KPMG

Euro Tax Flash from KPMG's EU Tax Centre

European Commission proposes Directive to implement Pillar Two in the EU

International tax system – Minimum tax – Allocation of taxing rights – Taxation of the digitalized economy – OECD BEPS Inclusive Framework – European Union legislation

On December 22, 2021, the European Commission published a proposed EU Directive to incorporate the Pillar Two rules into EU law. The rules generally mirror the OECD model rules released on December 20, 2021 but have a broader scope that includes large-scale purely domestic groups. The proposed Directive also clarifies the interaction between the Pillar Two income inclusion rule (IIR) and existing EU legislation on controlled foreign companies (CFCs).

On the same date, the European Commission published its proposal for the next generation of EU own resources. In particular, the Commission has proposed that 15 percent of the revenue generated under Pillar One of the OECD BEPS 2.0 proposals would be contributed by Member States to the EU budget, in lieu of the previously discussed EU COVID digital levy.

Background

On July 1, 2021, 130 members of the OECD Inclusive Framework (IF) countries approved a statement providing a framework for reform of the international tax rules (BEPS 2.0 including Pillar One and Pillar Two). By October 8, 2021, a further six jurisdictions (Barbados, Peru, Saint Vincent and the Grenadines, Estonia, Hungary and Ireland) had endorsed the updated statement, with Mauritania subsequently joining the IF as well. This means that only four (Pakistan, Kenya, Nigeria and Sri Lanka) of the 141 jurisdictions that are members of the IF have not yet approved the global agreement.

Of the 27 EU Member States, only Cyprus is not a member of the OECD Inclusive Framework and has therefore not formally signed the agreement. However, on October 9, 2021, authorities in Cyprus released an official statement confirming that Cyprus was aligned with the October 8 agreement and the OECD two-pillar solution.

The EU Directive to implement the Pillar Two rules are closely aligned to the OECD Pillar Two model rules released on December 20, 2021, consisting of two interlocking domestic rules (together, the Global Anti-Base Erosion (GloBE) Rules):

- An Income Inclusion Rule (IIR) that imposes top-up tax on a parent entity in respect of low-taxed income of constituent entities within an MNE group; and

- A supporting Undertaxed Payment Rule (UTPR) that allocates top-up tax amongst Constituent Entities to the extent the low tax income of a Constituent Entity is not subject to an IIR.

For more information on the model rules, please refer to the KPMG's Global Tax Policy website, where a detailed article which discusses the key elements of the new rules and the implications for businesses has recently been published.

The OECD Pillar Two project also contains a Subject to Tax Rule (STTR), which is a treaty-based rule that allows source jurisdictions to impose limited source taxation on certain related party payments that are subject to tax below a minimum rate. The STTR rules are expected in early 2022.

The BEPS 2.0 project also contains Pillar One which provides for new profit allocation and nexus rules for multinational (MNEs) that initially have a turnover of greater than EUR 20 billion and profit before tax margins of 10 percent of revenue to market jurisdictions. The OECD work on Pillar One is progressing and announcements are expected in early 2022. These rules will require modifications to tax treaties anticipated to occur through a Multi-lateral Convention (MLC). In the context of Pillar One, The October 8, 2021 OECD statement also commits that no new digital services taxes or other relevant similar measures would be enacted and imposed on any company from October 8, 2021 and until the earlier of December 31, 2023 or the coming into force of the MLC.

The Pillar One rules create a new taxing right for market jurisdictions embodied in “Amount A”. Amount A requires the development of sourcing rules and a revenue-based allocation key, with the October 8 statement indicating that 25 percent of profits under Amount A would be allocated to market jurisdictions. Details of a proposal for Amount B which deals with standard remuneration for in-country “baseline” marketing and distribution activities will be developed in 2022.

Summarizing the implementation plans for Pillar One and Two, the IF has previously set out target timelines for legislation/treaties to be implemented/ratified and for the rules to be in effect, as follows:

- the MLC containing the Amount A rules of Pillar One and its explanatory statement, as well as model domestic legislation and commentary, are to be concluded by early 2022;

- the MLC signing ceremony is to be organized by mid-2022;

- the STTR multilateral instrument (MLI) is to be developed by mid-2022;

- the GloBE rules implementation framework will be developed at the latest by the end of 2022;
- the Amount B deliverables are to be released by end of 2022.

For Amount A it is noted that implementation through the MLC is with a view to allowing it to come into effect in 2023. This is noted to occur once a critical mass of jurisdictions has ratified it, and IF jurisdictions signing the MLC will be expected to ratify it as soon as possible. The critical mass threshold is not yet defined and is to be set out in the MLC in early 2022, so it remains to be seen whether Amount A allocations will start from 2023.

The Pillar Two rules are, per the IF statement, to be brought into law in 2022 to be effective in 2023 (i.e. IIR and STTR) with the UTPR coming into effect in 2024. It is recognized that countries face limitations in speed of their legislative processes, so it remains to be seen by what stage a significant number of IF members have the rules in place. The timelines for the implementation of Amount B and the rollback of DSTs and other relevant similar measures are not yet clarified.

The OECD also announced that in early 2022, it will launch public consultations on the implementation aspects of Pillar One and Pillar Two, release Commentary relating to the Pillar Two model rules and address the co-existence of the rules with the US Global Intangible Low-Taxed (GILTI) rules. A public consultation event on the STTR will be held in March 2022.

For further background on the recent evolution of the OECD BEPS IF proposals for a global effective minimum tax rate, please refer to Euro Tax Flash Issues 452, 453, 458 and 459.

Pillar Two Implementation in the EU

The GloBE Rules are designed as a “common approach,” meaning that IF member jurisdictions are not required to adopt the rules, but they must accept their application by other IF members. However, in order to ensure a consistent and harmonized implementation across the EU, the EC has proposed that the agreement reached at OECD level would be implemented through a Directive, which has now been published on December 22, 2021.

In this regard, the Commission has noted that in an EU market of highly integrated economies, there is a need for common strategic approaches and coordinated action, to improve the functioning of the EU internal market and to maximize the positive impact of minimum effective taxation of business profits. In the Commission’s view, this can only be achieved if legislation is enacted centrally and transposed in a uniform fashion across the EU.

The proposed Directive is closely aligned with the OECD model rules and seeks to implement the OECD rules in a manner which is compatible with the EU Treaties, as interpreted by the Court of Justice of the EU, and existing EU legislation. To achieve consistency with EU law, particularly the principle of freedom of establishment, the Directive is not limited to cross-border situations but also applies to domestic groups and requires the Member State of a constituent entity applying the IIR, which is usually the jurisdiction of the UPE, to ensure effective taxation at the minimum agreed level not only of foreign subsidiaries but also of all constituent entities resident in that Member State and permanent establishments (PEs) of the MNE group established in that Member State.

The Directive to implement Pillar Two tabled by the European Commission also does not specifically provide for the STTR element of the OECD Pillar Two proposals. However, in the Explanatory Memorandum accompanying the Directive, the Commission highlights that the

"Directive implements the GloBE rules only" and that *"the STTR is naturally suited to be addressed in bilateral tax treaties"*.

The Directive is structured into eleven Chapters that set out the rules, including their application to domestic scenarios and interaction with existing EU legislation, as well as transitional arrangements.

Chapter I General Provisions

Chapter I of the Directive deals with general provisions, namely the subject matter, scope, definitions, and location of a constituent entity. The Directive will apply to entities resident in a Member State and to non-EU resident entities of an EU parented entity, that meet a revenue threshold where consolidated group revenue exceeds EUR 750 million in at least two of the last four consecutive fiscal years.

In addition, the Directive will also apply to large-scale domestic groups – groups in which all the group entities are located in a single EU Member State – that meet the scoping thresholds, with specific transitional rules included for large-scale domestic groups in Chapter XI (see below). The Commission notes that this framework should eliminate any risk of discrimination between cross-border and domestic situations.

Chapter II Application of the Income Inclusion Rule and the Under Taxed Payments Rule (UTPR)

Chapter II sets out the rules for the application of the Income Inclusion Rule (IIR) and the Under Taxed Payments Rule (UTPR) by Member States.

- Where the Ultimate Parent Entity (UPE) is located in the EU, the UPE will be required to apply the IIR top-up tax in respect of its low-taxed constituent entities in other EU Member States and third countries. Where the UPE is itself located in a low-taxed jurisdiction, it will be subject to the IIR top-up tax together with its low-taxed constituent entities in the same Member State.
- Where the UPE is located outside the EU, the low-taxed constituent entities may be subject to the IIR top-up tax if the UPE jurisdiction applies the IIR. However, if an iintermediate parent entity (IPE) or partially-owned parent entities (POPE) are located in the EU, then the IPE/ POPE will be subject to top-up tax in respect of any directly or indirectly owned low-taxed constituent entities.
- Provision is also made for cases where the POPE and UPE are both in located in the EU. While the UPE would typically be required to charge the top-up tax, there may be cases where the primary taxing right lies with the Member State of a POPE. In this case, a bottom-up approach is required, the IIR top-up tax applied at the level of the lowest POPE in the chain, with other POPEs and the UPE receiving credit for the tax suffered by POPEs lower in the chain.

The Directive provides an option for Member States to apply a Domestic Top-Up Tax to constituent entities located in that Member State. Where a Domestic Top-Up Tax is put in place, the parent entity applying the IIR will be required to give credit for the Domestic Top-Up Tax when calculating the top-up tax payable for that jurisdiction.

The Directive provides that in circumstances where the UPE is located outside the EU in a jurisdiction that does not apply a qualifying IIR, all its constituent entities in jurisdictions with an appropriate UTPR framework will be subject to the UTPR. In this circumstance, constituent entities of such an MNE group that are located in a Member State will be apportioned, and will have to pay in their Member State, a share of the top-up tax linked to the low-taxed subsidiaries of the MNE group. The calculation and allocation of the UTPR top-up tax in the Directive is based on the same two factors provided for under the OECD rules: number of employees and carrying value of tangible assets.

Chapter III Calculation of the Qualifying Income or Loss

Chapter III sets out rules for the determination of 'qualifying income', i.e. the adjusted income that will be taken into account for computing the effective tax rate, starting with the financial accounting net income or loss of the constituent entity for the fiscal year, as determined for the purpose of preparing consolidated financial statements.

In line with the OECD Model Rules, the Directive excludes international shipping income and partly ancillary international shipping income from the application of the GloBE rules.

Chapter IV Computation of Adjusted Covered Taxes

Chapter IV defines covered taxes and outlines the rules for the calculation of 'adjusted covered taxes' of a constituent entity for a fiscal year – covered taxes are assigned to the jurisdiction where underlying profits subject to these taxes were earned.

The original OECD BEPS Action Plan introduced a range of additional measures which have since been incorporated into EU law through EU Anti-Tax Avoidance Directive 2016/1164 (ATAD 1) as amended by EU Anti-Tax Avoidance Directive 2017/952 (ATAD 2). Most notably, the Directives introduced CFC and anti-hybrid rules, which apply to groups operating in the EU irrespective of size. The OECD Pillar Two rules are not a replacement and have been designed to co-exist with these rules, with specific allocation mechanisms in place to allocate taxes to CFC and hybrid entities. In this regard, the European Commission have concluded that it is not necessary to amend the CFC provisions of the ATAD to interact with the IIR of Pillar Two. In practice, it is expected that CFC rules will apply first and any additional taxes paid by a parent company under a CFC tax regime will be attributed to the relevant low-taxed entity under the GloBE rules when computing the jurisdictional effective tax rate. Existing CFC rules will continue to apply to groups that are not within the scope of Pillar Two. Similarly, taxes included in the accounts of the constituent entity-owner of a hybrid entity will be allocated to the hybrid entity.

Chapter V Calculation of Effective Tax Rate and the Top-Up Tax

Chapter V contains rules for the calculation of the effective tax rate of an MNE group in a jurisdiction for a fiscal year. This calculation takes the adjusted covered taxes of the group and divides them by the adjusted income earned by the group on a jurisdiction-by-jurisdiction approach. The definitions of adjusted covered taxes and adjusted income are aligned with the OECD model rules. The minimum effective tax rate is also aligned at 15 percent.

The top-up tax percentage is calculated for a jurisdiction as a difference between the minimum effective tax rate of 15 percent and the ETR of the jurisdiction. This top-up tax percentage is then multiplied by the income for the GloBE purposes of that jurisdiction for the year in question. Substance-based income exclusions based on payroll costs and tangible assets can be deducted to arrive at a jurisdictional top-up tax which is then apportioned among the constituent entities in that jurisdiction in the same manner as the OECD model rules (i.e. based on the income for GloBE purposes of each constituent entity in that jurisdiction). The Directive also provides for the *de minimis* exclusions which are contained in the OECD model rules.

Chapter VI Special Rules for Mergers and Acquisitions

Chapter VI contains special rules in respect of mergers, acquisitions, joint ventures and multi-parented MNE groups, with specific rules on revenue thresholds in a merger / de-merger situation, value adjustments for components of the GloBE rules (e.g. eligible payroll costs, GloBE deferred tax assets), rules for recognizing gains or losses on asset and liability transfers and special provisions for joint-venture entities which would not otherwise be included in the definition of an MNE group for GloBE purposes.

Chapter VII Tax Neutrality and Distribution Regimes

Chapter VII contains specific provisions to compute the income of a UPE where that UPE is a flow-through entity or subject to a deductible dividend regime. There are also specific rules and election options for determining the ETR of an investment entity. These provisions are closely aligned to the OECD model rules.

The treatment of distribution tax systems also follows the approach of the OECD model rules. Broadly, a distribution tax system means that the taxation of corporate profits is deferred until the profits are distributed. The Directive provides that, on making an annual election, a deemed distribution tax is included in the calculation of the adjusted covered taxes of the relevant constituent entities. There is a requirement to maintain a deemed distribution tax recapture account for each fiscal year for which the election is made. If, in a four-year period, no tax is paid at the minimum rate and the constituent entity has not incurred an allowable loss, then top-up tax is payable based on the outstanding balance of the recapture account for the year in question.

Chapter VIII Administrative Provisions

The Directive requires each constituent entity of an MNE group located in a Member State to file a top-up tax information return, unless the return is filed by the MNE group in another jurisdiction, with which the Member State has an exchange of information agreement. There is also scope for a constituent entity to designate another entity located in its Member State to file on its behalf. The returns must be filed within 15 months after the end of the fiscal year to which they relate to.

The Directive also requires Member States to introduce penalties for failures to file the information return within the prescribed deadline or for making false declarations. In this regard, the Directive states that an administrative pecuniary penalty of at least five percent of the constituent entity’s turnover should be introduced by the Member State.

Chapter IX Transitional Rules

The transitional rules in Chapter IX set out how some aspects of the GloBE rules should be applied when a group must do so for the first time. These rules are closely aligned with the OECD model rules, with transitional relief for MNE groups in the initial phase of international activity. Considering the compliance adjustments that the Pillar Two model rules will require, the proposed EU Directive allows groups that fall within the scope of this Directive for the first time to be granted a period of 18 months to comply with the information return filing requirements noted above.

Chapter X Specific Application of the IIR to Large-Scale Domestic Groups

Chapter X provides that the UPE of a large-scale domestic group should be subject to the IIR top-up tax for its low-taxed constituent entities. However, transitional rules are provided for large-scale domestic groups whereby the top-up tax will be reduced to zero for the first five years in which the group comes within the scope of the Directive.

Chapter XI Final Provisions

Chapter XI refers to the equivalence of the laws of certain third country jurisdictions to the IIR and sets out conditions which need to be fulfilled for granting equivalence. In particular, the equivalence of the US GILTI system and more specifically, its features as they will emerge from the US tax reform. After the US tax reform is completed, the Commission notes in the Explanatory Memorandum that it will assess whether the US rules fulfil the conditions for equivalence.

EU Tax Centre Comment

As expected, the EU Directive on Pillar Two is closely aligned to the model rules published by the OECD. The European Commission already commented publicly that it had provided assurances to Member States that they would not seek to add on additional features to the Directive to ensure as smooth a transposition process as possible. Unanimity amongst all 27 EU Member States will be required to approve the Directive and it is worth remembering that certain Member States had initial reservations related to Pillar Two and were heavily involved in negotiating the final OECD Pillar Two proposals.

As part of the launch of its Presidency of the Council of the EU, French President Emanuel Macron announced that the implementation of the model rules on Pillar Two would be a key priority item, setting a goal of reaching agreement on the implementation of the rules in the EU by Spring 2022. The transposition process will therefore need to continue at pace if the new rules are to enter into effect across the EU by the start of 2023.

In recent weeks, there have been indications from a number of Member States that they intend to introduce a domestic minimum top-up tax to address the Pillar Two proposals. For example, Cyprus (see E-News Issue 145), Spain (see E-News Issue 142) and Ireland (see E-News Issue 141) have recently announced plans to introduce an effective minimum rate of tax in line with the OECD Pillar Two proposals. However, a question remains regarding the timeline for approving the proposed EU Directive if progress stalls in the United States on the implementation of the OECD proposals. In this regard, some Member States have cautioned against the rushed implementation of an EU Directive without the parallel implementation approval of the OECD agreement in the United States and other jurisdictions.

It had previously been expected that the European Commission would also publish a Directive requiring companies with an EU presence that are within the scope of Pillar Two disclose publicly their effective tax rates, jurisdiction by jurisdiction in the EU. While this was not included alongside the proposed Directive to implement Pillar Two, the Commission has separately clarified that in 2022, "*the Commission will put forward another transparency proposal, requiring certain large groups to publish their effective tax rates*".

The European Commission has also noted that the transposition of the GloBE rules in the EU should allow for agreement to be reached on a proposal to recast the Interest and Royalties Directive, making the benefits of the Directive conditional on the interest being subject to tax in the destination state (see Euro Tax Flash Issue 448 for further details). However, it remains to be seen whether progress will be made on this proposal, as it has been with the Council of the EU since 2011.

Pillar One Implementation in the EU

While the 137 IF members also endorsed proposals for Pillar One of the BEPS 2.0 international tax framework on October 8, 2021, the OECD has conceded that the timeline for Pillar One is not as advanced as Pillar Two and that technical negotiations remain ongoing. Currently, it is expected that an OECD multilateral convention containing the Amount A rules of Pillar One as well its explanatory statement and model rules for bringing Pillar One into domestic legislation and commentary are expected in early 2022. Rules for Amount B of Pillar One are expected by the end of 2022. For further background on the Pillar One proposals, please refer to Euro Tax Flash Issue 458.

From an EU perspective, EU Commissioner for Economy – Paolo Gentiloni – has previously stated that for Pillar One, the Commission will "carefully examine whether a Directive is needed to ensure its consistent and effective implementation at EU level". On December 14, 2021, the European Commission published its indicative work program for the first half of 2022 and the indicative deadline for a proposal to implement the OECD Pillar One proposals is currently listed as July 27, 2022.

On December 22, 2021, the European Commission also published its proposal to establish the next generation of own resources for the EU budget, which includes certain tax measures (i.e. amounts collected by the Member States but allocated to the central EU budget). Included within the proposal is an EU own-resource whereby Member States would provide a national contribution to the EU budget based on the share of 15 percent of the taxable profits of multinational enterprises re-allocated to each Member State under Pillar One. The Commission's budget estimates that this could generate revenues of up to EUR 2.5 and 4 billion annually. In terms of next steps, the budget proposal notes that the Council of the EU has committed to deliberate on the first basket of new own resources by July 1, 2022, with a view to introducing the measures by January 1, 2023.

EU Tax Centre Comment

As previously reported in Euro Tax Flash Issue 448, the EU had previously suggested the introduction of an EU COVID digital levy as an EU own-resource measure. However, an EU digital levy measure has not been included in the published 2022 budget plan, most likely due to the agreed moratorium on new digital services taxes agreed as part of the October 8 OECD statement. It therefore appears that the EU Commission has instead opted to replace the measure with the national contribution to the EU budget from Pillar One revenues noted above.

If it transpires that the Pillar One proposals are not ultimately agreed internationally, the European Commission could seek to reintroduce proposals for an EU digital levy at a later stage, particularly given the need to fund the EUR 750 billion of funding committed as part of the European Union Recovery Instrument (NextGenerationEU) to mitigate the impact of the COVID-19 pandemic.

More broadly, the new own resources proposal also proposes allocating a percentage of revenue generated from the proposed carbon border adjustment mechanism (75 percent) and emissions trading (25 percent) to the EU budget. In terms of next steps, the budget proposal notes that the Council of the EU has committed to deliberate on the first basket of new own resources by July 1, 2022, with a view to introducing the measures by January 1, 2023.

It is also noteworthy that the Commission intends to present a proposal for a second basket of new own resources by June 2024. These additional new own resources could include a Financial Transaction Tax and an own resource linked to the corporate sector. This second package would build on the upcoming 'Business in Europe: Framework for Income Taxation (BEFIT)' proposal.

KPMG Insights

For further insights on BEPS 2.0, please refer to KPMG's dedicated webpage.

In addition, as part of the Future of Tax & Legal webcast series, KPMG International will host a session on Tuesday, January 11, 2022 focusing on "The path ahead for BEPS Pillar One and Two implementation". Join the webcast for a deep dive that will explore the Pillar Two model rules in-depth and unpack key considerations for multinationals. Please access the event page to register.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

Raluca Enache
Director, KPMG's EU Tax Centre

Robert van der Jagt
Chairman, KPMG's EU Tax Centre and Partner, KPMG in the Netherlands

Vinod Kalloe
KPMG Regional Tax Policy Leader for EMA

kpmg.com/socialmedia

Privacy | Legal

You have received this message from KPMG's EU Tax Centre. If you wish to unsubscribe, please send an Email to eutax@kpmg.com.

If you have any questions, please send an email to eutax@kpmg.com

You have received this message from KPMG International Limited in collaboration with the EU Tax Centre. Its content should be viewed only as a general guide and should not be relied on without consulting your local KPMG tax adviser for the specific application of a country's tax rules to your own situation. The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

To unsubscribe from the Euro Tax Flash mailing list, please e-mail KPMG's EU Tax Centre mailbox (eutax@kpmg.com) with "Unsubscribe Euro Tax Flash" as the subject line. For non-KPMG parties – please indicate in the message field your name, company and country, as well as the name of your local KPMG contact.

KPMG's EU Tax Centre, Laan van Langerhuize 9, 1186 DS Amstelveen, Netherlands

© 2021 Copyright owned by one or more of the KPMG International entities. KPMG International entities provide no services to clients. All rights reserved.

KPMG refers to the global organization or to one or more of the member firms of KPMG International Limited (“KPMG International”), each of which is a separate legal entity. KPMG International Limited is a private English company limited by guarantee and does not provide services to clients. For more detail about our structure please visit home.kpmg/governance.