TECHNICAL NOTE

CBT/TN/08/21

THE INCLUSIVE FRAMEWORK'S TWO-PILLAR SOLUTION TO ADDRESS THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY

AFRICAN TAX ADMINISTRATION FORUM

FORUM SUR L'ADMINISTRATION FISCALE AFRICAINE

BACKGROUND

After several years of highly complex and difficult negotiations, the Inclusive Framework (IF) issued its two-pillar solution to address the tax challenges arising from the digitalisation of the economy on 8th October 2021. This is an agreement resulting in a two-Pillar set of rules that represents the most significant changes to the international tax rules in the last 100 years. However, 4 of the IF's 140 members have not joined yet.

This agreement is a high-level political statement and includes an Implementation Plan that describes the work needed to implement the two-Pillar solution described in the body of the Statement. It also sets out a timeline for that process, including the key milestones for the IF going forward.

This Technical Note sets out the detail of the IF Statement and provides a number of comments by ATAF (in shaded boxes) in respect of the Statement.

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1 PILLAR ONE RULES

SCOPE OF THE NEW AMOUNT A RULES

The companies to which the Amount A rules will apply are the multinational enterprises (MNEs) with global turnover above 20 billion Euros and profitability above 10% (i.e., profit before tax/revenue) calculated using an averaging mechanism. The turnover threshold is to be reduced to 10 billion Euros, contingent on successful implementation including of tax certainty on Amount A, with the relevant review beginning 7 years after the agreement comes into force, and the review being completed in no more than one year. Extractives and Regulated Financial Services sector are excluded from the scope of the Amount A rules.

The current OECD estimate is that this will result in just over 100 MNEs being in scope for the new Amount A rules including the largest and most profitable digital companies which may account for up to 40% of the global profits reallocated under Amount A.

NEXUS

There will be a new special purpose nexus rule permitting the allocation of Amount A to a market jurisdiction when the in-scope MNE derives at least 1 million Euros in revenue from that jurisdiction. For smaller jurisdictions with GDP lower than 40 billion Euros, the nexus will be set at 250 000 Euros.

The special purpose nexus rule applies solely to determine whether a jurisdiction qualifies for the Amount A allocation. The Statement says that compliance costs (including on tracing small amounts of sales) will be limited to a minimum.

Based on World Bank Group data[1] 17 African IF members[2] will currently benefit from the lower nexus revenue threshold of 250,000 Euros.

QUANTUM

For in-scope MNEs, 25% of residual profit, defined as profit in excess of 10% of revenue, will be allocated to market jurisdictions with nexus using a revenue-based allocation key.

Based on OECD estimates the in-scope MNEs residual profit under the above definition will be approximately USD500 billion per annum and therefore USD125 billion (25%) of that residual profit will be reallocated to market jurisdictions under Amount A.

ATAF's own estimates indicate that the allocable Amount A profits may be lower than the OECD estimates and may be nearer to approximately USD95 billion at the allocation of 25% of residual profits.

ATAF has previously expressed to the Inclusive Framework its concern that these proposals do not result in a sufficient and appropriate re-allocation of MNE profits to market jurisdictions and called for at least 35% of the residual profits to be re-allocated to market jurisdictions.

ATAF will be monitoring closely the impact of Amount A on African countries and will continue to call for a greater percentage of the residual profit to be reallocated to market jurisdictions to redress the current imbalance in the allocation of taxing rights between residence and source jurisdictions which favours residence jurisdictions to the detriment of source jurisdictions.

1. GDP (current US$) | Data (worldbank.org)
2. *Benin, Botswana, Burkina Faso, Cabo Verde, Cameroon, Republic of Congo, Djibouti, Eswatini, Gabon, Liberia, Mauritius, Namibia, Senegal, Seychelles, Sierra Leone, Tunisia, and Zambia*

REVENUE SOURCING

Revenue will be sourced to the end market jurisdictions where goods or services are used or consumed. To facilitate the application of this principle, detailed source rules for specific categories of transactions will be developed. In applying the sourcing rules, an MNE must use a reliable method based on the MNE's specific facts and circumstances.

The current technical design for the revenue sourcing rules includes the ATAF proposal that where an in-scope MNE is unable to determine the location of the consumption of a portion of the revenue derived from the sales of finished goods to final customers through an independent distributor (the Tail-End Revenue) the rules to determine where that Tail-End Revenue arises will, in certain circumstances, treat the Tail-End Revenue as arising in Low Income Jurisdictions using a Low Income Jurisdiction Allocation Key.

Further design work is being carried out by the IF on the definition of a "Low Income Jurisdiction" and on the "Low Income Jurisdiction Allocation Key" and ATAF is closely monitoring this design work to ensure equity in the allocation of the tail end revenue across affected jurisdictions. ATAF will also continue to mobilise African members of the IF to engage closely and push for this equity.

TAX BASE DETERMINATION

The relevant measure of profit or loss of the in-scope MNE will be determined by reference to financial accounting income, with a small number of adjustments. Losses will be carried forward.

SEGMENTATION

Segmentation will occur only in exceptional circumstances where, based on the segments disclosed in the financial accounts, a segment meets the scope rules.

MARKETING AND DISTRIBUTION PROFITS SAFE HARBOUR

Where the residual profits of an in-scope MNE are already taxed in a market jurisdiction, a marketing and distribution profits safe harbour will cap the residual profits allocated to the market jurisdiction through Amount A.

ELIMINATION OF 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.

TAX CERTAINTY

In-scope MNEs will be eligible for a dispute prevention and resolution mechanism, which will avoid double taxation for Amount A, including all issues related to Amount A (e.g. transfer pricing and business profits disputes), in a mandatory and binding manner. Disputes on whether issues may relate to Amount A will be solved in a mandatory and binding manner, without delaying the substantive dispute prevention and resolution mechanism.

An elective binding dispute resolution mechanism will be available only for issues related to Amount A for developing economies that are eligible for deferral of their BEPS Action 14 peer review[3] and have no or low levels of MAP disputes. The eligibility of a jurisdiction for this elective mechanism will be reviewed regularly; jurisdictions found ineligible by a review will remain ineligible in all subsequent years.

3. The conditions for being eligible for deferral of the BEPS Action 14 peer review are provided in paragraph 7 of the current Action 14 Assessment Methodology published as part of the Action 14 peer review documents which is available at **BEPS Action 14 on More Effective Dispute Resolution Mechanisms - Peer Review Documents (oecd.org)**

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ATAF's major concern regarding the OECD Pillar One blueprint report of October 2020 was the proposal to impose on all IF members a mandatory dispute resolution mechanism for issues relating to Amount A.

ATAF strongly opposed this proposal as it would impose a costly and resource intensive process on many African countries which have limited capacity and where there is little risk of double taxation.

ATAF has succeeded in obtaining agreement that for many African and other developing countries they will not have the mandatory dispute resolution mechanism imposed upon them. Instead an elective binding dispute resolution mechanism will be available for issues related to Amount A for developing countries that are eligible for deferral of their BEPS Action 14 per review[4] and have no or low levels of MAP disputes. The eligibility of a jurisdiction for this elective mechanism will be reviewed regularly; jurisdictions found ineligible by a review will remain ineligible in all subsequent years. This is a major achievement for Africa.

The technical design of the elective mechanism is still to be undertaken however we anticipate that broadly the elective approach would mean that where there is a failed MAP case, it would only enter into the binding dispute resolution mechanism if both countries involved in the MAP case elected, through their Competent Authorities, for the case to go through that mechanism.

ATAF, working closely with its members, will input into the design of the elective mechanism to ensure its design is appropriate for African countries, and to define the general terms such as "regularly" and "Low levels of MAP" for better clarity.

AMOUNT B

The application of the arm's length principle to in-country baseline marketing and distribution activities will be simplified and streamlined, with a particular focus on the needs of low-capacity countries. This work will be completed by the end of 2022.

ATAF and its members have expressed support for the introduction of a transfer pricing simplification rule for distribution and marketing activities and the African Union Common African Position states that the transfer pricing simplification rule (Amount B) must be broad in scope if it is to be effective in increasing tax certainty.

The technical design of Amount B is still in its very early stages and ATAF will continue to call for a wide range of distribution and marketing activities that include sales agency and commissionaire activities as well as limited and medium risk distributors to be in scope for Amount B.

ADMINISTRATION

The tax compliance will be streamlined (including filing obligations) and allow in-scope MNEs to manage the process through a single entity.

UNILATERAL MEASURES

The Multilateral Convention (MLC) will require all parties to remove all Digital Service Taxes and other relevant similar measures with respect to all companies, and to commit not to introduce such measures in the future. No newly enacted Digital Service Taxes and other relevant similar measures will be imposed on any company from 8th October 2021 and until the earlier of 31st December 2023 or the coming into force of the MLC. The modality for the removal of existing Digital Service Taxes and other relevant similar measures will be appropriately coordinated. The IF notes reports from some members that transitional arrangements are being discussed expeditiously.

4. The conditions for being eligible for deferral of the BEPS Action 14 peer review are provided in paragraph 7 of the current Action 14 Assessment Methodology published as part of the Action 14 peer review documents which is available at **BEPS Action 14 on More Effective Dispute Resolution Mechanisms - Peer Review Documents (oecd.org)**

This represents a significant political commitment by IF members who have joined this agreement, as well as those who have not. ATAF is of the view that political pressure should not be exerted on IF members to remove digital service taxes and other relevant similar measures but rather meaningful engagement and guidance should be provided to these countries on any possible economic gains they might receive from joining the agreement. ATAF stands ready to provide technical support to members who are required to remove existing Digital Services Taxes and other relevant similar measures, as well as relevant advice to those who have not.

The term "other relevant similar measures" has not yet been defined by the IF and this is a further area where ATAF, working closely with its members, will input into the Inclusive Framework's drafting of the definition to try and ensure the definition is appropriate for African countries. ATAF will also input into the development of the MLC.

IMPLEMENTATION

According to the IF implementation plan, the MLC through which Amount A is to be implemented, will be developed, and opened for signature in 2022, with Amount A coming into effect in 2023. The said detailed implementation plan has been included as an Annex to the IF Statement.

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2 PILLAR TWO RULES

OVERALL DESIGN

Pillar Two consists of:

- two interlocking domestic rules (together the Global anti-Base Erosion Rules (GloBE) rules): (i) an Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity in respect of the low taxed income of a constituent entity; and (ii) an 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 an IIR; and
- a treaty-based rule (the Subject to Tax Rule (STTR)) that allows source jurisdictions to impose limited source taxation on certain related party payments subject to tax below a minimum rate. The STTR will be creditable as a covered tax under the GloBE rules.

RULE STATUS

The GloBE rules will have the status of a common approach. This means that Inclusive Framework members:

- are not required to adopt the GloBE rules, but, if they choose to do so, they will implement and administer the rules in a way that is consistent with the outcomes provided for under Pillar Two, including in light of model rules and guidance agreed to by the Inclusive Framework.
- accept the application of the GloBE rules applied by other Inclusive Framework members including agreement as to rule order and the application of any agreed safe harbours.

SCOPE

The GloBE rules will apply to MNEs that meet the 750 million Euros threshold as determined under BEPS Action 13 (country by country reporting). Countries are free to apply the IIR to MNEs headquartered in their country even if they do not meet the threshold.

Government entities, international organisations, non-profit organisations, pension funds or investment funds that are Ultimate Parent Entities (UPE) of an MNE Group or any holding vehicles used by such entities, organisations or funds are not subject to the GloBE rules.

RULE DESIGN

The IIR allocates top-up tax based on a top-down approach subject to a split-ownership rule for shareholdings below 80%.

The UTPR allocates top-up tax from low-tax constituent entities including those located in the UPE jurisdiction. The GloBE rules will provide for an exclusion from the UTPR for MNEs in the initial phase of their international activity, defined as those MNEs that have a maximum of 50 million Euros tangible assets abroad and that operate in no more than 5 other jurisdictions[5]. This exclusion is limited to a period of 5 years after the MNE comes into scope of the GloBE rules for the first time. For MNEs that are in scope of the GloBE rules when they come into effect, the period of 5 years will start at the time the UTPR rules comes into effect.

5. An MNE is considered to operate in a jurisdiction if that MNE has a Constituent Entity in that jurisdiction as defined for purposes of the GloBE rules.