

OECD/G20 Inclusive Framework reaches high-level agreement on two-pillar approach to international tax reform

JULY 5, 2021 9 MIN READ

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In this Update:

- 130 countries, including Canada and the United States, issued a statement announcing a high-level agreement regarding the OECD's two-pillar approach to international tax reform.
- Nine Inclusive Framework members (including Ireland and Hungary) have not signed on to the high-level agreement. Ireland announced that it agreed with most of the proposals but believes the global minimum tax rate of 15% is too high (particularly since the Irish tax rate is 12.5%).
- The statement calls for a comprehensive agreement by October 2021, with requisite changes for Pillar One and Pillar Two to be brought into law in 2022 and coming into effect in 2023.
- The statement calls for the removal of all digital service taxes and other relevant similar measures on all companies (although the statement is silent on the timing for when the removal will occur).
- These proposals mark a significant departure from the manner in which income and taxing rights are currently allocated between jurisdictions.
- New taxing rights under Pillar One are proposed to be allocated to market jurisdictions (where customers are located) on 20-30% of profit exceeding a 10% margin for multinational enterprises with global turnover above €20 billion (reduced to €10 billion after 7-8 years contingent on successful implementation).
- The global minimum tax rate under Pillar Two to be at least 15% determined on a country-by-country basis.

Statement on a two-pillar solution to address the tax challenges arising from the digitalisation of the economy follows commitment from the G7 Finance Ministers

The OECD and G20 have been working for the past two years on a two-pillar approach to international tax reform to address the taxation of the digital economy and unresolved BEPS issues. These proposals mark a significant departure from the manner in which income and

taxing rights are currently allocated between jurisdictions.

- Pillar One is intended to allocate additional taxing rights to market jurisdictions; and
- Pillar Two introduces a global minimum tax of at least 15% determined on a country-by-country basis.

On June 5, 2021, the Finance Ministers from the G7 group of leading economies – Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States (with the European Union participating as a guest) – released a [Communique](#) committing to the principal design elements for Pillar One and Pillar Two, including introducing a global minimum tax of at least 15%.

On July 1, 2021, 130 of the 139 countries in the OECD/G20 Inclusive Framework, representing more than 90% of global GDP, issued a statement endorsing the principal design elements agreed to by the G7 Finance Ministers and agreeing to additional details regarding the scope and operation of the new rules (the [Statement](#) [PDF]), described in more detail below). Nine countries in the OECD/G20 Inclusive Framework – Barbados, Estonia, Hungary, Ireland, Kenya, Nigeria, Peru, Saint Vincent and the Grenadines and Sri Lanka – have not signed the Statement as of the date of writing. The OECD will try to find agreement with the remaining OECD/G20 Inclusive Framework members and finalize any outstanding issues by the G20 Rome Summit scheduled for the end of October 2021.

The Statement describes high-level agreement regarding Pillar One and Pillar Two and calls for a comprehensive agreement by October 2021, with changes (including a global minimum tax of at least 15%) coming into effect in 2023.

For more details on the OECD's two-pillar approach to international tax reform, please see our [Osler Update](#) and [submission](#) to the OECD on the blueprint reports on Pillar One and Pillar Two. For more details on the G7 Finance Ministers' Communique, please see our [Osler Update](#).

Pillar One

Pillar One has three key elements: a new taxing right for market jurisdictions (where customers are located) to obtain a share of residual profit of a multinational enterprise or MNE (Amount A), the calculation of a fixed return for certain baseline and marketing and distribution activities in jurisdictions where an MNE has a physical presence (Amount B), and dispute prevention and resolution mechanisms (referred to by the OECD as Tax Certainty).

The original scope of Pillar One was focused on highly digitized businesses. The scope was initially broadened to include certain consumer facing businesses. Now the scope is focused on the largest and most profitable MNEs – regardless of whether they are digital or consumer facing (although with a carveout for the extractive and regulated financial services industries).

With respect to the magnitude of Pillar One, the G7 Finance Ministers had committed to allocating new taxing rights to market jurisdictions on at least 20% of profit exceeding a 10% margin for the “largest and most profitable multinational enterprises”. The Statement builds on the G7 announcement and provides additional details:

- Certain revenue thresholds were added, such that Pillar One would apply to MNEs with global turnover above €20 billion and profitability above 10%, with the revenue threshold to be reduced to €10 billion, pending successful implementation (determined 7-8 years

after Pillar One comes into effect) including with respect to tax certainty on Amount A.

- Profits and losses are to be measured by reference to financial accounting income, with a small number of adjustments. Losses will be carried forward (although it is unclear whether the carry-forward period will be indefinite).
- Limited segmentation will occur where, based on the segments disclosed in the financial accounts, a segment otherwise meets the scoping rules. This change appears intended to ensure that profitable businesses of diversified companies such as Amazon may be included – even if the overall enterprise may not meet the requisite profitability thresholds.
- 20-30% of residual profit (i.e. profit in excess of 10% of revenue) will be allocated to market jurisdictions with sufficient nexus using a revenue-based allocation key.
- Extractive industries and regulated financial services will be excluded from the scope of Pillar One.

The Statement also describes a special purpose nexus rule to determine whether an MNE has a sufficient nexus such that Amount A must be calculated for that jurisdiction. In this regard, Pillar One is contemplated to apply when the in-scope MNE derives at least €1 million in revenue from that jurisdiction. For jurisdictions with GDP below €40 billion, the nexus will be set at €250,000.

The Statement describes a marketing and distribution profits safe harbour to be developed to apply where the residual profits of an in-scope MNE are already taxed in a market jurisdiction.

Double taxation is to be eliminated through either the exemption or credit method (with the entity (or entities) earning residual profit bearing the tax liability for Amount A).

Dispute prevention and resolution mechanisms are contemplated to avoid double taxation for Amount A in a mandatory and binding manner. Also, consideration will be given to an elective binding dispute resolution mechanism for issues related to Amount A for developing economies that are eligible for deferral of BEPS Action 14 peer reviews and have no or low levels of mutual agreement procedure (MAP) disputes.

Work on Amount B (simplified and streamlined rules for applying the arm's length principle to in-country baseline marketing and distribution activities) is to be completed by the end of 2022.

The Statement confirms that Pillar One is intended to replace unilateral measures such as the Canadian digital services tax (DST) announced in budget 2021. Canada still intends to proceed with plans to introduce a 3% DST on revenue in excess of \$20 million from digital services that rely on the engagement, data and content contributions of Canadian users effective January 1, 2022, as an interim measure until the Pillar One proposals come into effect. For more details on the 3% DST proposed in budget 2021, please see our [Osler Update on Budget 2021](#).

Pillar Two

Pillar Two (also referred to as the GloBE proposal) consists of:

- Two domestic rules:
 - an income inclusion rule (IIR) which would impose current taxation on the income of a

- foreign-controlled entity (or foreign branch) if that income was otherwise subject to an effective tax rate that is below a certain minimum rate;
- an undertaxed payments rule (UTPR) which would either deny a deduction or impose a possible withholding tax on base eroding payments unless that payment is subject to tax at or above a specified minimum rate in the recipient's jurisdiction; and
- A treaty based rule, known as the subject to tax rule (STTR) which would ensure that treaty benefits for certain related party payments (particularly interest and royalties) are granted only in circumstances where an item of income is subject to tax at a minimum rate in the recipient jurisdiction.

The G7 Finance Ministers committed to introducing a global minimum tax at a rate of at least 15% on a country-by-country basis. The Statement confirms that MNEs could see a global minimum tax at a rate of at least 15% (for the IIR and UTPR) as soon as 2023. The Statement suggests that Pillar Two should be brought into law in 2022, to be effective in 2023. The Statement also specified that the minimum rate for the STTR will be between 7.5% and 9%.

The Statement contemplates Pillar Two having the status of a "common approach" rather than what is known as a "minimum standard." This means that OECD/G20 Inclusive Framework members are not required to adopt the Pillar Two measures. If an MNE is not subject to the agreed upon minimum rate in a particular state, then another state (e.g., where a parent entity is located) would have the right to collect additional tax from the parent entity up to the minimum rate.

With respect to the scope of Pillar Two, the Statement confirms:

- The new rules will apply to MNEs that meet the €750 million threshold used for purposes of country-by-country reporting (CbCR).
- There will be a formulaic substance carve-out that will exclude an amount of income that is at least 5% (in the transition period of five years, at least 7.5%) of the carrying value of tangible assets and payroll in a jurisdiction, and a *de minimis* exclusion.
- Exclusions are contemplated for government entities, international organisations, non-profit organisations, pensions funds or investment funds that are the ultimate parent of the group or any holding vehicles used by such entities, organisations or funds.

According to the Statement, the calculation of the effective tax rate in a jurisdiction (which will drive the application of Pillar Two) will use a common definition of covered taxes and a tax base determined by reference to financial accounting income (with agreed adjustments consistent with the tax policy objectives of Pillar Two and mechanisms to address timing differences).

While the Statement acknowledges the need to clarify the interaction between the GloBE and the U.S. GILTI rules, details surrounding how the rules will co-exist remains outstanding. These details are needed to address important issues such as which regime will take priority, for example, where a low-taxed subsidiary is owned by a U.S. corporation that in turn is owned by a corporation in a jurisdiction that adopts Pillar Two.

Next Steps

Until very recently, reaching global consensus on the OECD's two-pillar approach to international tax reform seemed unlikely. However, the new U.S. administration revitalized the negotiations, and appears to favour reaching a consensus-based multilateral agreement

– rather than threatening other countries with tariffs and trade wars. While many technical issues and certain political obstacles remain, the OECD/G20 will be looking to find agreement among all members of the OECD/G20 Inclusive Framework (consisting of 139 countries) by October 2021. The Statement also sets an ambitious target of an effective date in 2023 for both Pillar One and Pillar Two.

MNEs should carefully review the principal design elements agreed to in the Statement to determine how the proposals may impact their businesses, including whether any sector-specific exemptions or size limits may apply.

For more information on these international tax proposals, please contact any member of our [National Tax Group](#).