



GLOBAL MINIMUM TAX

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Background

The Organisation for Economic Co-operation and Development (“OECD”) published its Model Global Anti-Base Erosion (“GloBE”) Rules - Pillar Two, of its Inclusive Framework on Base Erosion and Profit Shifting (BEPS) in December 2021 (“Pillar Two”). The Pillar Two rules will impose top-up taxes where the effective rate of tax of the jurisdiction in which a Multinational Enterprises (“MNE”) is placed, is below the global minimum corporate tax rate. These rules are set to come into effect in the backdrop of the long-standing concerns regarding MNEs shifting their profitable activities to subsidiaries in low taxed jurisdictions for tax avoidance.

Scope of Pillar Two

Global minimum taxation under Pillar Two affects MNEs with a minimum turnover of Euro 750 Million in the Consolidated Financial Statements of the Ultimate Parent Entity in at least two of the four Fiscal Years immediately preceding the tested Fiscal Year.¹ Pillar Two seeks to ensure that the income of entities, arising in various jurisdictions, is taxed at an effective rate of at least 15% which is sought to be achieved through the levying of a "top-up tax". A *de minimis* exemption can be claimed in jurisdictions with average GloBE Revenue of less than Euro 10 Million and average GloBE Income / Loss of less than Euro 1 Million. If a jurisdiction qualifies as such, the top-up tax for Constituent Entities (entities to which the rules apply) in such jurisdiction will be deemed to be zero.

A commitment to the Pillar Two Rules by a country, however, does not require it to introduce the GloBE Rules in its local legislation. It in effect requires a country to accept the application of the rules by other countries, and to act consistently if the country subsequently decides to adopt its implementation. The implementation of Pillar Two is expected to begin in 2023.

Structure in a Nutshell

Pillar Two has incorporated the following taxing structure which will be followed in implementing the global minimum tax.²

- a. Income Inclusion Rule (IIR) that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate which is below 15%, up to the said ceiling. The Ultimate Parent Entity’s jurisdiction has the first right to apply the IIR. If such jurisdiction does not apply the IIR, then an intermediate parent jurisdiction may apply the rule;
- b. Undertaxed Payments Rule (UTPR) 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 under IIR when the

¹ OECD (2021), Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS, OECD, Paris, <<https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm>> , Article 1.1.1

² This is a high level summary of the proposals and a very broad categorization.

minimum tax threshold is not met in the source country. The right to top-up tax under the UTPR is given to Constituent Entities (as explained below) in the jurisdictions that have implemented the UTPR;

- c. Subject to Tax Rule (STR) that would complement the UTPR by subjecting a payment to withholding or other taxes at source where the payment is not subject to tax at a minimum rate. This overrides Treaty benefits for certain related party payments and allows jurisdictions to charge top up tax when payments are made to group entities in low tax jurisdictions below 9%.

Key Elements

MNE Group

The Articles of Pillar Two which sets out its scope specify that the rules apply to Constituent Entities that are members of an MNE Group. An MNE Group means all entities which are included in the consolidated financial statements of the Ultimate Parent Entity, if at least one Entity or Permanent Establishment is not located in the jurisdiction of the Ultimate Parent Entity³ (i.e., each such entity will be a Constituent Entity). The following entities are however excluded from the scope of Constituent Entities:

- (a) a Governmental Entity;
- (b) an International Organisation;
- (c) a Non-profit Organisation;
- (d) a Pension Fund;
- (e) an Investment Fund that is an Ultimate Parent Entity;
- (f) a Real Estate Investment Vehicle that is an Ultimate Parent Entity.⁴

Effective Tax Rate

The aim of Pillar Two, as stated above, is to maintain a uniform ‘effective tax’ floor, and to that extent, rather complex methods have been set out for the purpose of computing such effective tax rate for every tax jurisdiction. Effective Tax Rate is calculated on a jurisdictional basis. The Adjusted Covered Taxes of all Constituent Entities in the jurisdiction is divided by the Net Global Income of all Constituent Entities in the jurisdiction to arrive at the ETR as follows:

$$\text{ETR} = \frac{\text{Aggregated Adjusted Covered Taxes}}{\text{Net GloBE Income}}$$

³ *Supra* note 1, Article 1.2.1

⁴ *Supra* note 1, Article 1.5.1

The “GloBE Income / Loss” of each Constituent Entity and the “Adjusted Covered Taxes” of each Constituent Entity is computed after making several adjustments to the Accounting Net Income or Loss and the Current Accrued Tax Expense extracted from the financial statements of such Constituent Entity respectively.

Only Taxes on income or profits are considered for this purpose⁵ and taxes based on revenue are arguably kept out of the scope of computing Covered Taxes. While Deferred taxes are included, it is to be computed at the lower of 15% and the domestic tax rate. This may result in top up tax becoming due even in respect of high tax locations when brought forward losses are being utilized.

Conclusion

The Pillar Two arrangement requires enhanced levels of corporation among the proposed signatories. The supposed benefits that are to be reaped will be futile if this coordination is not achieved. While the proposals have seen great support from many countries, Kenya, Pakistan, Nigeria and Sri Lanka are yet to subscribe to these rules.⁶ However, in the current context of various speculation on Sri Lanka’s potential plans to join the global minimum tax agreement, it must not be forgotten that Pillar Two will increase compliance burdens as a result of its specific reporting obligations.

⁵ *Supra* note 1, Article 4.2.1

⁶ OECD, International community strikes a ground-breaking tax deal for the digital age <<https://www.oecd.org/tax/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm>> accessed 19 October 2022