All about Two-Pillar Solution!! -Part-1

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❖ **The Journey hitherto…**

The digitalization and the globalization have created a massive impact on the economy as a whole and on the lives of the people around the world. This has brought many benefits like in terms of growth, employment, reduced cost, saving time etc. at the same time this has also brought various challenges to law makers in terms of drafting rules for taxing international business income. Currently many multinational enterprises (MNEs) are not paying their true share of taxes to the countries from which they are making money. Now a days, the MNEs are adopting various business models to target the new market. The digitalization has enabled businesses to have significant engagements with the clients and users in the jurisdiction without having any physical presence in such market jurisdiction. This has bolstered shifting of profits by various enterprises from high tax jurisdictions to law tax or nil tax jurisdictions. The existing provisions under the Double taxation avoidance agreements (DTAA) are not adequate to address this current issue i.e., issue relating to taxing an entity in the utterly new digital world. Until now, various efforts were accomplished by Organization for Economic Co-Operation and Development (OECD) to address this challenge. After announcing 15 actions plan (i.e., Project-BEPS-1.0), the OECD further continued their efforts to address the challenges arising from digitalization.

As an outcome, during the period of October 2020, OECD released a package comprising a report on the pillar one blueprint and pillar two blueprint (i.e., Project-BEPS-2.0). Subsequently, on 1st July 2021, 130 countries/jurisdiction joined this new two pillar solution plan to reform international taxation rules and to ensure that the MNEs pay their fair share of tax to the respective countries or jurisdiction where they operate. With this, let us grab an idea about what exactly this two pillars solution talk about.

❖ **Pillar One-An Overview**

Under Pillar One, the principle is that the 'largest and most profitable' businesses will need to allocate a certain share of 'global residual profit' to market countries/jurisdiction, where they ultimately supply their product or provides a service. The Pillar one aims to target the fairer distribution of profits and taxing rights among the countries and jurisdiction. Pillar one mainly applies to about 100 biggest and most profitable MNEs and it allows to distribute part of their profit to countries/jurisdiction where they sell their products or provides services. Basically, Pillar one is having significant departure from the existing international taxation rules, which largely required a physical presence in a country/jurisdiction before such country/jurisdiction has a right to tax. The key elements of this pillar one can be mainly grouped into three categories i.e., Amount A, Amount B and Tax certainty.

Where, **Amount A** (new taxing right) is 'share of residual profit' which will be allocated using a formulaic approach to various countries/jurisdictions where the MNEs market their products or provides a service.

Amount B (fixed 'baseline' return) is for marketing and distribution functions based on the arm length principle and applicable to all business.

Tax certainty-MNEs will get benefit from the dispute prevention and resolution mechanisms, which will avoid double taxation.

By saying this, let us have a bird eye view on this pillar one.

- **Applicability:** All MNEs with global turnover exceeding 20 billion euros and profitability above the 10%. Here, the profitability would be determined by adopting formula of profit before tax to total revenue.

  In addition, it has also been stated that apropos applicability of Pillar one is concern, the above limit of 20 billion euros will be further reduced to 10 billion euros after the period of 7 years from the beginning of agreement into force.

  <u>Exclusion-Extractives and regulated financial services are kept as an out of the scope of applicability.</u>

  Here, it should be noted that the threshold for the profit is capped at the rate of 10%, which will eventually be known as a routine profit and accordingly, a profit which is beyond this threshold of 10%, is known as non-routine or residual profit.

- **Profit Allocation/Quantum:** 25% of the residual/non routine profit will be allocated to various countries/jurisdictions with nexus using 'revenue-based allocation key'.

  As stated above, the total profits of MNEs will be divided into two parts i.e., Routine Profit and Non-Routine/Residual Profit. Here, it has been provided that 25% of the residual/non routine profit will be allocated, which means that the <u>Amount A will be 25% of the Residual/Non-Routine Profit.</u>

  Let us take an example to understand this concept, Suppose, total profit in terms of percentage of one of the MNEs is 12%, then in such a case, residual/non-routine profit will be 2% [Profit beyond the threshold prescribed (i.e., 12%-10%)] and the quantum of an amount which will be allocated to various countries/jurisdiction will be 25% of the 2% Profit.

- **Revenue Sourcing Rule:** Revenue will be sourced to the end market jurisdictions where goods or services are ultimately used or consumed. To facilitate the application of this principle, detailed source rules for specific categories of transactions is yet to be developed.

- **Nexus:** The above specified Amount A will be allocated only to those country/jurisdictions, from where the MNEs to which the Pillar One applies, derives revenue of at least 1 million euro from the respective country/jurisdiction. Moreover, for smaller jurisdiction (i.e., with GDP lower than 40 billion euros), it has been stated that the said amount of 1 million euros will be replaced by 2.5 lakhs euros.

  Therefore, it will not be allocated to each and every country/jurisdiction rather it will be allocated to only such country/jurisdiction which qualifies for the allocation based on the threshold provided in the nexus rule.

  Hence, this will aide to know that whether particular country/jurisdiction qualify for the allocation of the profit or not.

- **Tax based determination:** The profit or loss of the MNEs to which this pillar one applies will be determined by referring to the financial accounting income, with certain few adjustments. Here, the losses will be allowed to carry forward.

- **Elimination of the Double taxation:** Double taxation of profit allocated to market jurisdictions will be relieved using either the exemption or credit method. The entity (or entities) that will bear the tax liability will be drawn from those that earn residual profit.

- **Amount B:** It focuses to standardize the remuneration of related party distributors that perform "baseline marketing and distribution activities" to align with the Arm's Length Price. Further work is being done on this and is expected to be completed by the end of 2022.

- **Tax Certainty:** The MNEs to which the pillar one applies, will get benefit from the dispute prevention and resolution mechanisms, which will ultimately avoid double taxation under the mandatory and binding environment.

- **Unilateral Measures:** The Multilateral Convention (MLC) will be executed between parties to remove all Digital Services Taxes and other relevant similar measures with respect to all companies, and to commit not to introduce such measures in the future. In addition, no newly enacted Digital Services Taxes or other relevant similar measures will be imposed on any company from 8 October 2021 and until the earlier of 31 December 2023 or the coming into force of the MLC.

❖ **Implementation Part-Pillar One:** The Amount A of the Pillar One will be implemented through MLC between all countries/jurisdiction regardless of whether a tax treaty currently exists between those countries/jurisdictions or not. The MLC will contain a detailed rules necessary to determine and allocate an Amount A and eliminate double taxation. Such MLC will be developed and opened for signature of countries/jurisdiction in 2022, with an Amount A coming into effect in 2023. Whereas for Amount B, the detailed works targeted to be finalized by end of 2022. It is expected that, under this pillar one, more than $125 billion of profit will be reallocated to the market jurisdiction each year.

This was all about the Basics of Pillar one under Two-Pillar Solution. Now, apropos Pillar Two which is mainly focusing on the introduction of global minimum corporate tax, the same will learn in the next series.