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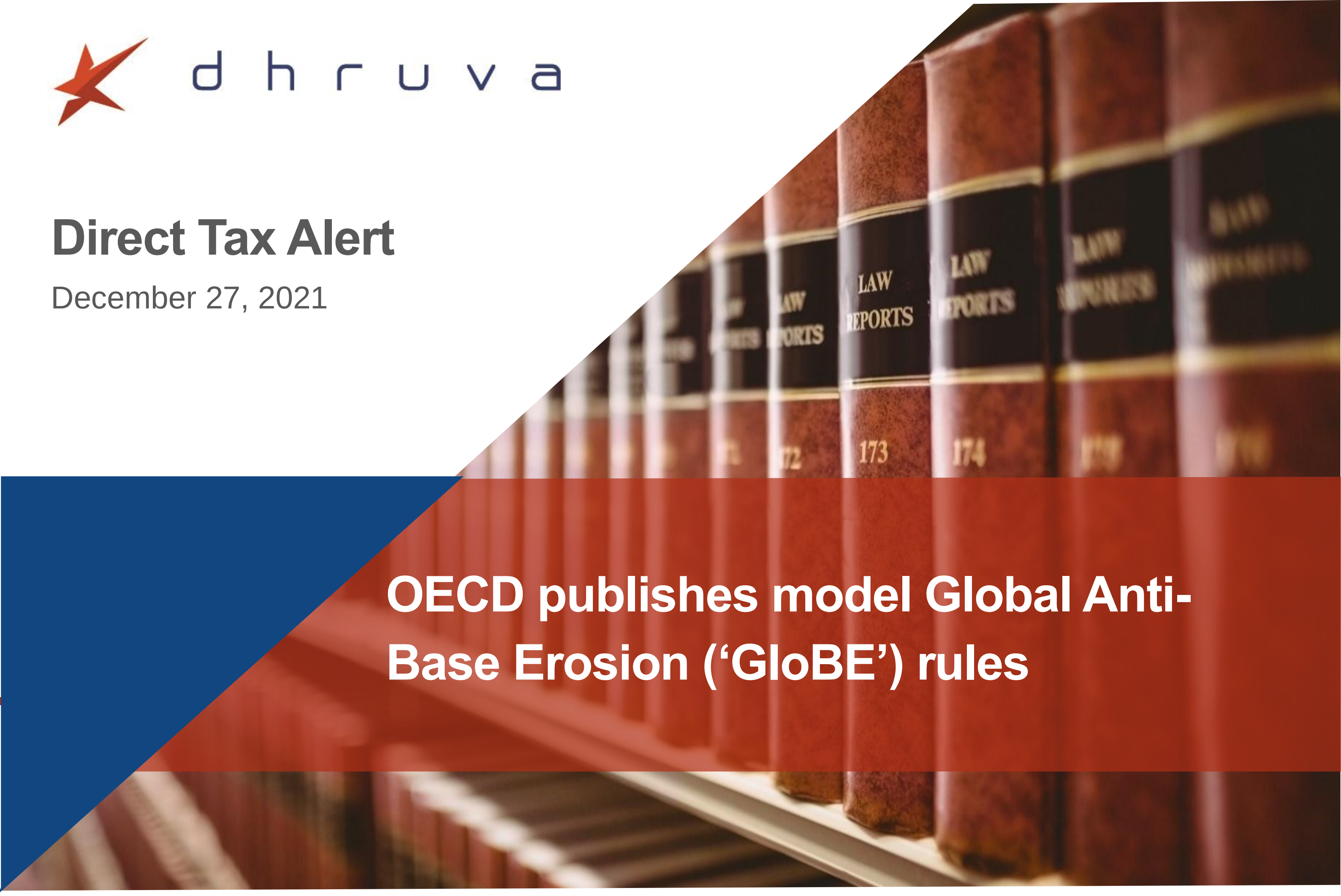
Direct Tax Alert

December 27, 2021



OECD publishes model Global Anti-Base Erosion (‘GloBE’) rules

In continuation of the work being carried out by the OECD / G20 Inclusive Framework to address the tax challenges arising from digitalisation of the economy, the OECD has recently released Model Rules which lay down the key operative provisions of the Pillar Two approach.

Introduction

- With the immense proliferation of digital means of doing business and incoherence of the existing tax systems to deal with digitisation, taxation of digital economy has been a key policy issue of the BEPS framework. Action Plan 1 of the Base Erosion and Profit Shifting (‘BEPS’) project addresses the tax challenges arising from digitalisation. The OECD / G20 Inclusive Framework has made major progress in development of Two-Pillar approach for, inter-alia, addressing the tax challenges of the digital economy. Until end of November 2021, the key components of Two-Pillar approach have received approval of 137 members jurisdictions, representing more than 95% of global GDP.

- Whilst Pillar One provides for a mechanism to allocate profits amongst home and market jurisdictions, Pillar Two also referred to as ‘Global Anti-base Erosion Rules’ (‘GloBE Rules’) provides that all countries will impose a minimum tax of 15 per cent on corporates. This is an important step towards eliminating tax havens and addressing the issue of harmful tax competition. While countries may still choose to not impose a 15 per cent tax, Pillar Two provides that where profits are earned in jurisdictions where the rate of tax is less than 15 per cent, the home jurisdiction or the source jurisdiction can tax those profits by way of application of following rules:

Income Inclusion Rule ('IIR')	Parent company pays top-up tax[1] on its proportionate share of income of its group entity located in low-tax jurisdiction
Undertaxed Payments Rule ('UTPR')	This rule kicks in especially in cases where IIR is inapplicable. As per UTPR, payments made to entities located in low tax jurisdictions are disallowed to the extent required to make the ETR of the entity at 15%. IIR has priority over UTPR.
Subject to tax Rule ('STTR')	This Rule triggers when the covered payment is subject to nominal rate of tax in payee jurisdiction. For example, if the payment is taxable at 5% in payee jurisdiction, as per STTR, additional withholding tax of 4% will apply in the payer jurisdiction (irrespective of the tax treaty rate).
Switch-Over Rule ('SOR')	Compliments the IIR by providing an enabling mechanism to overturn tax treaty obligations.

- On 20 December 2021, the OECD released Model Rules[2] on Pillar Two (along with a summary[3] and FAQs[4]) which are intended to assist countries to translate them into domestic law within the agreed timeframe and in a coordinated manner. A detailed commentary on the Model Rules is expected to be released early next year.

GloBE Rules

- As per the Model Rules released by the OECD, the steps in determining the top-up tax liability of a Multinational Enterprise ("MNE") are illustrated below:

[1] Amount of tax required to make the Effective Tax Rate ('ETR') at 15%
[2] https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf
[3] https://www.oecd.org/tax/beps/pillar-two-model-rules-in-a-nutshell.pdf
[4] https://www.oecd.org/tax/beps/pillar-two-model-GloBE-rules-faqs.pdf

Step 1- Identify the MNE Group, its Constituent Entities and their location

Step 2- Compute GloBE income or loss

Step 3 - Compute Covered Taxes

Step 4 - Compute Effective Tax Rate ('ETR') and Top-up tax at a jurisdictional level

Step 5 - Payment of top-up taxes under IIR and UTPR approach

Identify the MNE Group, its Constituent Entities ('CE') and their location

- The MNE Group is defined to mean any Group that includes at least one entity or Permanent Establishment ('PE') that is not located in the jurisdiction of the Ultimate Parent Entity. Rules provide for exclusion of specified entities5 from scope of MNE group.

- The GloBE rules are applicable to MNE group having annual revenues exceeding Euro 750 million in Consolidated Financial Statements ('CFS') of the Ultimate Parent Entity ('UPE') in at least two out of four fiscal years immediately preceding the tested financial year.

- The Group shall comprise of entities that are related through ownership or control such that the assets, liabilities, income, expenses and cash flows of those entities are included in the CFS of the UPE; or are excluded from the CFS of UPE solely on size or materiality grounds, or on the grounds that the entity is held for sale.

Compute GloBE income or loss

- The starting point for determining GloBE income of a CE is the net income or loss that is used for preparing CFS of the UPE. The GloBE income or loss is then subjected to certain specified adjustments[6]. The net income or loss for each constituent entity is determined basis the accounting standards used in preparation of CFS of UPE without eliminating consolidation adjustments for intra-group transactions.

- The Rules further provide that net income or loss of the PE shall be computed separately from the main entity. However, GloBE loss of the PE would be treated as 'Expense' of main entity. Any subsequent profits of the PE would be treated as GloBE income of the main entity (not of the PE) to the extent of recovery of earlier GloBE loss of the PE claimed as an

[5] Government entities, International Organization, Non-Profit Organization, Pension Funds, Investment Fund and Real Estate Investment Vehicle which are UPE, and certain other entities owned by aforementioned entities

[6] Net tax expense, Excluded dividends, Excluded equity gain or loss, Included revaluation method gain or loss, Gain or loss from disposition of certain assets and liabilities, Asymmetric foreign currency gains or losses; Policy disallowed expenses; Prior period errors and changes in accounting principles; and Accrued pension expense

expense. Separate mechanism has been provided for allocation of income or loss of flow-through entities[7].

Compute Covered Taxes

- 'Covered Taxes' means taxes recorded in the financial accounts of a constituent entity with respect to its income or profits or its share of the income or profits of a constituent entity in which it owns an ownership interest.
- The starting point for the computation of Covered Taxes is the current tax expense accrued for Financial Accounting Net Income or Loss subject to certain specified adjustments for deferred taxes, tax credits, etc.
- The Rules provide that covered taxes shall also include taxes on distributed profits, deemed profit distributions, taxes imposed in lieu of a generally applicable corporate income tax; taxes levied by reference to retained earnings and corporate equity, etc. However, top-up tax under GloBE rules is excluded from scope of Covered Taxes.
- The Rules provide for a mechanism with respect to allocation of covered taxes in cases of PE's, tax transparent entities, hybrid entities, CFC taxes, etc.

Compute Effective Tax Rate and Top-up Tax

The computation of ETR and top-up taxes could be divided into following steps:

Step 1	Compute jurisdiction wise Effective Tax Rate **ETR =** $\frac{\textit{Sum of Adjusted Covered Taxes of each constitutent entity in a jurisdiction}}{\textit{Net GloBE income}}$ [8]
Step 2	Where ETR is lower than minimum rate of 15%, compute Top-up tax percentage as under: *Top-up tax percentage = Minimum Rate – Effective Tax Rate*
Step 3	Compute jurisdictional excess profits *Excess Profits = Net GloBE income – Substance based Income Exclusion*[9]
Step 4	Compute 'Jurisdictional top up tax' *Jurisdictional top-up tax = Top up tax percentage * excess profits*
Step 5	Computation of Top-up tax of each constituent entity **Top-up tax of CE** = $Jurisdictional\ top-up\ tax \times \frac{GloBE\ income\ of\ CE}{Aggregate\ income\ of\ all\ CEs}$

- The GloBE rules provide for *De Minimus exclusion* from payment of top-up tax. No tax would be payable in a jurisdiction, if average GloBE revenue from such jurisdiction is less than EUR 10 million and average GloBE profit or loss from

[7] The Rules define flow-through entity as a tax transparent entity or reverse hybrid entity with respect to its income, expenditure, profit or loss to the extent that it is not fiscally transparent in the jurisdiction in which the owner is located, unless it is tax resident and subject to a Covered Tax on its income or profit in another jurisdiction.
[8] Net GloBE income is aggregate of GloBE income of all constituent entities as reduced by aggregate GloBE losses of all constituent entities in a particular jurisdiction.
[9] Substance based income exclusion is sum of payroll carve-out and tangible asset carve-out for each constituent entity. In first year of implementation, Payroll carve-out is allowed at 10% of eligible payroll cost of eligible employees which perform activities of MNE group in such jurisdiction, whereas Tangible assets carve-out is allowed at 8% of carrying value of eligible tangible assets located in such jurisdiction, which shall be reduced to 5% each over a period of 10 years of implementation.

such jurisdiction is a loss or is less than EUR 1 million computed on a three-year average basis.

- A special mechanism for recalculation of ETR of previous years is provided, where there is a material reduction in tax liability of that year. To the extent additional Top-up Tax liability results from such adjustment, the amount of Top-up Tax is to be paid in the current fiscal year (i.e., no amended return is required for the prior year).

Payment of top-up tax under Income Inclusion Rule ('IIR') and Undertaxed Payments Rule ('UTPR') approach

- The IIR follows a top-down approach. The UPE or next Intermediate Parent Entity in the ownership chain would be liable to pay the allocable top-up tax of the low-taxed constituent entity. However, where the ownership interest is held by a Partially Owned Parent Entity[10], such entity would discharge only the allocable share of top-up tax.

- Parent entity's allocable top-up tax shall be calculated by multiplying top-up tax of each constituent entity with Parent Entity's Inclusion Ratio[11].

  *Parent entity's allocable top-up tax = Top-up tax of each constituent entity * Parent Entity's Inclusion Ratio*

- Where several parent entities are liable to pay top-up tax, the parent entity which is higher in ownership chain shall be allowed to off-set the top-up tax paid by lower-tier intermediate parent entity or partially owned parent entity.

- Furthermore, the Rules provide that UTPR shall operate as a back-up mechanism, where the low-taxed constituent entity is beneficially owned by UPE which is not covered within the scope of IIR. Under UTPR, the Constituent Entities of MNE Group shall be denied a deduction (or required to make an equivalent adjustment under domestic law) in an amount resulting in those Constituent Entities having an additional cash tax expense equal to the UTPR Top-up Tax Amount for the Fiscal Year allocated to that jurisdiction. Where adjustment is insufficient to produce additional cash expense during the fiscal year, the difference shall be carried forward to succeeding fiscal years.

- The Total UTPR Top-up Tax Amount for a Fiscal Year shall be equal to the sum of the Top-up Tax calculated for each Low-Taxed Constituent Entity of an MNE Group for that Fiscal Year.

- The UTPR Top-up tax shall be allocated amongst UTPR jurisdictions as under:

$$50\% * \frac{Number\ of\ employees\ in\ jurisdiction}{Number\ of\ employees\ in\ all\ UTPR\ jurisdictions}$$

$$+ 50\% * \frac{Total\ value\ of\ tangible\ assets\ in\ jurisdiction}{Total\ value\ of\ tangible\ assets\ in\ all\ UTPR\ jurisdictions}]$$

[10] Constituent Entity that has more than 20% of the Ownership Interests held by non-group members.

[11] A Parent Entity's Inclusion Ratio is calculated as ratio of (a) the GloBE Income of the Low-Taxed Constituent Entity for the Fiscal Year, reduced by the amount of such income attributable to Ownership Interests held by other owners, to (b) the GloBE Income of the Low-Taxed Constituent Entity for the Fiscal Year

Compliance

- Every constituent entity shall be liable to file a GloBE Information Return with the tax administration by itself or through designated local entity within 15 months from last day of the reporting fiscal year. However, where the UPE or designated filing entity is located in a jurisdiction having qualifying competent authority agreement in effect with jurisdiction of constituent entity for the reporting fiscal year, such constituent entity shall notify the identity and jurisdiction of the entity filing the GloBE information return to its jurisdictional tax administration.

Transitional rules

- Safe-harbour rules shall be developed to limit compliance and administration burden for MNE's operations that are likely to be taxable at or above 15% on a jurisdictional basis and shall be published in the Implementation Framework to be released in 2022.

- Relief shall be allowed to MNEs from applicability of UTPR rules during initial phase of international activities.

Dhruva Comments

The Two-Pillar approach marks a revolutionary development on international tax front. Traditionally, MNEs adopt practices to park their profits in low-tax jurisdictions. However, multilateral agreements on minimum global tax would nullify such base erosion and profit shifting practices of the MNEs. Notably, countries like UAE, Switzerland, Netherlands, etc., traditionally referred as tax havens or low-taxed jurisdictions have agreed on implementation of the Two-Pillar framework. This would enhance the tax cost of the MNE Group and could also incentivize MNEs to shift profits back to home jurisdictions having actual operations and substance. This may have impact on international trade corridors.

The MNEs would need to assess and examine the alignment of existing ownership and supply chain with the new rules after assessment of existing structures, understanding of new rules and modeling of alternative structures. The integration of Two-Pillar rules with existing domestic laws and treaty network would be important aspect to be watched out in 2022. Multilateral instrument shall be signed for implementation of rules for implementation from 2023.

The OECD statement released in October 2021, discussed treaty-based 'Subject to Tax Rule ('STTR') that allows source jurisdictions to impose limited source taxation to certain related party payments subject to tax below a minimum rate of 9%. The final blueprint of STTR and detailed rules regarding the same is expected by March 2022. The countries are expected to translate these Model Rules into domestic law. Given that the Rules are expected to come into force in 2023, the process of enacting them into the domestic law should happen in 2022. One needs to watch out whether India makes necessary amendments as part of the forthcoming budget exercise, or whether this will happen by way of a separate process later in the year 2022.

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