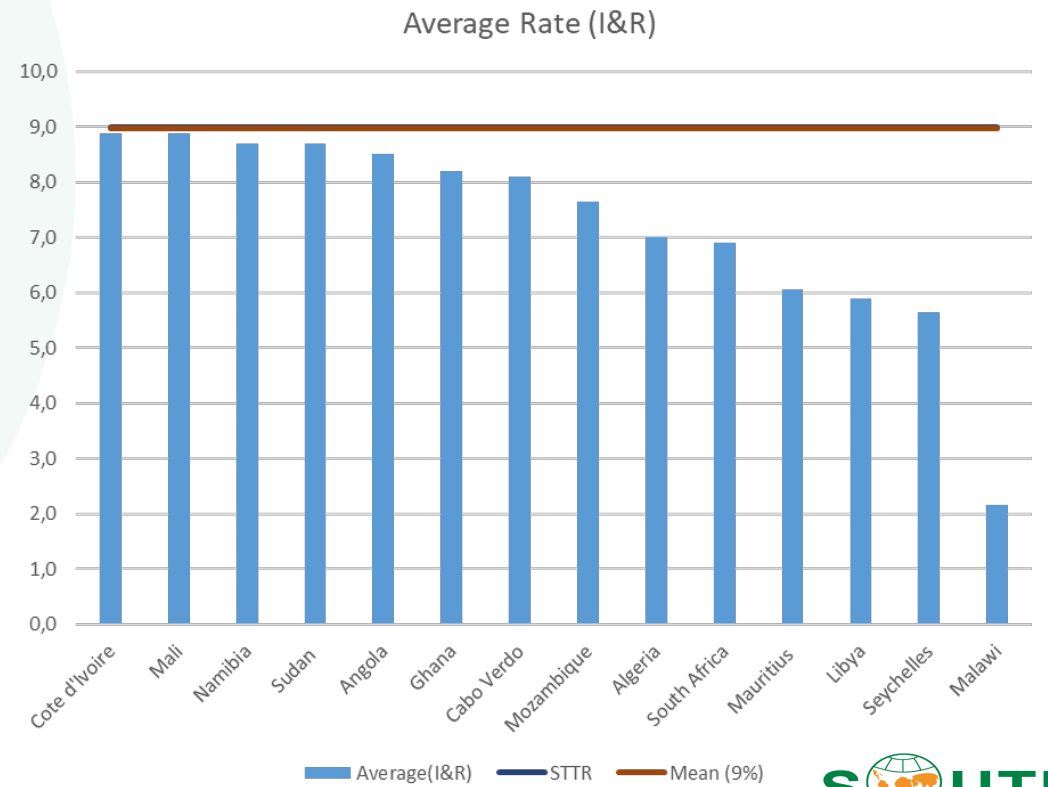
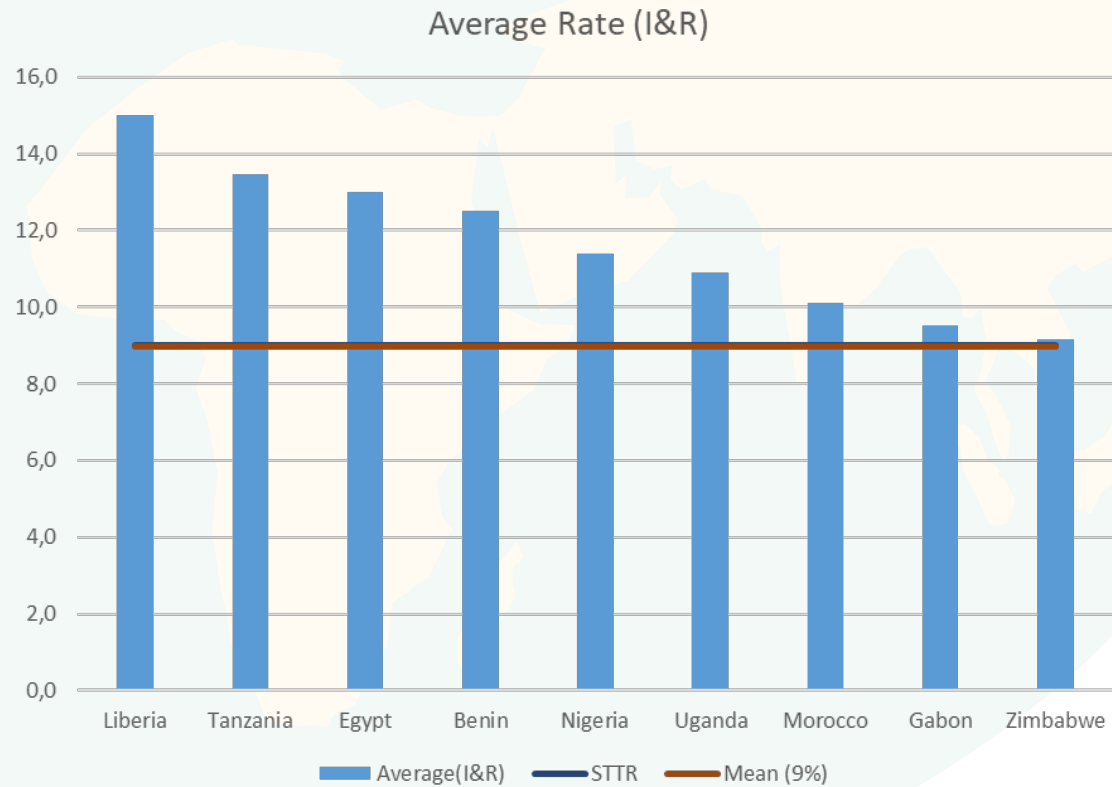
South Centre Member Countries average rate for interest and royalties

- Total countries covered: 48
- 26 countries with average rate of 9% or above (from 10% to 15%).
- 22 countries with average rate below 9%.
- 10 countries with average rate between 8% and 9%.
- 12 countries with average rates below 8%.



South Centre Member Countries from Africa

- Total countries covered: 23
- 9 countries with average rates of 9% or above (from 10% to 15%).
- 14 countries with average rates below 9%.
- 7 countries with average rates between 8% and 9%.
- 7 countries with average rates below 8%.



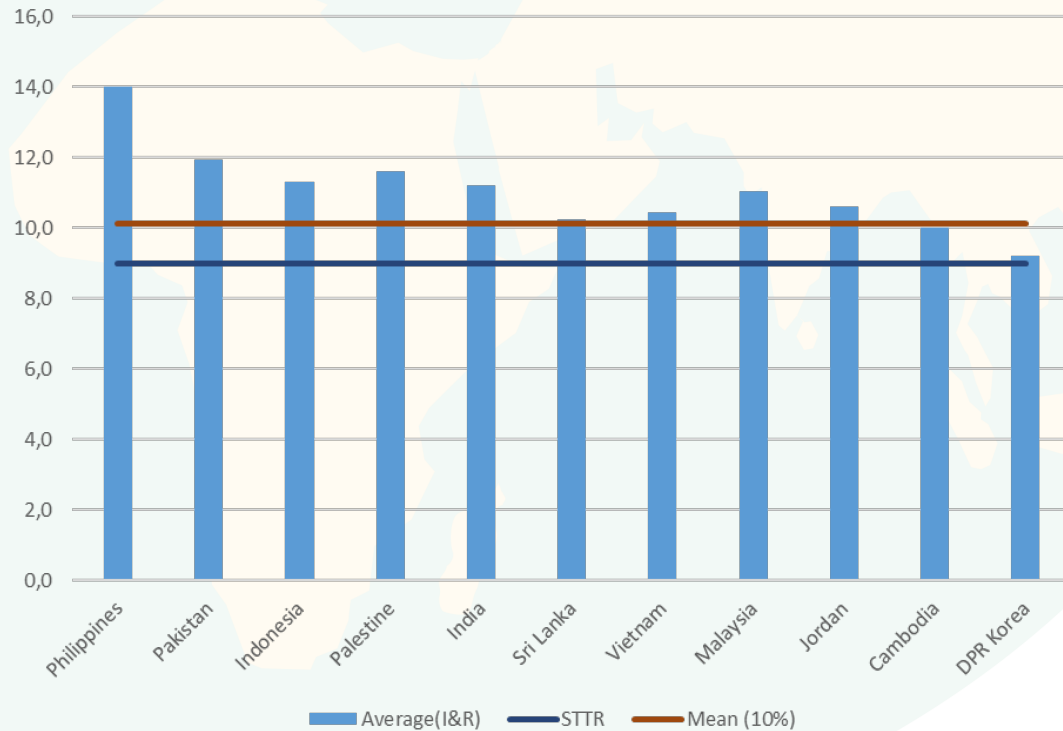
South Centre Member Countries from Asia

- Total countries covered: 14
- 11 countries with average rate of 9% or above (from 10% to 14%).
- 3 countries with average rate below 9%.

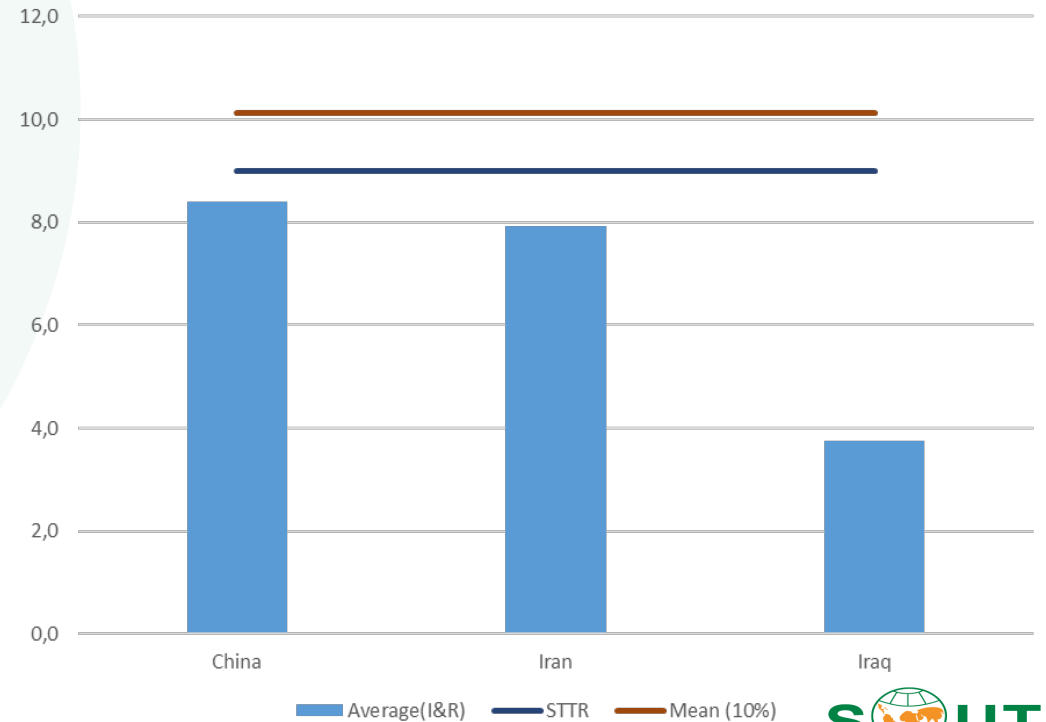
1 country with average rate between 8% and 9%.

2 countries with average rate below 8%

Average Rate (I&R)

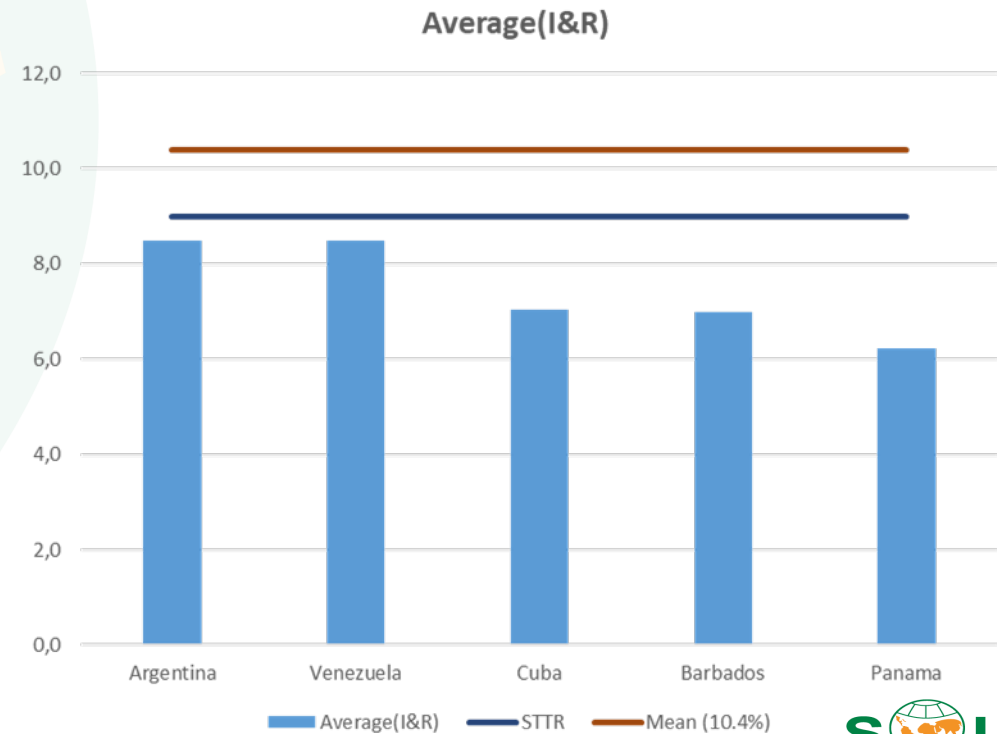
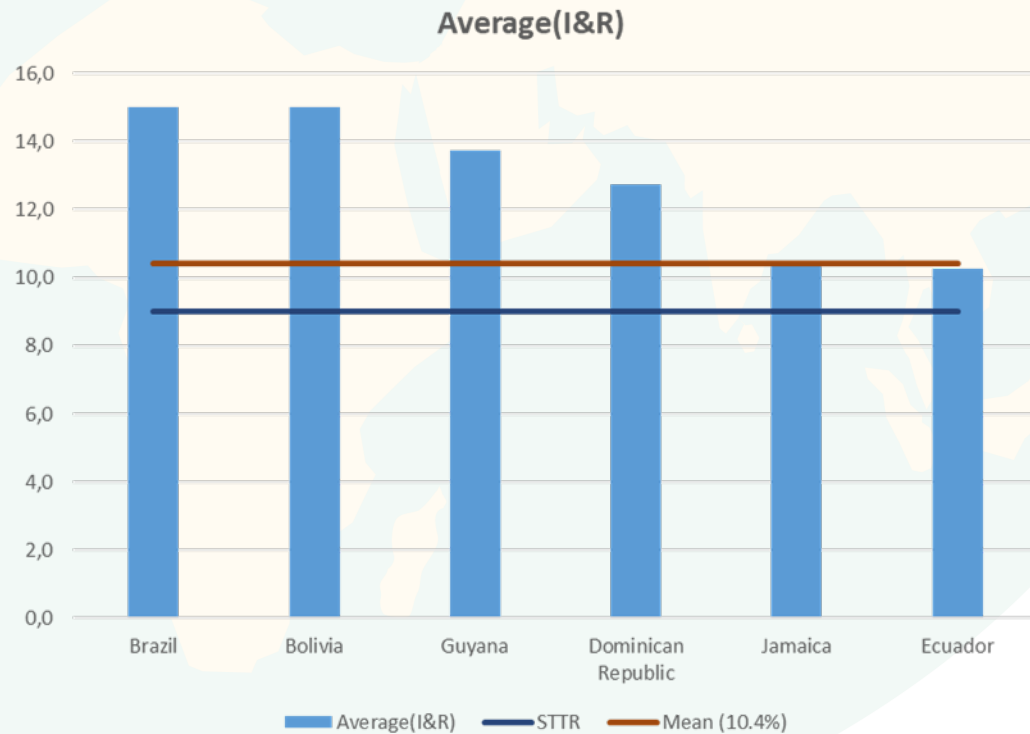


Average Rate (I&R)



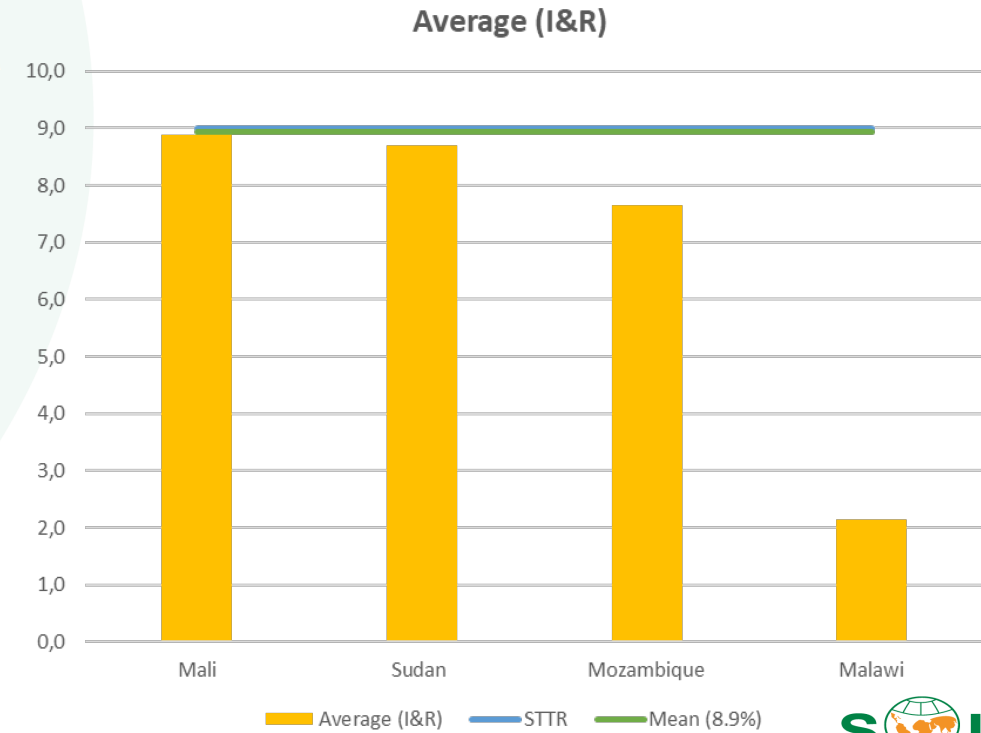
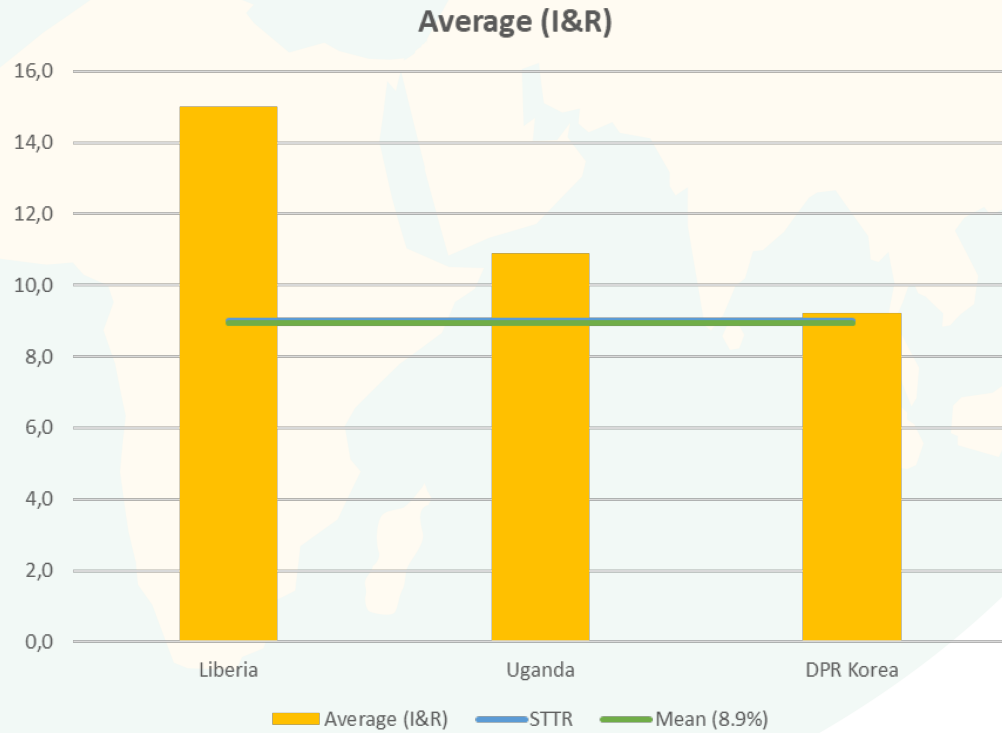
South Centre Member Countries from Latin America and Caribbean

- Total countries covered: 11
- 6 countries with average rates of 9% or above
- 5 countries with average rates below 9%
- 2 countries with average rates between 8% and 9%
- 3 countries with average rates below 8%



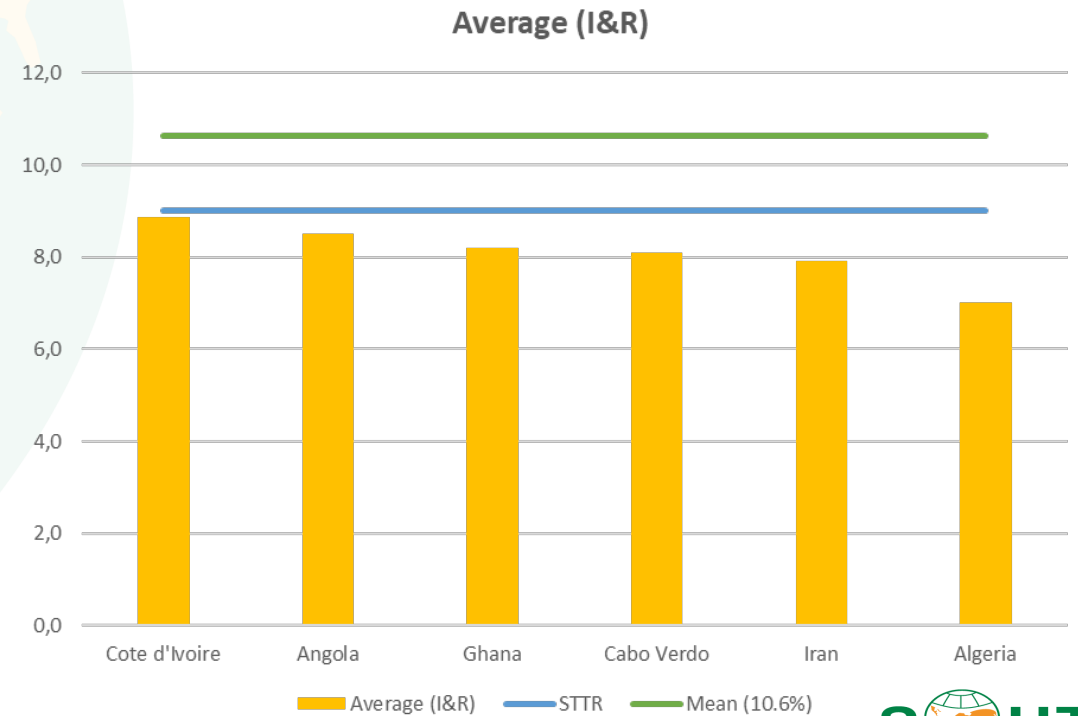
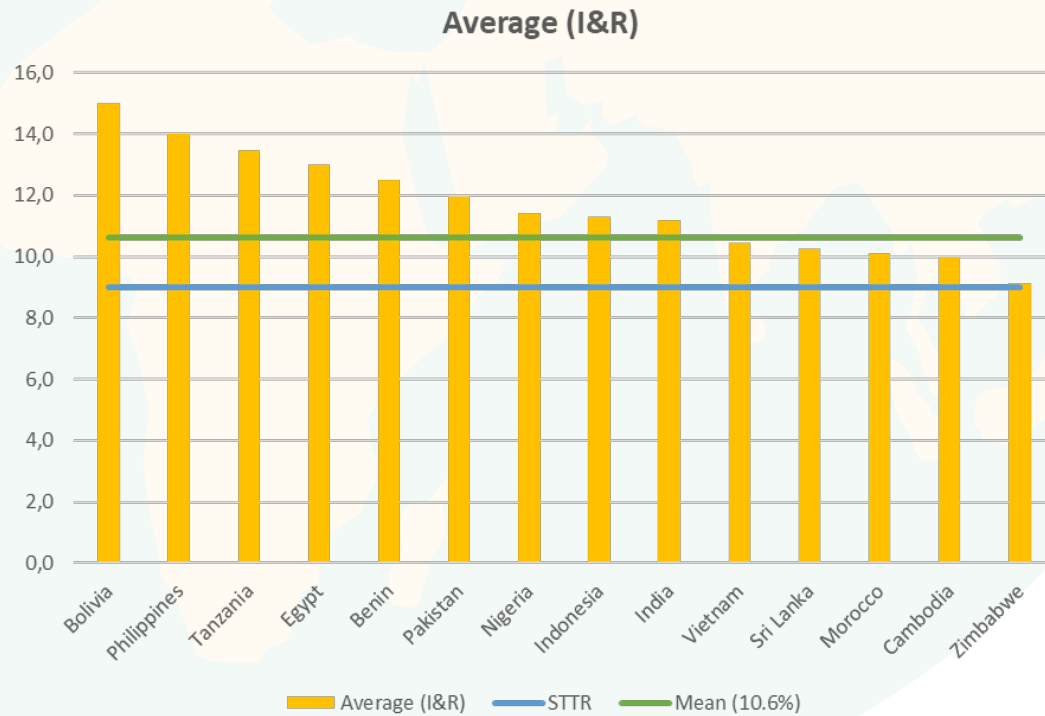
South Centre Member Countries by income category: Low-Income Countries

- Total countries covered: 7
- 3 countries with average rates of 9% or above
- 4 countries with average rates below 9%
- 2 countries with average rates between 8% and 9%
- 2 countries with average rates below 8%



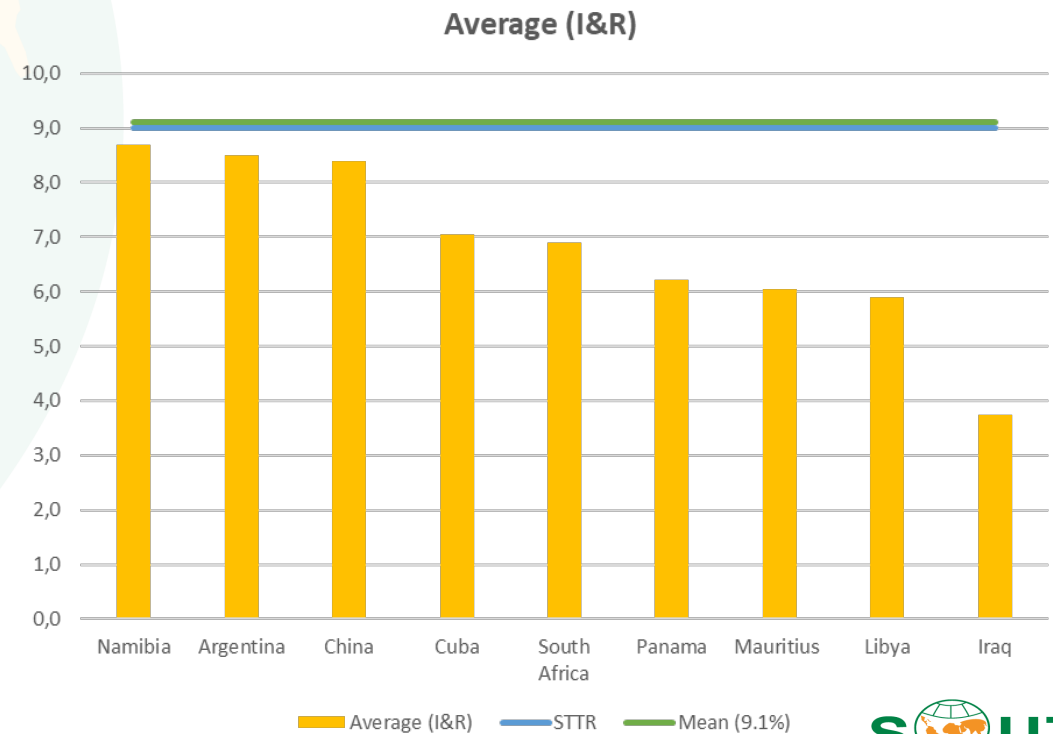
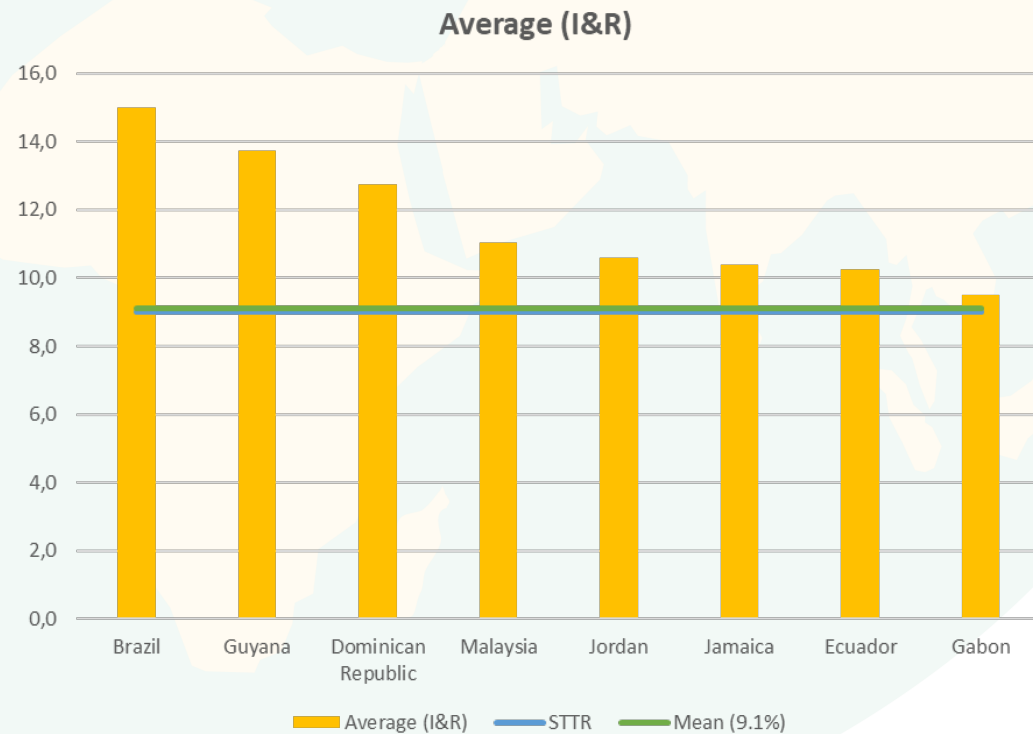
South Centre Member Countries by income category: Lower-Middle Income Countries

- Total countries: 20
- 14 countries with average rates of 9% or above
- 6 countries with average rates below 9%
- 4 countries with average rates between 8% and 9%
- 2 countries with average rates below 8%



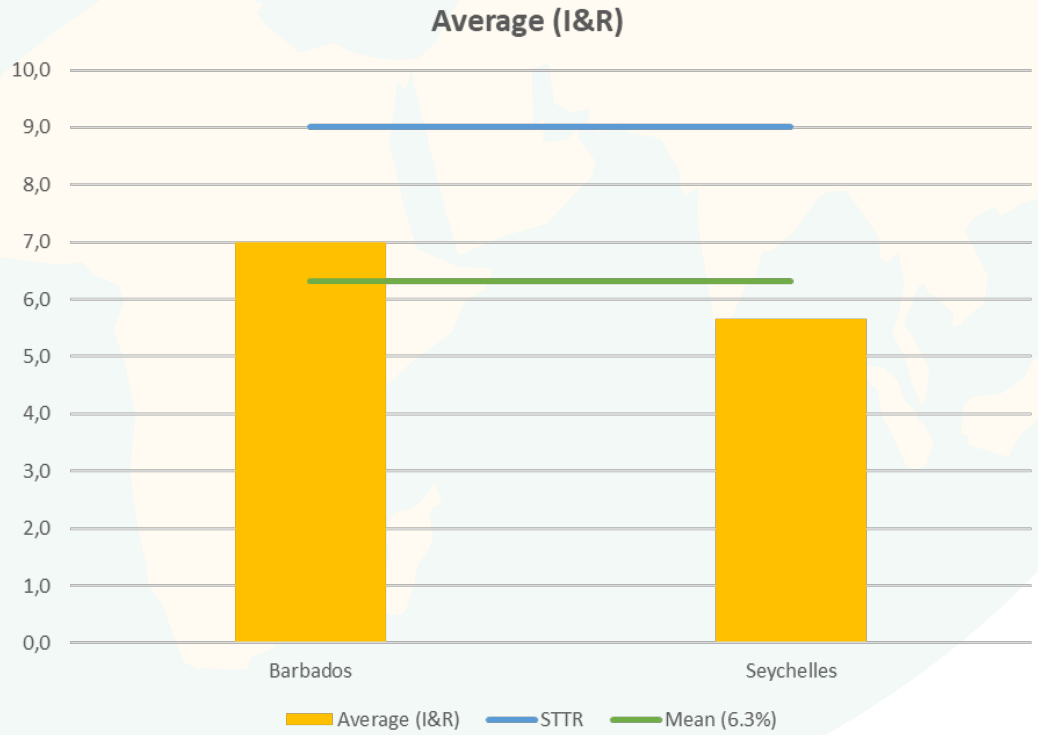
South Centre Member Countries by income category: Upper-Middle Income Countries

- Total countries: 17
- 8 countries with average rates of 9% or above
- 9 countries with average rates below 9%
- 3 countries with average rates between 8% and 9%
- 6 countries with average rates below 8%



South Centre Member Countries by Income category: High-Income Countries

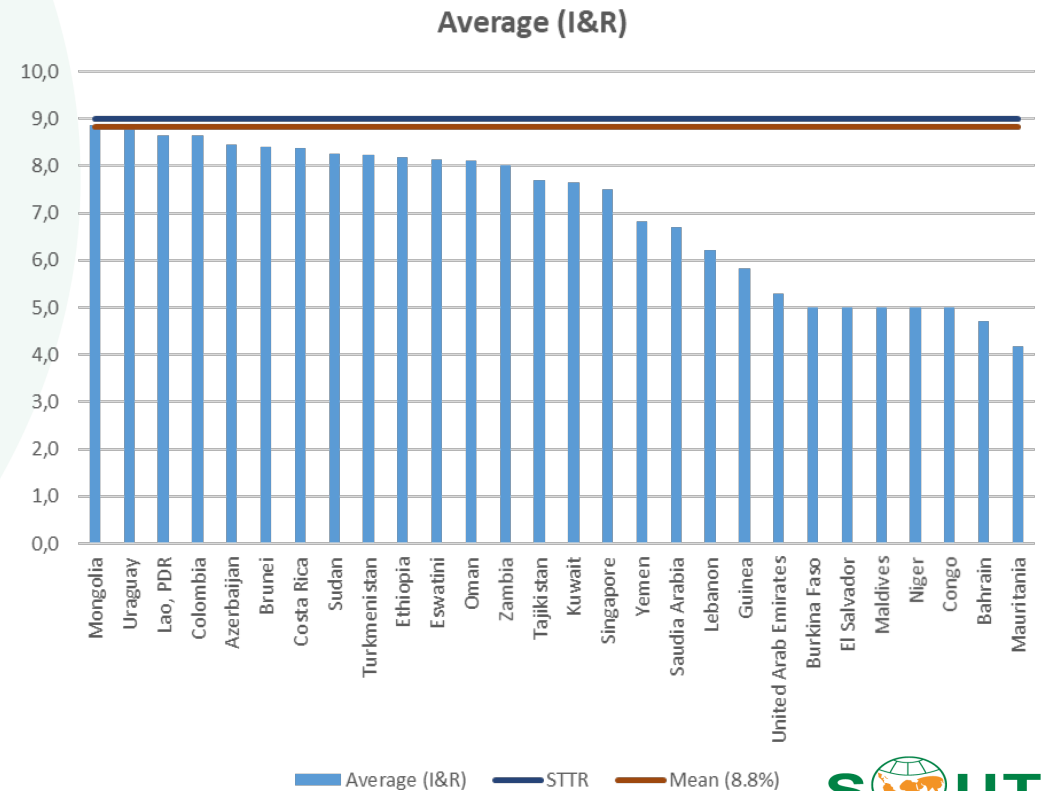
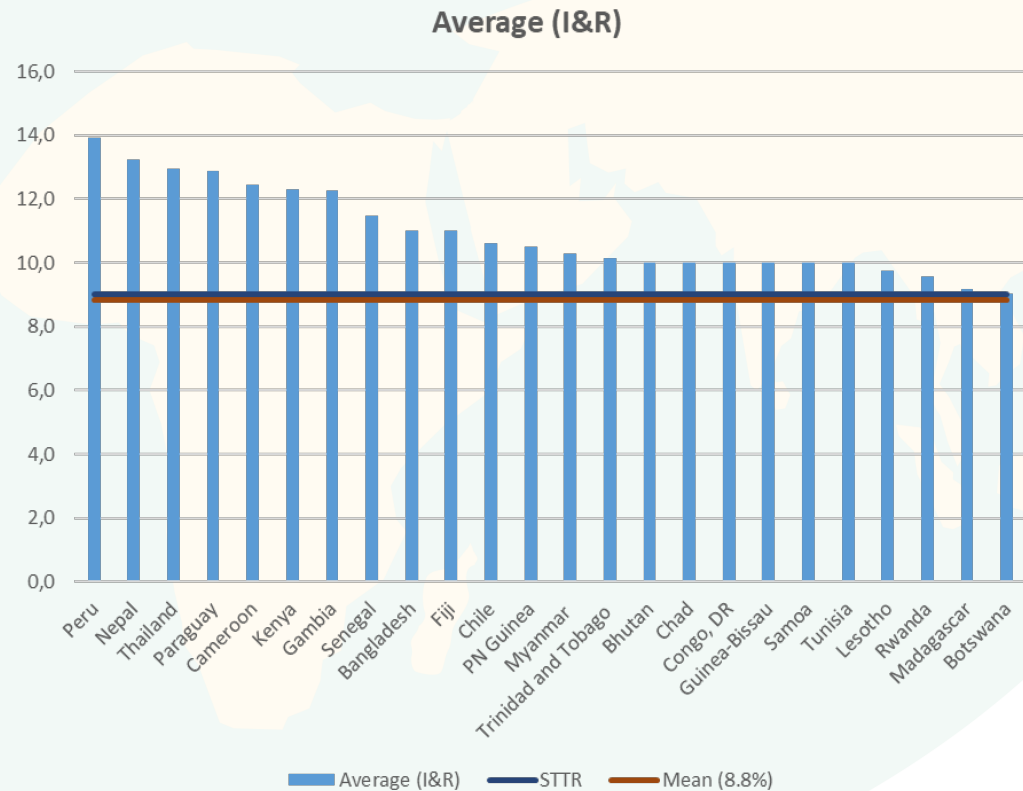
- 2 countries with average rates below 8%



G-77 and China Member countries average rate for interest and royalties

- Total countries: 52
- 24 countries with average rates of 9% or above
- 28 countries with average rates below 9%

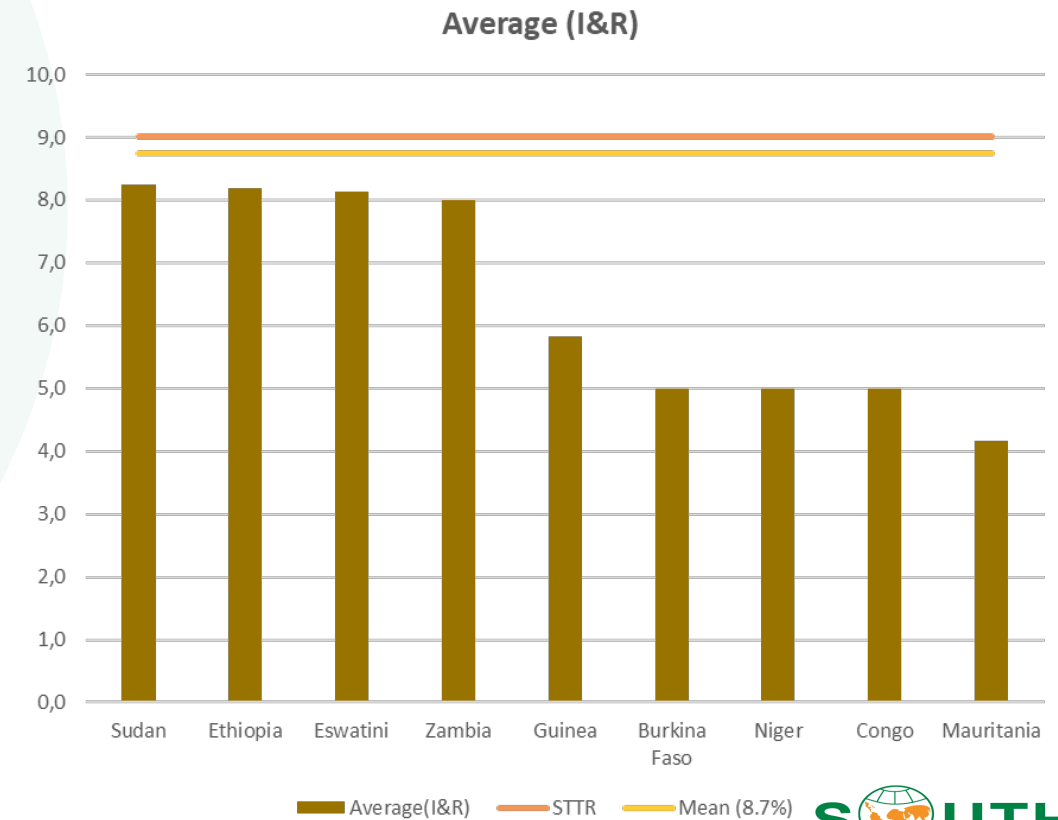
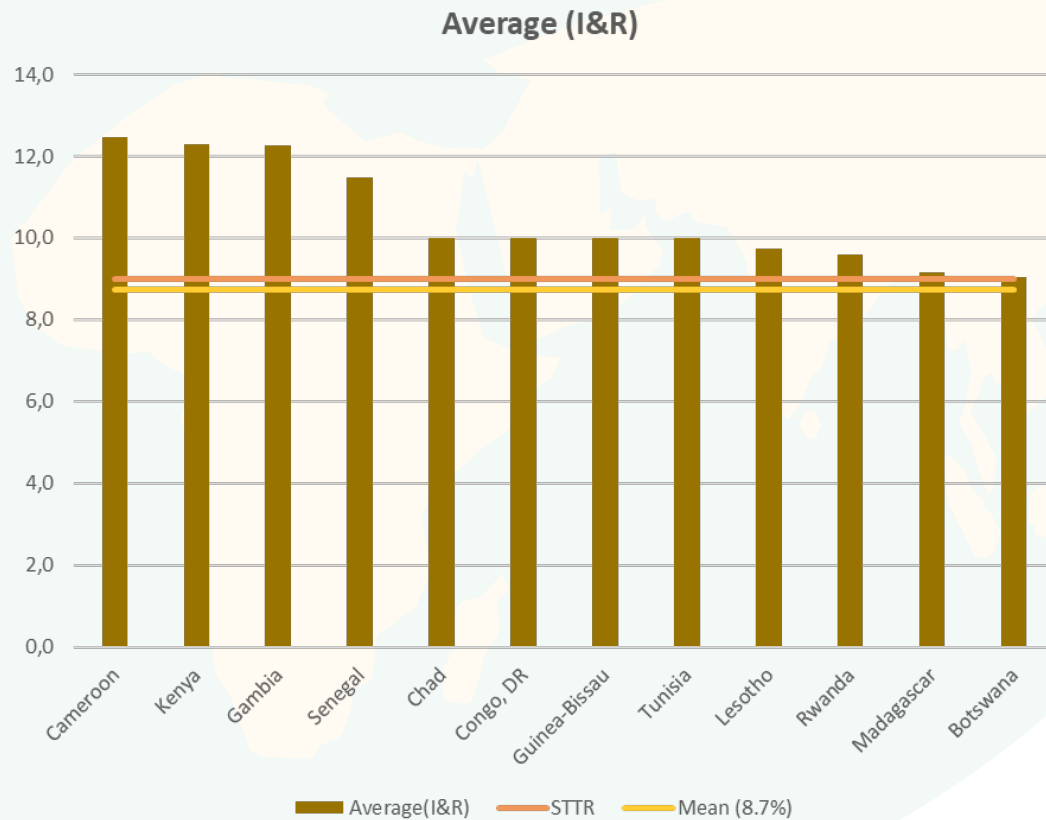
- 13 countries with average rates between 8% and 9%
- 15 countries with average rates below 8%



G-77 and China Member Countries from Africa

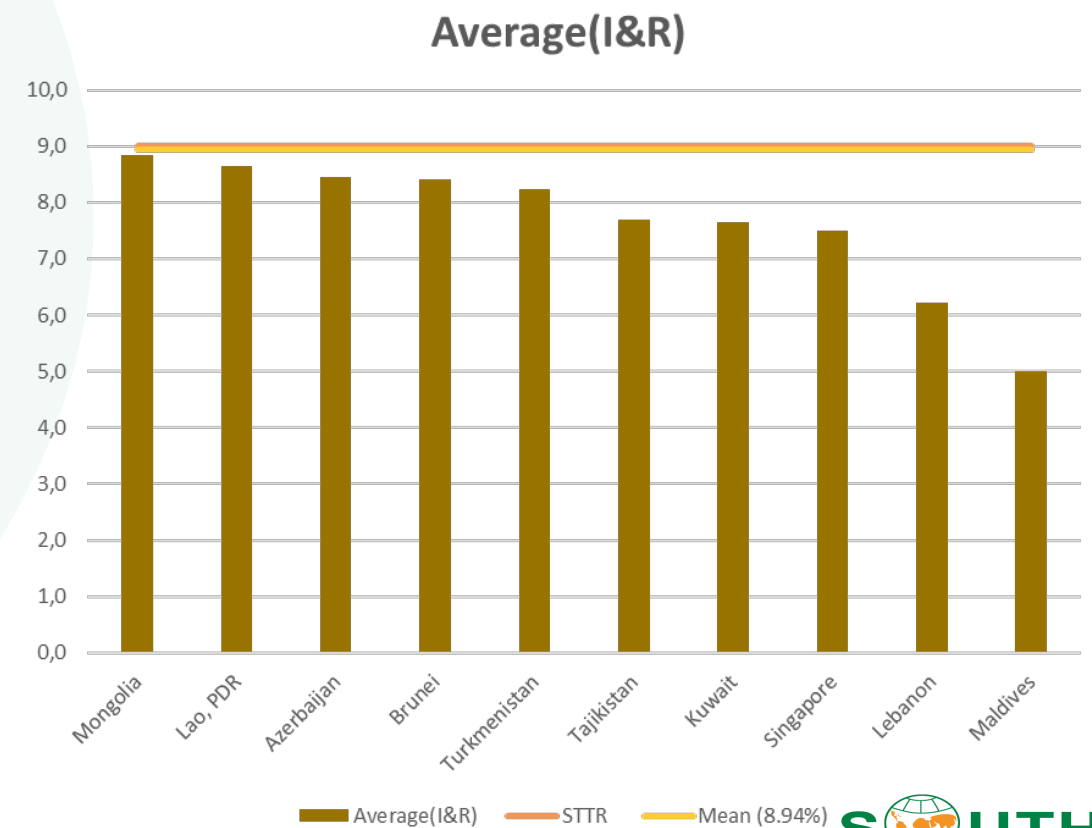
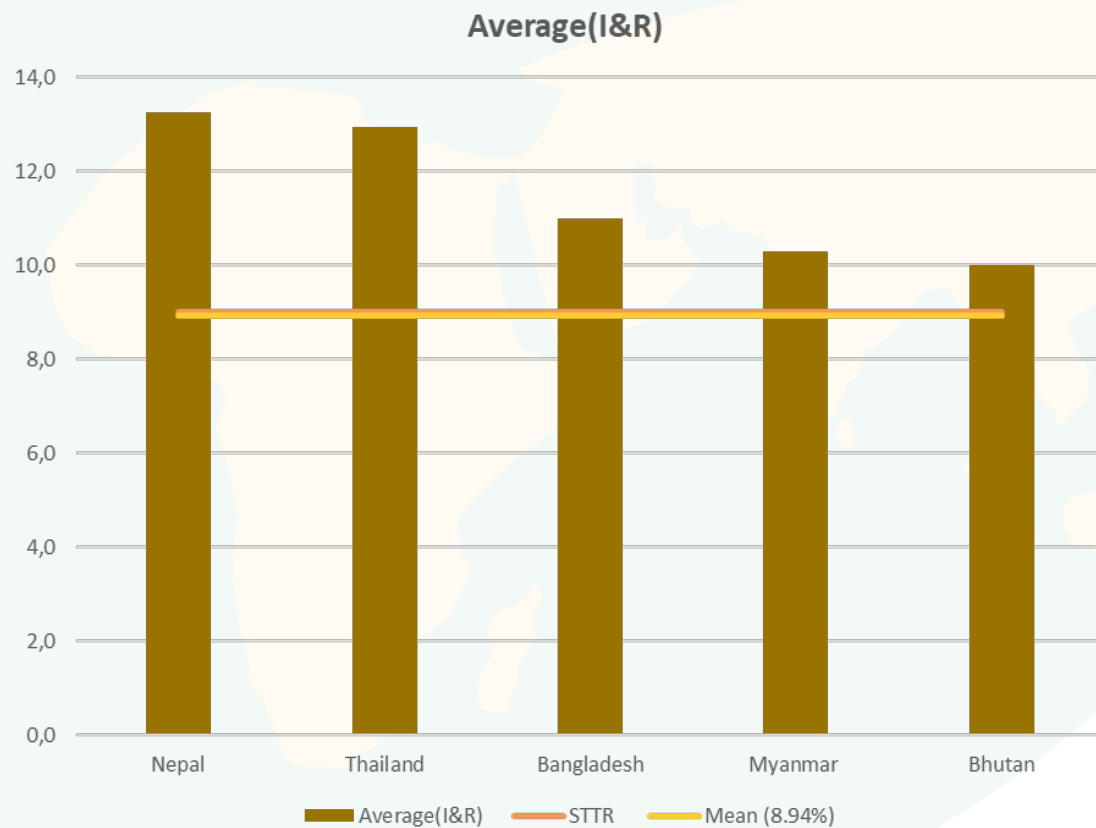
- Total countries: 21
- 12 countries with average rates of 9% or above
- 9 countries with average rates below 9%

- 4 countries with average rates between 8% and 9%
- 5 countries with average rates below 8%



G-77 and China Member Countries from Asia

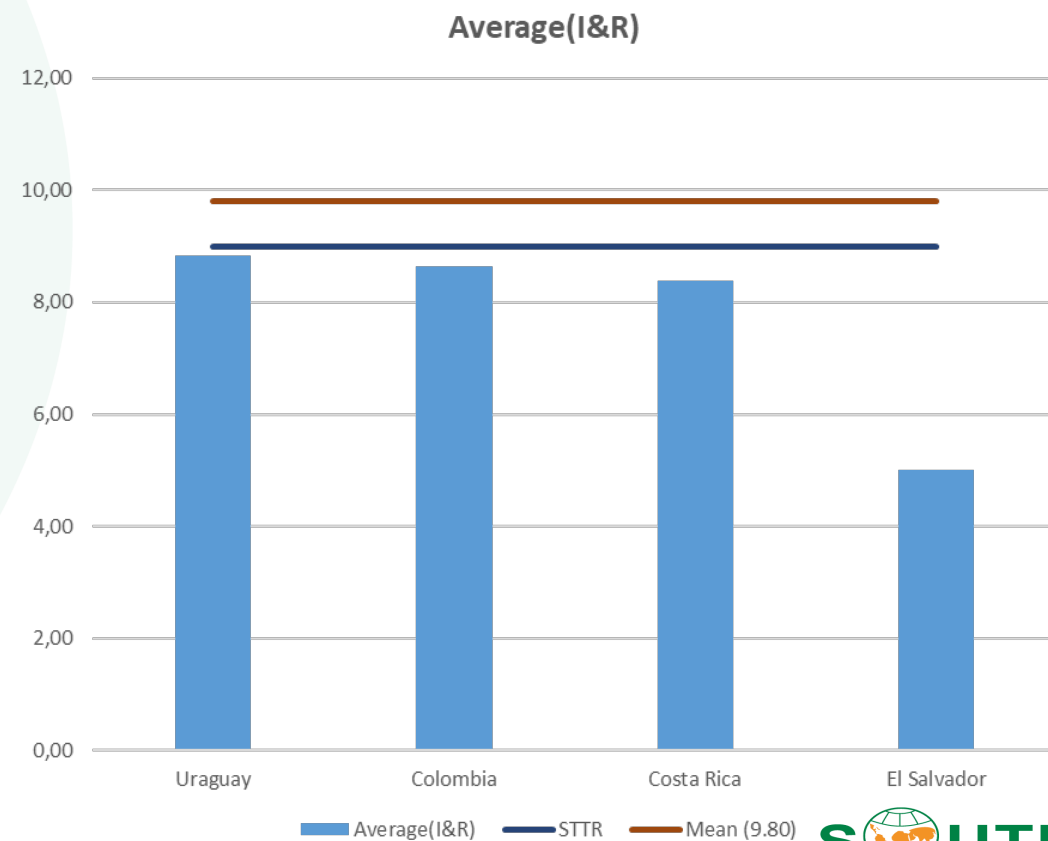
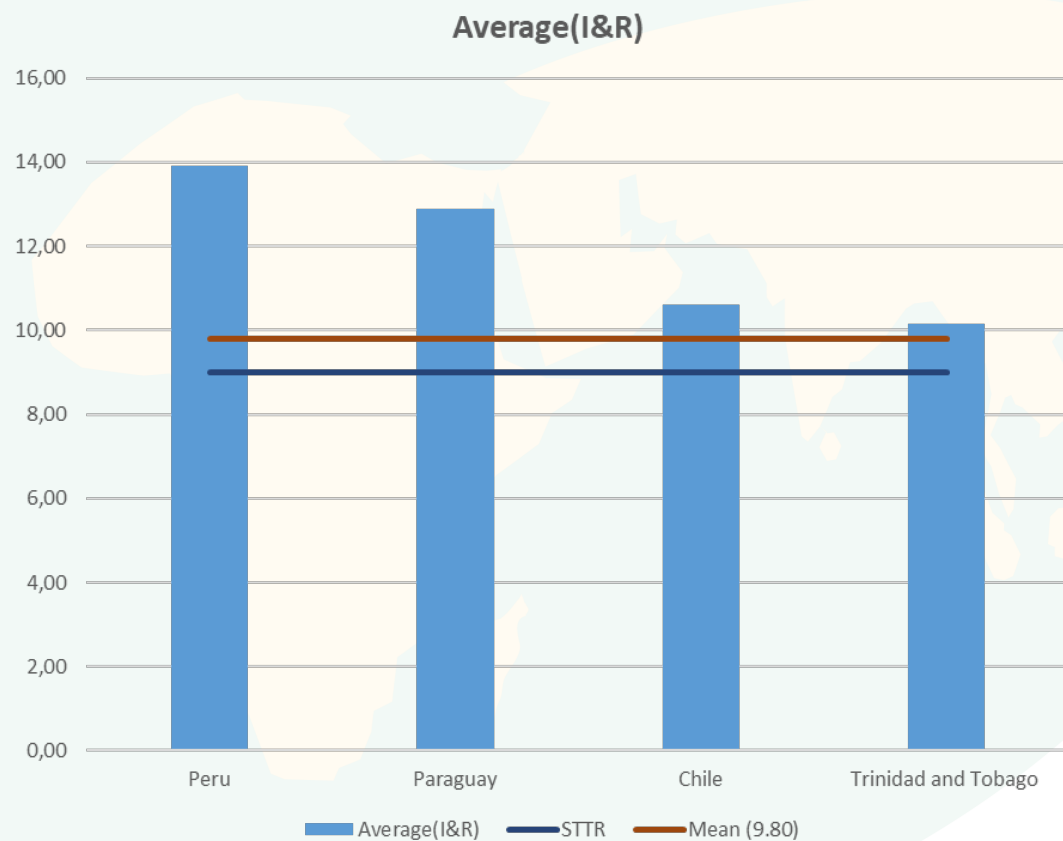
- Total countries: 15
- 5 countries with average rates of 9% or above
- 10 countries with average rates below 9%
- 5 countries with average rates between 8% and 9%
- 5 countries with average rates below 8%



G-77 and China Member Countries from Latin America and Caribbean

- Total countries: 8
- 4 countries with average rates of 9% or above
- 4 countries with average rates below 9%

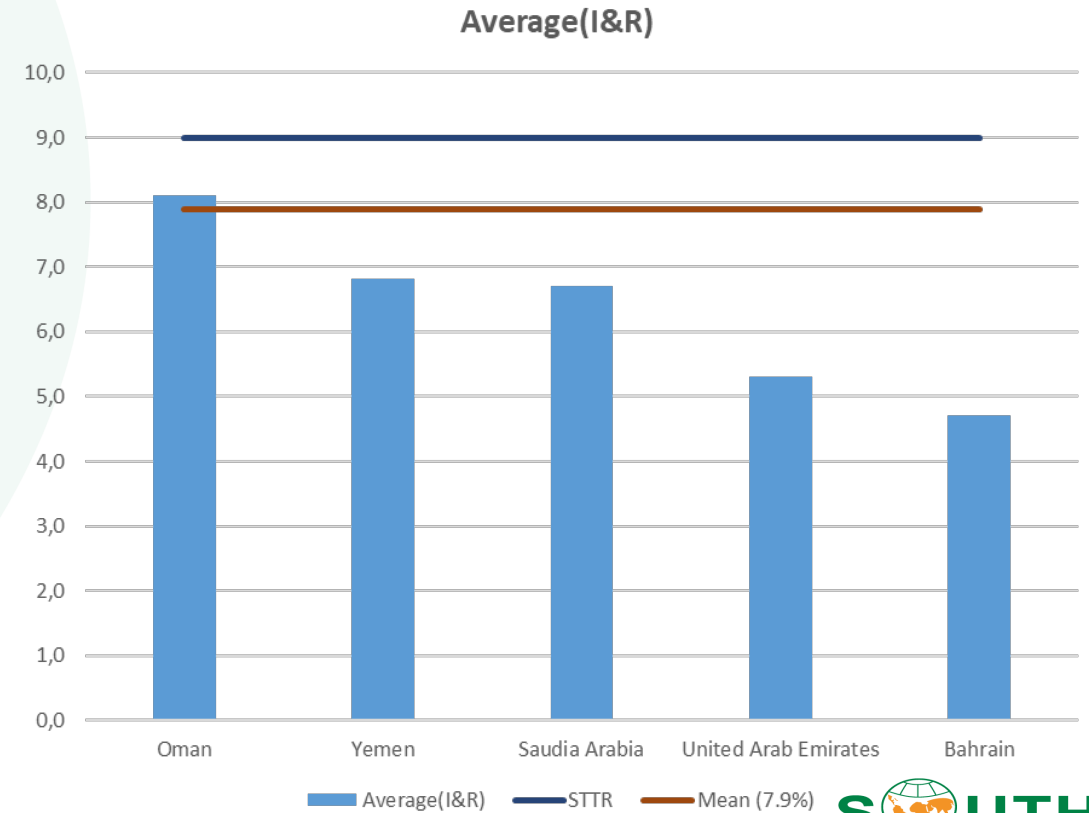
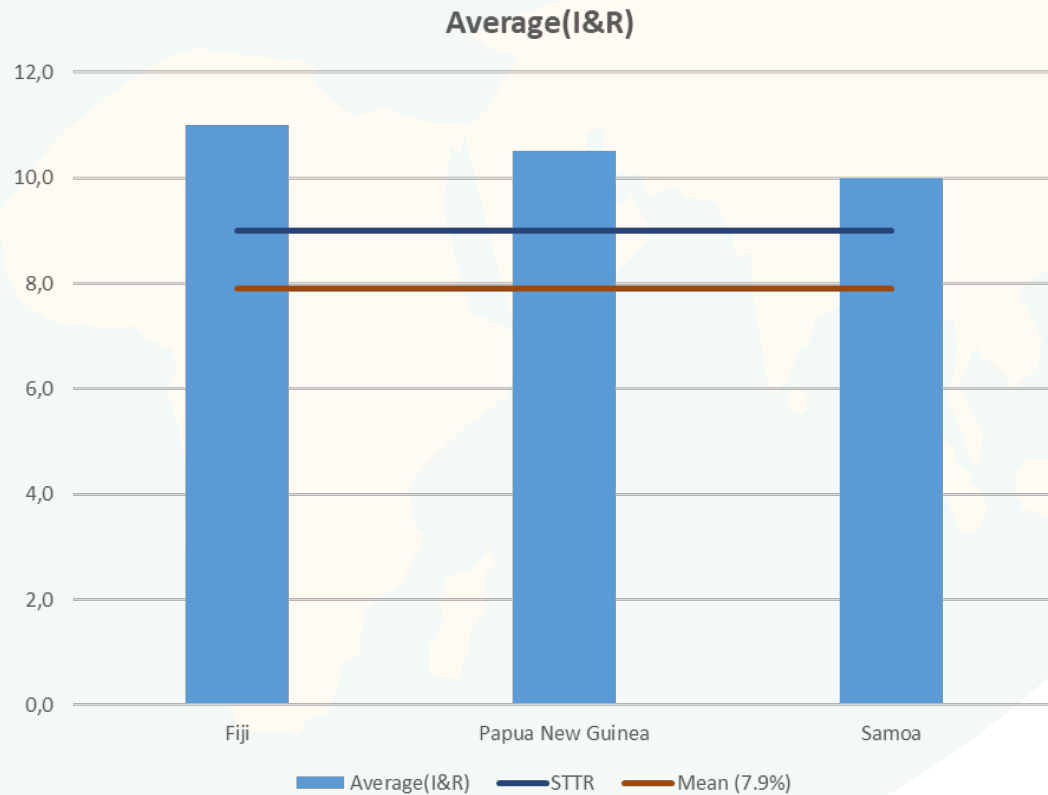
- 3 countries with average rates between 8% and 9%
- 1 country with an average rate of 5%



G-77 and China Member Countries from Middle East and Oceania

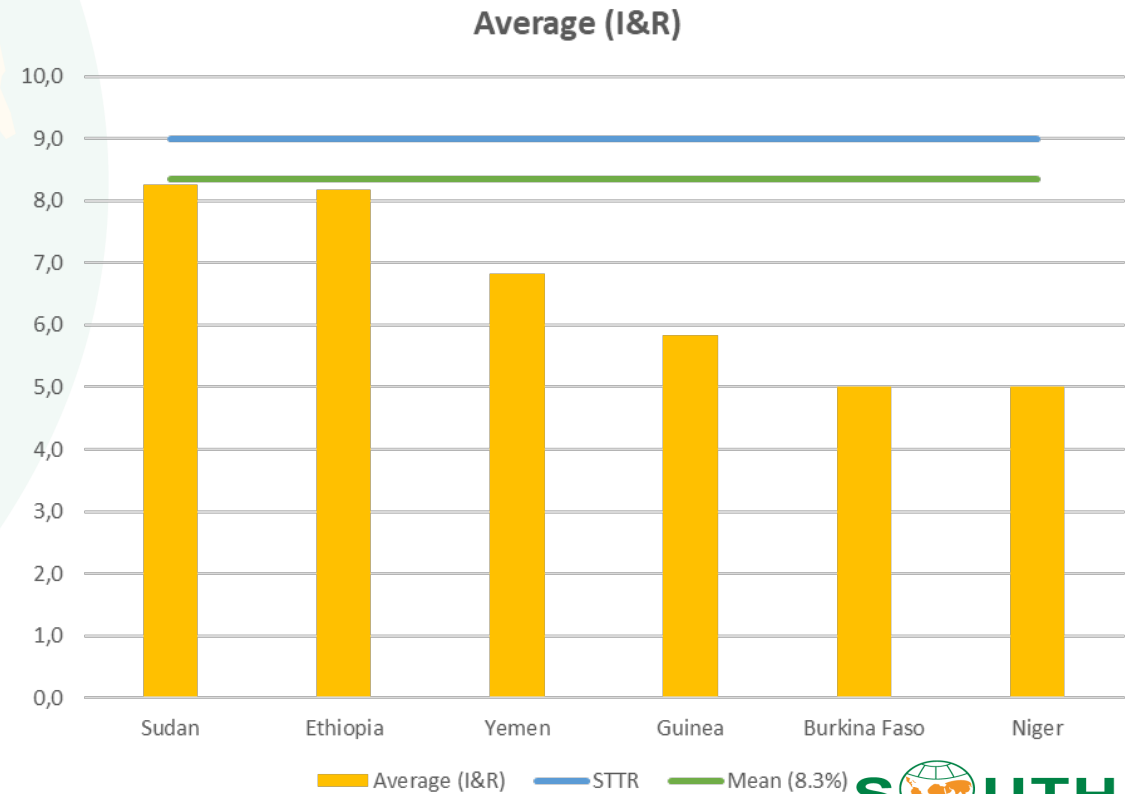
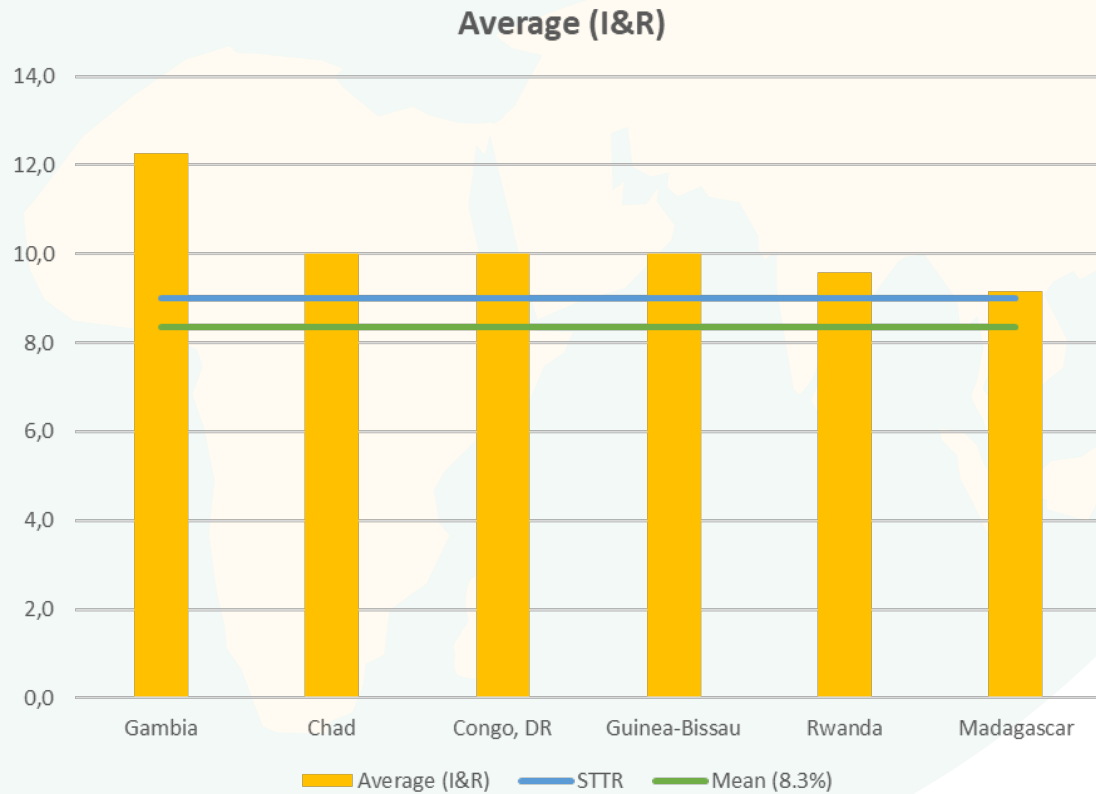
- Total countries : 8
- 3 Countries with average rates of 9% or above
- 5 Countries average rates below 9%

- 1 Countries with average rate between of 8%
- 4 Countries with average rates below 8%



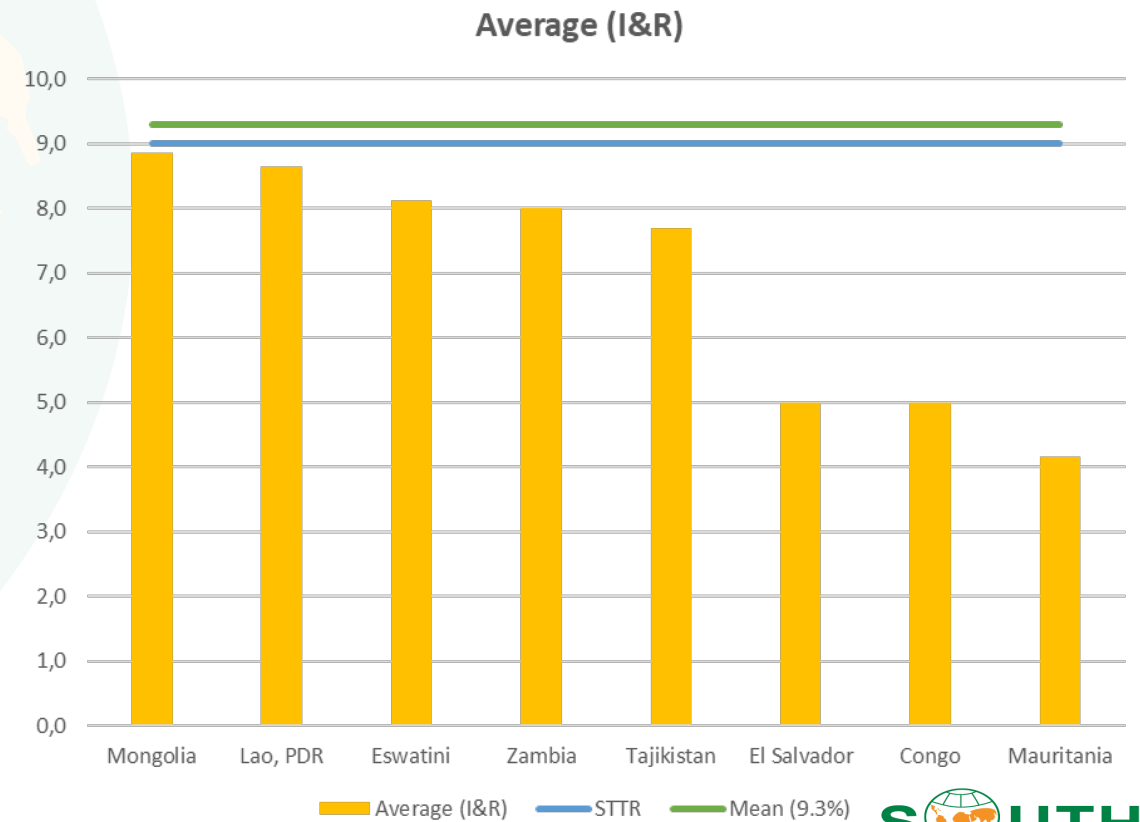
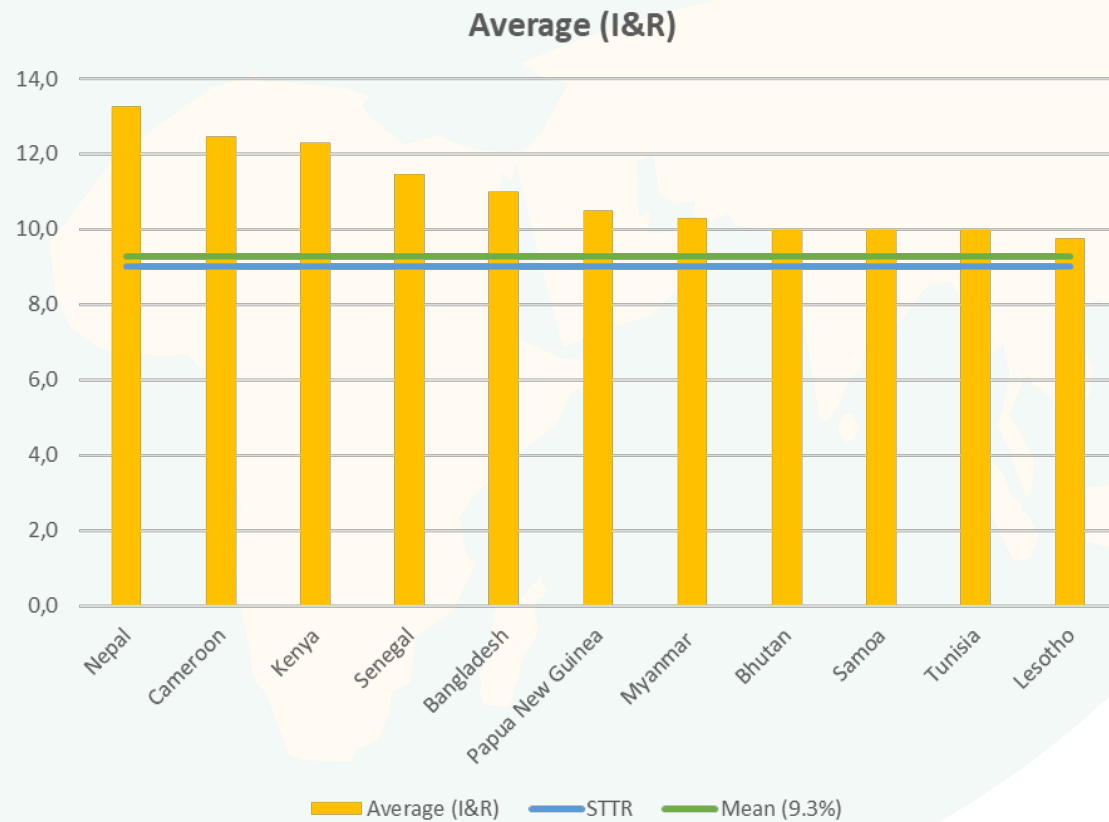
G-77 and China Member Countries by Income category: Low-Income countries

- Total countries: 12
- 6 countries with average rates of 9% or above
- 6 countries with average rates below 9%
- 2 countries with average rates between 8% and 9%
- 4 countries with average rates below 8%



G-77 and China Member Countries by Income category: Lower-Middle Income countries

- Total countries: 19
- 11 countries with average rates of 9% or above
- 8 countries with average rates below 9%
- 4 countries with average rates between 8% and 9%
- 4 countries with average rates below 8%



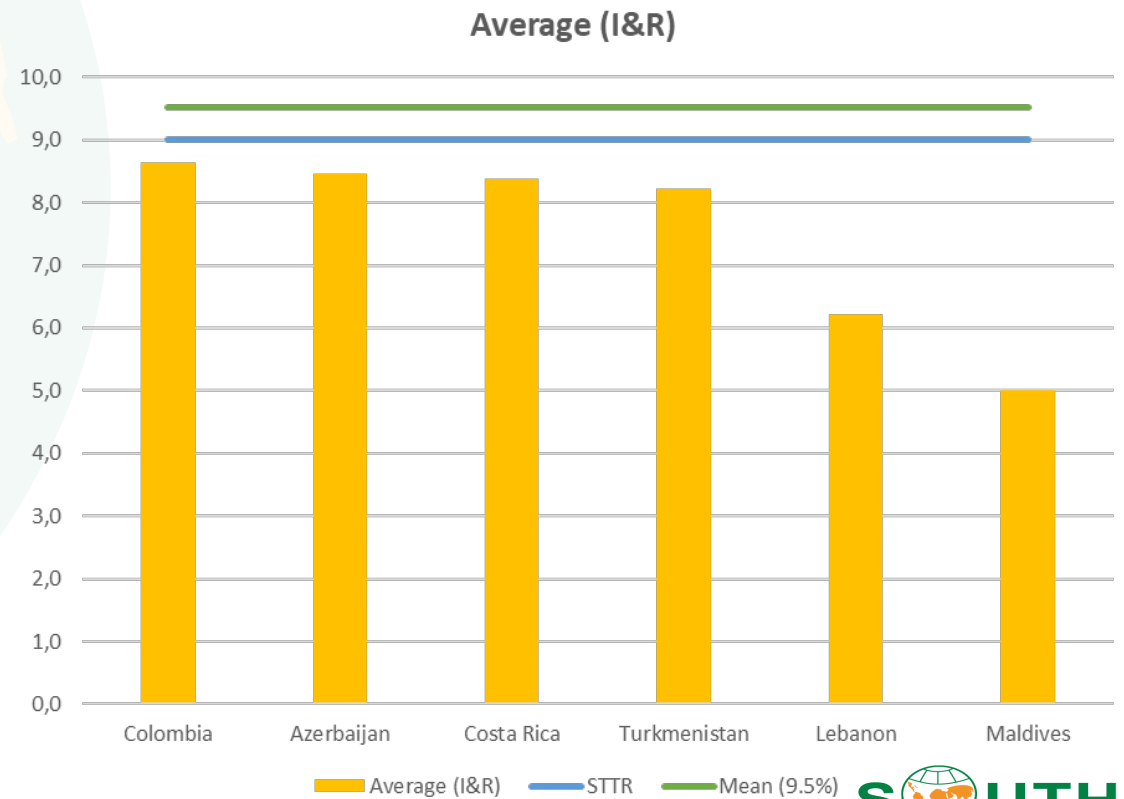
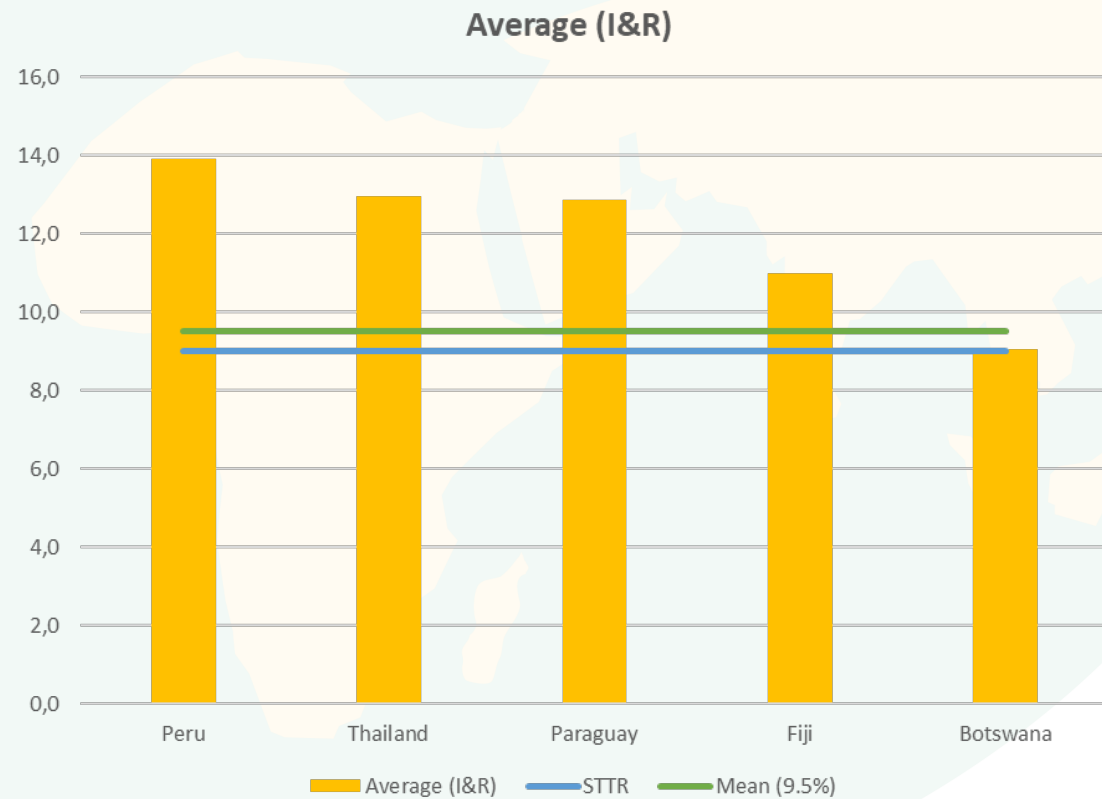
G-77 and China Member Countries by Income category: Upper-Middle Income countries

Total countries: 11

5 countries with average rates of 9% or above

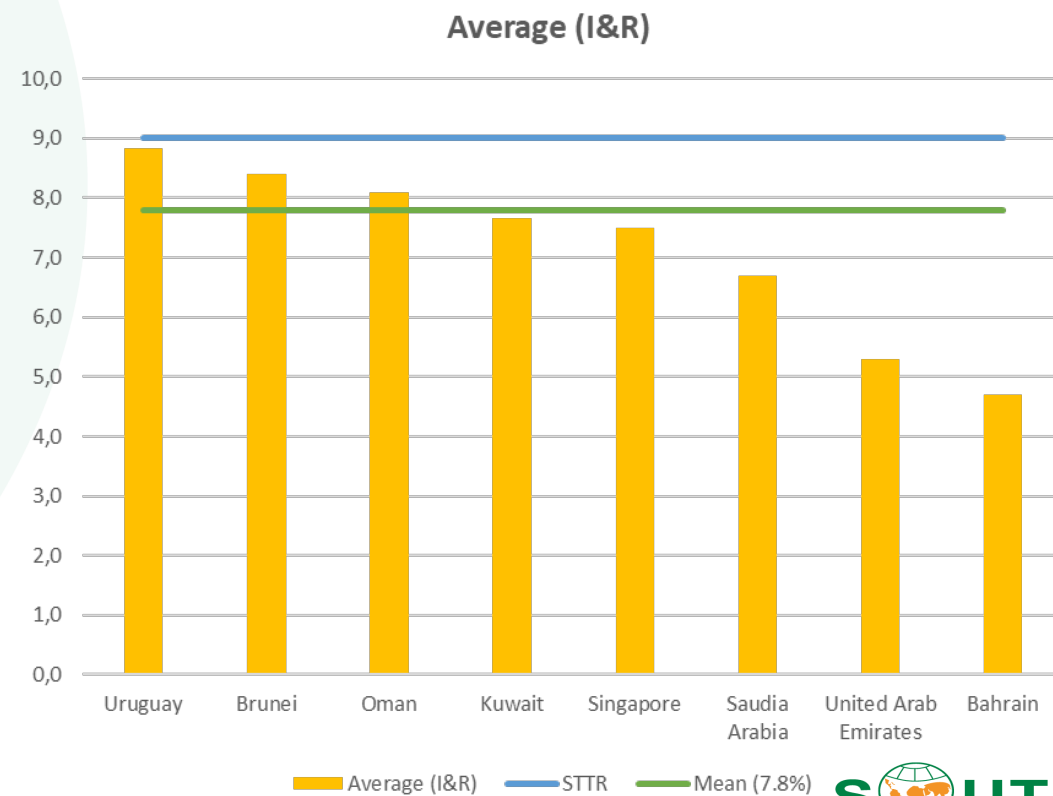
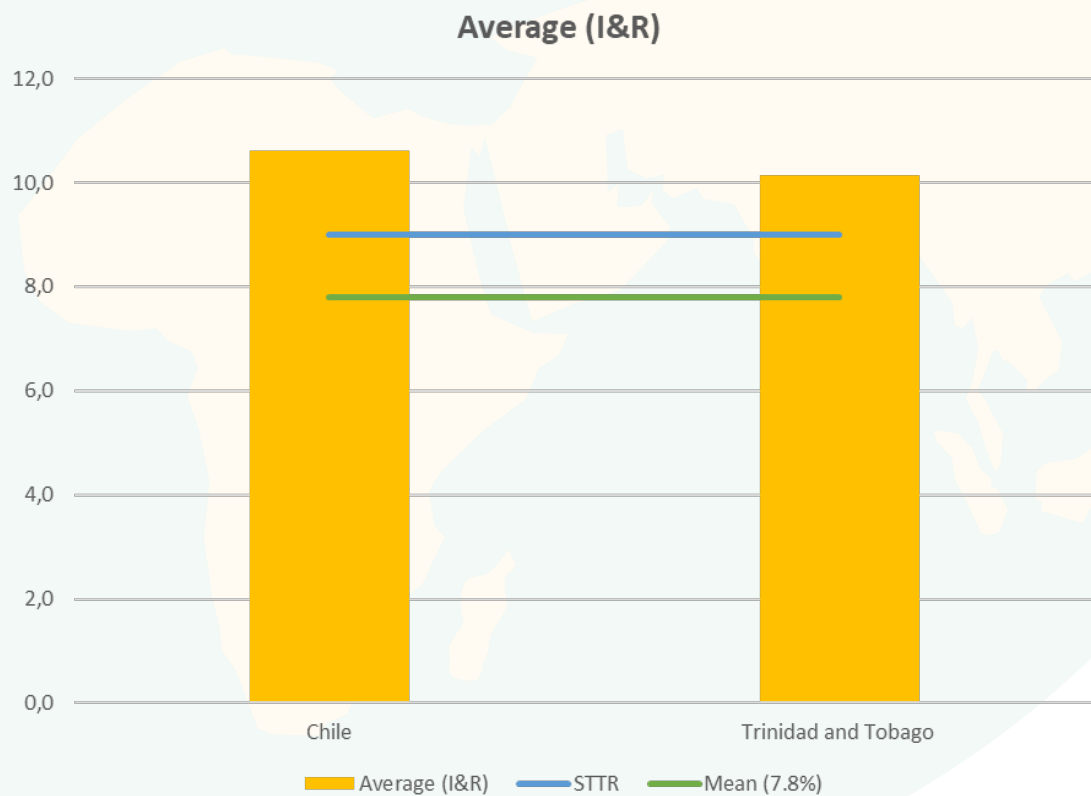
6 countries with average rates below 9%

- 4 countries with average rates between 8% and 9%
- 2 countries with average rates below 8%



G-77 and China Member Countries by Income category: High-Income countries

- Total countries: 10
- 2 countries with average rates of 9% or above
- 8 countries with average rates below 9%
- 3 countries with average rates between 8% and 9%
- 5 countries with average rates below 8%



STTR in UN Model Tax Convention

Pillar Two STTR of limited use for the developing countries

Underlying problem however needs to be solved – opportunity to include a better version of STTR in UN MTC

Possible features:

- Covers all payments covered in DTAA
- Applies to all persons irrespective of their relationship; including individuals
- Simple transaction-based rule
- No low-return exclusion

STTR in UN Model Tax Convention

Materiality threshold can be considered – P2 Blueprint recommends either on MNE Group Size (could be EUR 500 M), tiered value of covered payments (annual value of payments + tier to GDP) or ratio of total value of payments to proportion of total expenditures.

Administrative question – should withholding be imposed on all payments or only “doubtful” payments? Advantage of former is to encourage payees to file returns to obtain the refund while latter is administratively complex.

STTR should also encourage service contracts between parties (related or unrelated) to require disclosure of information related to nominal tax rate to help taxpayers in enforcing the withholding; call for transparency on the tax havens.

Can be added to Article 29 of UN MTC (Entitlement of Benefits) or as a new provision

Enforcement through a possible UN MLI? South Centre Policy Brief outlines structure of such an MLI:

<https://www.southcentre.int/tax-cooperation-policy-brief-15-june-2021/>

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