KPMG report: Summary and initial analysis of Pillar Two Blueprint

October 12, 2020

kpmg.com

Introduction and overview

On October 12, 2020, the Organisation for Economic Co-operation and Development ("OECD") released the Tax Challenges Arising from Digitalisation—Report on the Pillar Two Blueprint (the "**Pillar Two Blueprint**" [PDF 4.3 MB]). While the Pillar Two Blueprint was approved by the OECD/G20 Inclusive Framework on BEPS ("Inclusive Framework"), it does not reflect an agreement, but provides a "solid basis" for a future agreement. The initial timeline for the work had contemplated an agreement by the end of 2020, but the Inclusive Framework's stated goal is now to "bring the process to a successful conclusion by mid-2021."

The Pillar Two Blueprint proposes a set of rules that attempt to ensure that large internationally operating businesses pay a minimum level of tax regardless of where they are headquartered or the jurisdictions in which they operate. The Pillar Two Blueprint proposes four new rules to accomplish this goal.

The subject to tax rule ("STTR") would apply first and would deny treaty benefits for certain deductible intragroup payments that are subject to no or low rates of nominal taxation in the recipient jurisdiction (though further consideration is being given to applying the STTR in situations beyond deductible intragroup payments). The STTR is intended to help source countries protect their tax base, especially for countries with lower administrative capacities.

The income inclusion rule ("IIR") would trigger an inclusion at the level of the shareholder when the income of a controlled foreign entity is taxed at below the effective minimum tax rate. The shareholder would be subject to a "top-up tax" to bring the low-taxed entity's effective tax rate ("ETR") up to the agreed minimum. The IIR is complemented by a switch-over rule ("SOR") that allows the application of the IIR to certain branch structures when an income tax treaty otherwise obligates a contracting state to exempt the earnings of the branch.

The undertaxed payment rule ("UTPR") applies when an in-scope entity is not already subject to an IIR. The UTPR would allocate the top-up tax with respect to a low-taxed entity to other members of the group, based on deductible payments made by those other group members. The Pillar Two Blueprint defines the IIR and UTPR together as the "GloBE rules"—in other words, the GloBE rules do not include the STTR.

One key issue in the Pillar Two Blueprint is how the U.S. global intangible low-taxed income ("GILTI") regime will be coordinated with the IIR and UTPR. The Pillar Two Blueprint suggests that GILTI may be treated as a qualified IIR for purposes of the GloBE rules, which would mean that other jurisdictions would not impose the UTPR with respect to entities the earnings of which are included in GILTI. The Pillar Two Blueprint states that the Inclusive Framework recognizes that an agreement on the coexistence of GILTI and the GloBE is needed as part of a political agreement, and strongly encourages the United States to limit the operation of the base erosion and anti-abuse tax (the "BEAT") in respect of payments to entities that are subject to an IIR.

KPMG observation

If GILTI is treated as a qualifying IIR, the GloBE rules could still have a significant impact on U.S.-parented groups. U.S.-parented groups could still be subject to the UTPR with respect to their earnings in the United States (which are not included in GILTI), and payments to group members (wherever resident) could still be subject to the STTR.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

As a next step, the Inclusive Framework will develop model legislation and guidance, develop a multilateral review process, and explore the use of a multilateral convention that could coordinate the implementation of Pillar Two, though the Pillar Two Blueprint argues that changes to tax treaties are not strictly necessary to implement the IIR and UTPR.

In a separate document (Public Consultation Document, Reports on the Pillar One and Pillar Two Blueprints), the Inclusive Framework welcomes stakeholder input on the Pillar One and Pillar Two Blueprints, and announces that it will hold a public consultation in January 2021. Written comments on the Blueprints are due Monday, December 14, 2020.

Contents

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

GloBE rules

Scope of the GloBE rules

In general

Under the Pillar Two Blueprint, the GloBE rules generally would apply to "MNE Groups" and their "Constituent Entities" that are subject to Country by Country Reporting ("CbCR")—specifically, groups of entities (including permanent establishments) that are required to prepare consolidated financial statements for financial reporting purposes (or would be so required if the interests in any of the enterprises were publicly traded) and that have annual revenue of more than €750 million.

However, certain Ultimate Parent Entities ("UPEs") that typically benefit from an exclusion or an exemption from tax under the laws of the jurisdiction where they are incorporated are excluded ("Excluded Entities"). The Pillar Two Blueprint states that further consideration will be given to cases in which the exclusion arguably should still apply in respect of a Constituent Entity that is not otherwise the UPE, such as certain life insurance and pension structures that are consolidated within an MNE Group and whose income is not beneficially owned by the MNE Group.

Excluded entities

The UPEs that qualify as Excluded Entities are investment funds, pension funds, governmental entities (including sovereign wealth funds), and international and non-profit organizations.

An investment fund for this purpose means an entity or arrangement that meets several criteria, including: (a) it is designed to pool assets from an Excluded Entity or a number of investors (at least some of which are not connected); (b) it invests in accordance with a defined investment policy and/or to reduce transaction costs and research and analytical costs and/or to spread risk collectively; (c) the fund, or the management of the fund, is subject to the regulatory regime for investment funds in the jurisdiction in which it is established or managed (including appropriate anti-money laundering and investor protection regulation); and (d) it is managed by fund management professionals on behalf of the investors. An investment fund also includes an entity that is wholly owned or almost exclusively owned by one or more investment funds or other Excluded Entities, that does not carry on a trade or business, and that is established almost exclusively to hold assets or invest funds for the investment fund or Excluded Entities.

KPMG observation

A "fund of one" can meet the definition of an investment fund, as long as the investor is an

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Excluded Entity. In other cases, the investment fund must pool assets from more than one unrelated investor.

KPMG observation

The definition of investment fund in the Pillar Two Blueprint is broader than the definition of a collective investment vehicle in the Commentaries on the Articles of the OECD Model Tax Convention, which requires that a collective investment vehicle be widely held, hold a diversified portfolio of securities, and be subject to investor-protection regulation. The definition of investment fund under the Pillar Two Blueprint may incorporate some alternative investment vehicles, though only those that are subject to regulation as investment funds.

Pension fund means an entity or arrangement that is established by a government (including any political subdivision or local authority) to provide social security, retirement or ancillary and incidental benefits or is established and operated in a jurisdiction exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and that is regulated as such by that jurisdiction or one of its political subdivisions or local authorities. A pension fund also includes an entity that is wholly owned by one or more pension funds or is established by a government, that does not carry on a trade or business, and that is established almost exclusively to hold assets or invest funds for the benefit of pension funds.

KPMG observation

The definition of pension fund under the Pillar Two Blueprint is based on, but is broader than, the definition of a recognised pension fund under the OECD Model Tax Convention on Income and Capital 2017 (“OECD Model Tax Convention”). In particular, the definition under the Pillar Two Blueprint does not include the requirement that the pension fund be treated as a separate taxable person.

Governmental entity means an entity or arrangement that meets several criteria, including: (a) it is established by a government (including any political subdivision or local authority thereof); (b) it has the principal purpose of: (i) managing or investing that government’s or jurisdiction’s assets through the making and holding of investments, asset management, and related investment activities for the government’s or jurisdiction’s assets; or (ii) fulfilment of a government function; (c) it does not carry on a commercial trade or business; and (d) its assets vest in such government upon dissolution and to the extent it distributes net earnings, such net earnings are distributed solely to such government with no portion of its net earnings inuring to the benefit of any private person. A governmental entity also includes an entity that is wholly owned, directly or indirectly, by a governmental entity, that does not carry on a trade or business, and that is established to hold assets or invest funds for the benefit of that governmental entity.

KPMG observation

The definition of governmental entity should cover many sovereign wealth funds and the structures through which they invest.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

International organization means any intergovernmental organization (including a supranational organization) or wholly owned agency or instrumentality thereof, that meets all of these criteria: (a) it is comprised primarily of governments; (b) it has in effect a headquarters or substantially similar agreement (for example, arrangements that entitle the organization's offices or establishments in the jurisdiction (*e.g.*, a subdivision, or a local, or regional office) to privileges and immunities) with the jurisdiction in which it is established; and (c) it is prevented by law or its governing documents from inuring its income to the benefit of private persons. It also includes an entity that is wholly owned by an international organization, that does not carry on a trade or business, and that is established almost exclusively to hold assets or invest funds for the benefit of that international organization.

Non-profit organization means an entity or arrangement that meets all of these criteria: (a) it is established and operated in its jurisdiction of residence for certain enumerated purposes; (b) it is wholly exempt from income tax in its jurisdiction of residence; (c) it has no shareholders or members who have a proprietary or beneficial interest in its income or assets; (d) the income or assets of the non-profit organization may not be distributed to, or applied for the benefit of, a private person or non-charitable entity other than pursuant to the conduct of the entity's charitable activities or for certain other reasons; and (e) upon termination, liquidation or dissolution of the entity or arrangements, all of its assets must be distributed or revert to a non-profit organization or to the government or any governmental entity of the entity's jurisdiction of residence or any political subdivision thereof. A non-profit organization does not include any entity or arrangement carrying on a commercial trade or business that is not directly related to the purposes for which it was established.

KPMG observation

The definitions of the Excluded Entities (other than non-profit organizations) include wholly owned entities, but the criteria for wholly owned entities vary slightly depending on the category (*e.g.*, in some cases they may be owned by more than one Excluded Entity, in some cases they must be established "almost exclusively" to invest funds for the Excluded Entity or Entities). In general, wholly owned entities must not carry on a trade or business in order to qualify for the exclusion. The Pillar Two Blueprint says that a business that earns all or substantially all of its income from dividends**,** interest, and capital gains would not be a commercial trade or business. The Pillar Two Blueprint does not discuss entities that derive income from rents or share trading activity, which are important revenue streams for many investment entities.

The income of a UPE also may be excluded from the GloBE rules if that income qualifies for tax neutral treatment under a tax transparency or taxable distribution regime in the jurisdiction in which that entity is established or incorporated, provided that the owners of the UPE are subject to an immediate tax on their share of the entity's income at a rate that equals or exceeds the minimum rate.

KPMG observation

The exclusion for UPEs subject to a tax neutrality regime appears to be intended to cover S corporations and certain types of cooperatives.

KPMG observation

In its public consultation document concerning the GloBE proposal released on October 9, 2019

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

(the "Consultation Document"), the OECD discussed the possibility of carve-outs based on regimes compliant with the standards of BEPS Action 5 on harmful tax practices, as well as companies operating in certain sectors or industries. The Pillar Two Blueprint does not include carve-outs on either of those bases, but does state that the Inclusive Framework will undertake further work to determine whether, and to what extent, the GloBE rules should apply to international shipping.

Consolidated revenue threshold

The GloBE rules are proposed to apply to MNE Groups that have annual consolidated revenue of €750 million or more in the immediately preceding fiscal year or a near equivalent in domestic currency, which is the same threshold that applies under the CbCR rules.

GloBE ETR

To apply the GloBE rules, an MNE Group must determine its ETR. The GloBE ETR is calculated on a jurisdictional basis as the amount of "covered taxes" divided by the amount of income as determined under the GloBE rules. We will consider each part of the GloBE ETR fraction in turn.

Determining the amount of covered taxes

Section 3 of the Pillar Two Blueprint defines covered taxes as "any tax on an entity's income or profits (including a tax on distributed profits) and includes any taxes imposed in lieu of a generally applicable income tax. Covered taxes also includes taxes on retained earnings and corporate equity."

A tax, in turn, is defined as a "compulsory unrequited payment to general government."

The Pillar Two Blueprint is clear that that the definition of covered taxes should be read for the purposes of the GloBE ETR only and should not be used when considering Article 2 (Taxes Covered) of the OECD Model Tax Convention.

Examples of covered taxes include:

- Taxes on income;
- Taxes *in lieu* of a generally applicable income tax;
- Taxes on retained earnings and corporate equity;
- Taxes on multiple components;
- Taxes on distributed profits;
- Taxes paid under CFC rules.

Examples of non-covered taxes include:

- Consumption and sales taxes (including VATs);
- Excise taxes;
- Digital services taxes;
- Stamp and other transfer taxes;
- Payroll taxes and social security contributions;
- Property taxes.

Determining the amount of income, or GloBE tax base

Once the amount of covered taxes has been determined, the second step is to determine the amount of income for GloBE purposes (the "GloBE Tax Base").

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

The methodology to calculate the GloBE Tax Base can be summarized as follows:

1. Determine the net income of each Constituent Entity using the financial accounting standard used by the parent in the preparation of its consolidated financial statements.

2. Make adjustments in order to arrive at the profit (or loss) before tax, by eliminating certain items of income and disallowing certain expenses from the GloBE Tax Base.

3. Consider whether any modifications can be made to the GloBE Tax Base to address timing differences in recognition of income and taxes.

As noted above, the GloBE ETR is calculated on a jurisdictional basis. This requires both income and taxes to be assigned across those jurisdictions where an MNE operates. For the purposes of the GloBE rules, a permanent establishment ("PE") is treated as a separate Constituent Entity when performing these calculations. This means that the profit (or loss) before tax for PEs is determined based on the income and expenses treated as arising for tax purposes in the jurisdiction where the PE is located.

Use of parent's financial accounting standard

While recognizing it is not a perfect solution, the Pillar Two Blueprint highlights that using the financial accounting standard of the parent in the preparation of its consolidated financial statements allows the GloBE Tax Base to build on existing internationally agreed standards, neutralize the impact of structural differences in calculating a tax base, and minimize mismatches in the treatment of transactions between Constituent Entities.

KPMG observation

The Inclusive Framework rejected the idea of calculating the GloBE tax base using the tax rules of the UPE's jurisdiction or that of any other Constituent Entity. Instead, the idea is to create a globally uniform tax base to facilitate the determination of whether a Constituent Entity's income is low-taxed. The creation of a global tax base is a fundamental departure from existing international tax standards and is a key innovation of the Pillar Two Blueprint.

Acceptable financial accounting standards include IFRS and any equivalent financial accounting standard, such as the generally accepted accounting principles of Australia, Canada, Hong Kong (China), Japan, New Zealand, the People's Republic of China, the Republic of India, the Republic of Korea, Singapore, and the United States.

The Pillar Two Blueprint recognizes that most commonly used accounting standards (including IFRS) do not strictly define profit (or loss) before tax. Therefore, the GloBE Tax Base is computed by starting with net income as computed under the relevant accounting standard (including other comprehensive income if and as it is recognized on the profit and loss statement) and making adjustments for specific items.

Adjustments for permanent differences

Once the net income is determined, the next step is to make certain required adjustments. Examples of adjustments to financial accounts that would be required under the Pillar Two Blueprint include:

- **Intragroup dividends** (where a dividend is distributed from one Constituent Entity to another Constituent Entity within the same MNE Group, it is excluded).
- **Portfolio dividends** (these are not excluded, noting that the ownership threshold is still to be confirmed).

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

- Profit (or loss) attributable to an investment in an entity accounted for using the equity method of accounting (this is generally excluded).
- Gains (or losses) arising from the disposition or stock (including mergers) (these are generally excluded).
- Gains or losses arising on an equity interest accounted for using the fair value method (these are also excluded).
- **Covered taxes** (these are not deductible and are added back to net income, including covered taxes that are not treated as income taxes for financial accounting purposes. Taxes that do not qualify as covered taxes (*e.g.*, excise taxes and payroll taxes) are treated as deductible).
- **Stock-based compensation** (deductible to the extent allowed as a deduction in the local tax base of the jurisdiction of the entity that employed or contracted with the party receiving the stock-based compensation, or, if the jurisdiction does not impose an income tax, deductible as determined for financial accounting purposes).
- Bribes, kickbacks or other illegal payments (not deductible).
- **Fines and penalties (**exceeding €50,000 (including the aggregate amount of a periodic penalty) are not deductible).
- **Gains and losses on restructuring** (excluded—this would apply for example to tax deferral provisions arising as a result of the transfer of assets (including intangible property) among Constituent Entities).
- **Covered taxes on excluded income** (excluded from the numerator of the ETR calculation, except for income tax on dividends from a Constituent Entity).
- **Investment returns of life insurance policy holders** (excluded from the GloBE Tax Base if they are included in the income of the insurance company pursuant to the financial accounting standard used by the company).
- **Adjustments to take account of Pillar 1** (depending on the final design of Pillar 1).

KPMG observation

The inclusion of portfolio dividends in the GloBE Tax Base is intended to address both the fact that many Inclusive Framework jurisdictions include portfolio dividends in their tax base and the fact that many financial services businesses will derive significant portfolio dividends in their businesses. A test based on percentage ownership may be more administrable than a test based on whether the taxpayer is in a financial services business.

KPMG observation

Gains or losses from the disposition of stock is generally excluded, and the acquired entity is generally required to use the historical carrying value of its underlying assets to compute its GloBE Tax Base. However, an exception applies to a stock transaction between parties tax resident in the same tax jurisdiction that is treated as a taxable asset sale in that jurisdiction and taxed at a rate above the minimum rate, in which case the target entity can use the stepped-up carrying value of its assets. This exception appears likely to apply to U.S.-to-U.S. acquisitions to which an election under section 338 of the U.S. Internal Revenue Code of 1986, as amended (the "Code"), applies, thereby reducing somewhat the potential for book-tax differences to cause U.S. resident entities to have a low ETR for GloBE purposes.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Modifications to address immediate expensing and accelerated depreciation of assets

The GloBE Tax Base would also be adjusted for temporary differences that arise as a result of immediate expensing and accelerated depreciation of business assets. Two approaches are being considered to address this temporary difference:

1. **Leverage relevant deferred tax accounting at the Constituent Entity level**, with respect to eligibility for immediate expensing or accelerated depreciation for tax purposes.
2. **Use the cost recovery allowance or depreciation rates and conventions** used by the MNE for local tax purposes to compute the GloBE Tax Base.

Modifications to address distribution-based corporate income tax systems

The second modification outlined in the Pillar Two Blueprint addresses instances in which income tax is levied on a corporation's income when it is distributed to shareholders (as opposed to when it is earned). The modification operates by allowing a Constituent Entity that is subject to a distribution-based corporate income tax regime to elect to increase the amount of its covered taxes for the year by the amount of the distribution tax up to the minimum tax liability for the purposes of the GloBE ETR calculation in the jurisdiction, but requires the corporation to recapture the increase to the extent an equal amount of distribution tax is not paid within a reasonable period of time.

Treatment of government grants and tax credits

The Pillar Two Blueprint includes detail about when government grants and tax credits should be treated as income or a reduction in tax liability for the purposes of the GloBE ETR calculation. The rules are broadly set out as follows:

(a) **Qualified refundable tax credit**—entire amount of credit is treated as income.
(b) **Non-qualified refundable tax credit**—entire amount of credit is treated as reducing a covered tax liability.
(c) **Non-refundable tax credits**—entire amount of the credit is treated as reducing a covered tax liability.
(d) **Government grants**—entire amount of the grant is treated as income.

The Pillar Two Blueprint includes review provisions to identify specific risks (an identified specific risk can be brought to the Inclusive Framework on a case-by-case basis) and a general review (where risks are identified over a number of years, the Inclusive Framework will consider designing further conditions).

Emergency government assistance

Finally, the Pillar Two Blueprint recognizes that the provision of government grants and tax credits, such as those designed to mitigate the impact of COVID-19, may skew the GloBE ETR calculation. Further work is to be undertaken in this area.

Jurisdictional blending

The Pillar Two Blueprint also proposes rules for how to determine an MNE Group's ETR under the GloBE rules on a jurisdictional basis ("Jurisdictional ETR"). To determine a Jurisdictional ETR, an MNE Group:

1. Determines the income of each entity in the MNE Group (using entity-level financial information that is used in preparing the parent entity's consolidated financial statements to determine profit or loss before tax, with adjustments at the entity level in respect of consolidated items); and
2. Assigns the income and covered taxes paid by each entity to a jurisdiction.

Generally speaking, the covered taxes that are associated with a particular jurisdiction's income will be assigned to that jurisdiction. For example, covered taxes paid with respect to dividends distributed by another Constituent Entity are assigned to the jurisdiction of the Constituent Entity that paid the dividend.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Covered taxes paid with respect to the income of a PE are assigned to the location of the PE. For Constituent Entities that do not have a tax jurisdiction of residence, the share of profits of each owner that is a Constituent Entity is assigned to the owner's tax jurisdiction of residence if that owner's jurisdiction treats the entity as tax transparent; any remaining profits are assigned to the stateless jurisdiction.

Consolidation adjustments

As set out above, an MNE Group can rely on entity-level financial information that is used in preparing the parent's consolidated financial accounts to determine the profit (or loss) before tax of each Constituent Entity. Under jurisdictional blending, transactions between Constituent Entities in different jurisdictions are required to be treated in the same manner as transactions with unrelated entities in accordance with the arm's length principle. Other items maintained at the consolidated level (such as purchase accounting adjustments) should be taken into account in determining the profit and loss of an entity only when those items can be reliably and consistently traced to that entity.

Computing the jurisdictional ETR

Generally, the ETR of each jurisdiction will be calculated as follows:

$$\frac{\text{Aggregate adjusted covered taxes assigned to the jurisdiction}}{\text{Aggregate profit (or loss) before tax assigned to the jurisdiction}}$$

If the aggregate profit before tax assigned to a jurisdiction is zero (or there is a loss), there will be no GloBE income and no corresponding tax liability under the GloBE rules for that jurisdiction for the relevant year.

Adjustments to ETR and top-up tax

The Pillar Two Blueprint provides for adjustments to the calculation of the GloBE ETR and the top-up tax (i.e., the tax imposed under the GloBE rules to bring the Jurisdictional ETR up to the agreed minimum) to account for timing differences between local tax and financial accounting rules that could result in distortion in a particular year.

The adjustments related to timing differences reflect a carryforward approach, rather than a deferred tax accounting approach, which was considered inappropriate because of its reliance on estimates of future tax liabilities. Under the carryforward approach, timing differences are accounted for by way of rules providing for carryovers of losses and local taxes, each tracked by jurisdiction, and a credit for purposes of the top-up tax imposed under the IIR, tracked at the level of a parent of an MNE Group.

KPMG observation

In the Consultation Document, the OECD considered, in addition to a carryforward approach and a deferred tax accounting approach, a third possible method of addressing timing differences—the use of a multi-year average effective tax rate to determine whether income is low-taxed. This third possibility is not addressed in the Pillar Two Blueprint.

In addition, the Pillar Two Blueprint provides for an exclusion from the scope of the GloBE rules for a fixed return for certain activities within a jurisdiction. This "formulaic substance-based carve-out" expands on a suggestion in the Consultation Document to allow for a return on tangible assets. Further consideration is being given to proportionally adjusting the covered taxes taken into account for purposes the ETR and top-up taxes to the extent the carve-out is claimed.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

The Pillar Two Blueprint highlights that transition rules may be needed to mitigate the consequences of timing differences around the applicability date of the GloBE rules to an MNE Group. Such rules might provide for an MNE Group to compute an opening balance for loss and local tax carryforwards as if the GloBE rules had applied during a transition period. However, more consideration is required.

Loss carryover

The amount of a loss carried over under the GloBE rules is the amount by which the expenses taken into account in the jurisdictional GloBE Tax Base, including losses carried forward from a previous year, exceeds the income in the base. A loss may be carried forward indefinitely and carried back to the extent allowed under the laws of the jurisdiction, but only reduces the tax base if the jurisdiction has an ETR below the minimum tax rate without regard to the loss carryover. Carryovers for GloBE purposes may deviate from those for local tax purposes, given that for local tax purposes limitations may apply, carryovers may result in refunds, and carryovers may not be available to apply to other entities in the same jurisdiction.

KPMG observation

It is not clear how the rule allowing carrybacks of losses to the extent permitted under the laws of the relevant jurisdiction would be reconciled with the GloBE rules and their application on a jurisdictional basis in all cases. For example, if the laws of a jurisdiction allowed for carrybacks of losses on an entity-by-entity basis, it is not clear whether the resulting loss carryback for the jurisdiction should be allocated to all the Constituent Entities in that jurisdiction under the general rules described below in Part II.C.5 or only to the entity that generated the loss carryback.

Excess taxes, IIR credit, and local tax carryforward

In any year in which there are excess taxes (defined below) for a jurisdiction, an IIR tax credit is created if IIR tax has been paid with respect to that jurisdiction for preceding tax years during a lookback period. The amount of the credit is the lesser of the excess taxes for the year and the IIR tax paid during the lookback period that has not already given rise to an IIR tax credit. An IIR tax credit can be used to reduce an IIR tax liability relating to any jurisdiction, and thus it can be used in the same year in which it arises or a future year, with no time limit on its future use. It can also be used in any jurisdiction chosen by the parent of the MNE Group, but if there are multiple parents in a group, they may not use each other's IIR tax credits. The Pillar Two Blueprint raises the possibility that jurisdictions could allow an IIR tax credit to be applied against other tax liabilities in the jurisdiction of the MNE's parent corporation.

Excess taxes for a jurisdiction that do not create an IIR tax credit, including because IIR tax has not previously been paid with respect to a jurisdiction, give rise to a local tax carryforward that can be used in the computation of the ETR for a future year. Local tax carryforwards are used in chronological order to compute the ETR in the jurisdictions in which they arose and are reduced to the extent used to increase the ETR to the minimum tax rate. The period for which a local tax may be carried forward would be limited.

For purposes of both the IIR tax credit and the local tax carryforward, "excess taxes" are the amount of taxes reported as due and payable in the jurisdiction for the year to the extent they exceed the minimum tax rate on the aggregate GloBE Tax Base for the jurisdiction for the year. The Pillar Two Blueprint suggests seven years as a reasonable period for the lookback period for determining an IIR tax credit as well as the local tax carryforward period, but also notes that longer periods could be appropriate for certain industries.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

KPMG observation

Timing differences may not reverse within seven years in some industries. For example, certain book-tax differences with respect to certain insurance products may take a decade or more to reverse. The Pillar Two Blueprint suggests that special rules may be provided for such situations.

The IIR credit and local tax carryforward rules are generally also used to account for post-filing adjustments to tax liabilities, in lieu of requiring amendments to the returns to which such adjustments relate. A post-filing tax adjustment is taken into account when it is determined with finality due to either the period for disputing the tax adjustment having expired or an administrative or judicial determination having been made.

A tax reduction (including a refund) results in a reduction in the amount of the local tax carryforward, first to the local tax carryforward for the year to which the refund relates, then to the carryforwards for subsequent years; to the extent it exceeds such amounts, it reduces the taxes for the year in which the tax reduction becomes final. If a tax reduction exceeds the local tax carryforwards and the taxes for the year, the excess is treated as a current liability for IIR tax. If a tax reduction does not relate to a particular year, such as because it results from the distribution of a dividend, it first decreases the current year tax liability and then excess taxes paid in prior years. Any amount in excess thereof is treated as a current liability for IIR tax.

A post-filing tax increase results in IIR tax credits to the extent of IIR tax paid during the lookback period that has not already given rise to an IIR tax credit. Any excess is treated as a local tax carryforward related to the year to which the tax increase relates or the last year in which IIR tax was paid, with the carryforward period based on such year.

KPMG observation

Although the Pillar Two Blueprint does not specify, presumably a local tax carryforward resulting from a post-filing increase in tax should be treated as related to the later of the year to which the tax increase relates or the last year in which IIR tax was paid in order to minimize the possibility of expiration of the carryforward without use.

In the case of the correction of an error in the prior period financial statements on which GloBE computations are based, or of a change in accounting method that affects such financial statements, the cumulative change is to be reflected in the GloBE Tax Base computation for the year in which the prior period error is corrected or the method is adopted.

Transfers of tax attributes

The Pillar Two Blueprint notes that the development of rules concerning acquisitions and dispositions of Constituent Entities will be necessary. The preliminary assumption is that carryforwards should be associated with an MNE Group rather than a Constituent Entity therein, thus limiting the transfer of tax attributes with an entity to a greater extent than might otherwise occur under local law. However, rules would be necessary to prevent a double benefit to a seller or double expense to a buyer of the mismatch in treatments of carryforwards between the GloBE rules and local tax rules. Accordingly, the Pillar Two Blueprint concludes that an adjustment to carryforwards is appropriate when a Constituent Entity is sold outside of an MNE Group. It could be effectuated by requiring the buyer and seller to adjust carryovers of losses and excess taxes by the amount of the related deferred tax asset retained by the target (or

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

inherited by the successor, if applicable), as well as to identify deferred tax assets transferred to the buyer and make corresponding adjustments. Further development is planned with regard to these rules.

Formulaic substance-based carve-out

The Pillar Two Blueprint proposes an adjustment to the GloBE Tax Base to carve out a fixed return based on a payroll component and a tangible asset component. This formulaic carve-out is intended to allow routine returns to be sheltered for both labor-intensive and capital-intensive businesses. If the carve-out amount exceeds the GloBE income for a year, it cannot be carried forward to reduce future GloBE income.

The payroll component of the carve-out is computed as a fixed percentage of the eligible payroll costs for all employees as well as independent contractors participating in ordinary operating activities. Independent contractors can include individuals employed by a staffing company if their daily activities are performed under the direction and control of the Constituent Entity, but independent contractors do not include employees of a corporate contractor providing goods or services to the Constituent Entity. Payroll costs are taken into account based on the jurisdiction where actual activity is performed. For this purpose, the CbCR treatment of employee activities as performed in the residence jurisdiction of the Constituent Entity paying the employee's salary generally applies, but if the activities or services are performed elsewhere, the residence of the employee is to be used, unless there is strong evidence that the actual activity is performed in another jurisdiction. A consistent method for determining location of employee activities should be used across an MNE Group and from year to year.

Eligible payroll costs are the total amount of payroll expenditures during a year (rather than solely those treated as an expense on an income statement), provided they give rise to a direct and separate personal benefit to the employee, including expenditures for salaries and wages and employee benefits. Eligible payroll costs also include payroll taxes (or other employee expense-related taxes such as fringe benefits taxes) and employer social security contributions.

The tangible asset component of the carve-out is computed on a jurisdictional basis as the sum of:

- A fixed percentage of the depreciation of property, plant and equipment ("PP&E"), taken into account in the jurisdiction of the Constituent Entity (including a permanent establishment) that uses the asset;
- A fixed percentage of the deemed depreciation of land, taken into account in the jurisdiction in which the land is located;
- A fixed percentage of the depletion of natural resources (including oil and gas deposits, timber tracts and mineral deposits), taken into account in the jurisdiction in which the natural resource is located; and
- A fixed percentage of the depreciation of a lessee's right-of-use tangible asset (including the rental cost for operating leases), taken into account in the jurisdiction of the Constituent Entity lessee that uses the property in its business.

Excluded from consideration for the carve-out are:

- Buildings and land held as investment properties, determined as those—
    - Held to earn rental income or for capital appreciation (or both) and not owner-occupied;
    - Not used in production or supply of goods and services or for administration; and
    - Not held for sale in the ordinary course of business;
- Assets held for sale rather than use, as indicated by their availability for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets, if the sale is highly probable; and
- Assets leased to customers (but the customer may include the leased asset to the extent of the corresponding right-of-use asset).

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

The depreciation and depletion computations (including the base, the useful or service life, and the method of depreciation or depletion) must conform with the computations used for financial accounting purposes and to compute the GloBE Tax Base, but any increases resulting from revaluations or related party asset sales (other than ones in which gain on the asset sale is recognized in the GloBE Tax Base) or similar basis-hyping back-to-back transactions with unrelated parties are disregarded. In order to avoid duplication, amounts included in the carry cost of a self-constructed asset for labor costs and depreciation of an asset used in the construction of the asset are disregarded. However, impairment charges are treated as equivalent to depreciation or depletion, and the post-impairment decreases thereto for financial accounting purposes are regarded. However, depletion charges should be computed without regard to restoration-related costs. Depreciation and depletion charges that are accounted for as product costs are included in the carve-out base in the year incurred regardless of when the related product is sold. Deemed depreciation on land is computed using the original acquisition cost for the land (determined separately from any buildings or agriculture produce thereon), a deemed useful life of 57 years, and a straight-line depreciation method.

Calculation of ETR and top-up tax

A three-step process applies to determine the ETR for each jurisdiction in an MNE Group and the top-up tax imposed on each Constituent Entity in a particular jurisdiction. First, the ETR for a jurisdiction is determined by dividing the adjusted covered taxes for the jurisdiction by the adjusted GloBE income for the jurisdiction.

The adjusted covered taxes are the covered taxes assigned to the jurisdiction and reported as due and payable for the year, except taxes attributable to income excluded from the GloBE Tax Base, increased by so much of the local tax carryforward as is necessary to achieve an ETR that is equal to the minimum rate. Taxes that are not paid, for example due to a practice of taking into account loss carryovers on administrative assessment rather than self-assessment, are not taken into account in the numerator. Furthermore, for this purpose, in order to mitigate the risk of double taxation due to the both imposition of tax under the IIR or the UTPR and a withholding tax under an STTR, any withholding tax accrued on income other than a distribution from another Constituent Entity that will be paid within 12 months of the end of the year of the income accrual may be included in covered taxes for the year of the income accrual. Any amount of tax reported but not paid within a certain period (suggested to be two years) would be treated as a reduction in covered taxes in the subsequent year.

Adjusted GloBE income is the combined income and loss of all Constituent Entities located in the jurisdiction for the year, without regard to whether the Constituent Entities are wholly owned by the MNE Group, decreased by the loss carryforward for the jurisdiction.

KPMG observation

Although the Pillar Two Blueprint, like the Consultation Document, does not specify the minimum tax rate, the examples in the Pillar Two Blueprint assume a minimum tax rate of 10%, down from 15% in the Consultation Document.

If the ETR for a jurisdiction is below the minimum tax rate, a "top-up tax percentage" for the jurisdiction is determined as the excess of the minimum ETR over the ETR as calculated for that jurisdiction in the relevant period. The amount of top-up tax for each Constituent Entity in the jurisdiction that has positive net income for the year is determined as its adjusted GloBE income multiplied by the top-up tax percentage. The adjusted GloBE income for a Constituent Entity is determined by reducing its GloBE income by a share of loss carryforwards, losses of other Constituent Entities in the jurisdiction, and the

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

carve-out amount for the jurisdiction, each allocated to Constituent Entities with positive net income proportionally based on their net income.

Potential simplification measures

The Pillar Two Blueprint notes that public comments stressed the need for simplification measures to reduce the complexity and administrative burden of performing ETR calculations on a jurisdiction-by-jurisdiction basis, particularly in low-risk situations. It notes that four simplification measures have been considered, including:

a) A safe-harbor permitting use of CbCR data to calculate ETR;
b) A *de minimis* profit exclusion;
c) Allowing a single jurisdictional ETR calculation to cover several years; and
d) Tax administrative guidance identifying "low risk" jurisdictions

The Pillar Two Blueprint further notes, however, that a decision on whether to adopt any particular simplification method would be made only after further public consultation.

CbCR ETR safe harbor

The Inclusive Framework is considering a safe-harbor under which MNE Groups that prepare their CbCR report based on their parent company's consolidated financial accounts would not be required to perform a separate GloBE ETR calculation for a jurisdiction in which the ETR calculated on the basis of the CbCR report, with a number of adjustments, was above a threshold (to be specified later) set above the agreed minimum rate.

The Pillar Two Blueprint lists a substantial number of adjustments that would be required in order to rely on CbCR information, including among others: (1) elimination of income or loss reported in Profit (Loss) before Income Tax under the equity method of accounting; (2) the permanent adjustments required to financial accounting income under the GloBE rules; (3) reassigning tax on dividends and CFC taxes to reflect the assignment of income under the GloBE rules; (4) increasing Income Tax Accrued (Current Year) by any covered taxes that are not income taxes for financial accounting purposes; and (5) reducing Income Tax Accrued (Current Year) by the amount of any refunds of tax. Consideration is also being given to incorporating deferred tax accounting information into the determination of the ETR safe harbor. The Pillar Two Blueprint notes that adjustments may also be identified as work continues.

KPMG observation

The Pillar Two Blueprint notes that as part of the 2020 review of CbCR, consideration is being given to including movements in deferred tax (even though deferred tax accounting seems to have been rejected as a basis for addressing timing differences under the GloBE rules), and some of the other adjustments described above, into the CbCR rules. To the extent that this is the case, starting from the CbCR information has the potential to avoid duplicative efforts. If such change would not be necessary other than for purposes of the GloBE regime, however, the reduction in administrative burden appears to be limited.

De minimis **profit exclusion**

A *de minimis* profit exclusion would require MNE Groups to apply the GloBE rules only to jurisdictions in which profits exceed a minimum threshold, such as 2.5% of the MNE Group's pre-tax profit. This approach would rely on the transfer pricing guidance introduced under Actions 8-10 of the BEPS Action Plan to prevent splitting of ownership of valuable IP among a large number of low-taxed IP vehicles. The

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Pillar Two Blueprint notes that such an approach could reduce the number of ETR calculations that would be required, particularly for MNE Groups operating in very large numbers of countries. While it would still require a computation of pre-tax profit in all jurisdictions in which the MNE Group operated, consideration is being given to allowing MNE Groups that do CbCR based on the parent's consolidated accounts to use that CbCR data to calculate pre-tax profit (either with or without adjustments of the type described above with respect to the CbCR ETR safe harbor).

In addition to the need to agree on where to set the *de minimis* percentage, the Pillar Two Blueprint identifies a number of additional areas for further work, including: (1) whether the denominator of the *de minimis* calculation would include or exclude the MNE Group's profit in its parent jurisdiction; (2) treatment of losses; (3) management of temporary differences; and (4) whether additional measures would be needed to address the risk of fragmentation of activities. Consideration is also being given to fixed monetary thresholds rather than thresholds based on relative percentage of the group profit.

KPMG observation

While a *de minimis* threshold could reduce administrative burden, particularly for MNE Groups operating in very large numbers of countries, the amount of simplification it would provide seems relatively limited, particularly to the extent that significant adjustments to CbCR data are required.

ETR calculation to cover several years

Another option being considered would be to permit an MNE Group with a jurisdictional ETR that exceeds a certain threshold rate in a particular year (the "base year") to rely on that ETR for a grace period (for example, 3-5 years), rather than performing the calculation every year. To prevent abuse, consideration is being given to additional restrictions, including requiring MNE Groups relying on this measure to make an annual representation that no business change occurred during the grace period, as well as to prevent manipulation of ETR in a base year. Consideration is being given to requiring computation of the ETR for multiple consecutive years rather than a single year.

KPMG observation

This option would require calculation of ETR at least once in every jurisdiction every few years, possibly based on data from multiple different years, which appears to significantly limit its ability to provide meaningful simplification.

Tax administrative guidance

This simplification measure would establish a process for tax administrations to work, together with stakeholders, to identify jurisdictions where the tax base is sufficiently similar to the GloBE Tax Base and the rate is sufficiently high. MNE Groups would benefit from a presumption that an ETR calculation would not be required for identified low-risk jurisdictions unless requested specifically by a tax authority within a specified period of time. The "low-risk" determination could be (1) jurisdiction-wide, (2) limited to MNE Groups operating within certain sectors; or (3) limited to MNE Groups outside certain sectors. Significant changes in tax base or rate within a jurisdiction would require redetermination of "low risk" status.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

KPMG observation

This measure appears to present by far the greatest potential to simplify compliance and improve certainty for taxpayers. As noted in the Pillar Two Blueprint, such an approach would be most effective if it took place before the GloBE rules become effective.

IIR and switch-over rule

The top-up tax computed on an MNE Group's profits in a particular jurisdiction would be collected either through an IIR or through the UTPR. The computation of the top-up tax with respect to each Constituent Entity is done independently of the allocation of that liability under the IIR and UTPR. As discussed in further detail in Section II.F, below, where an IIR applies, the IIR takes priority over the UTPR.

Where an IIR applies, it requires a taxpayer that is the parent of an MNE Group (or of a part of an MNE Group) to pay the top-up tax on its proportionate share of the income of any low-tax Constituent Entity in which that taxpayer has a direct or indirect ownership interest. Where multiple IIRs could apply to the same income of a Constituent Entity, a coordination rule (the "top-down approach") gives priority to the jurisdiction of the Constituent Entity that is closest to the top of the ownership chain in the MNE Group, beginning with the UPE. An exception to the top-down approach applies in the case of "split ownership" structures in which a significant portion (*e.g.*, 10% or more) of the equity interests in a Constituent Entity (the "Partially Owned Intermediate Parent") are held by persons that are not part of the MNE Group. A "switch-over" rule would ensure that a parent entity's jurisdiction of residence would be permitted to apply its domestic law IIR to tax the profits attributable to a PEof the parent entity even where a tax treaty would otherwise exempt those profits. Each of these features is discussed in further detail below.

Top-down approach

As noted above, the top-down approach gives priority to the jurisdiction of the Constituent Entity that is closest to the top of the ownership chain in the MNE Group, beginning with the Ultimate Parent Entity.

The IIR would provide that any "Parent" that owns (directly or indirectly) an equity interest in a foreign low-taxed Constituent Entity would be obligated to apply the IIR to its proportionate share of the income of any Constituent Entity in which it holds (directly or indirectly) an equity interest. The term "Parent" is defined as a Constituent Entity that (1) owns (directly or indirectly) an equity interest in another Constituent Entity; (2) is located in a jurisdiction that has adopted an income inclusion rule; and (3) is not controlled, directly or indirectly, by another Constituent Entity or Entities that are subject to an IIR. The term "Parent" also includes a Partially Owned Intermediate Parent, as discussed below.

Under this top-down approach, if a UPE is subject to an IIR, Constituent Entities (other than Partially Owned Intermediate Parents) that are controlled by that UPE are not Parents for purposes of the IIR, and therefore will not be subject to IIR in their jurisdiction of residence.

KPMG observation

The top-down approach appears to significantly reduce the number of jurisdictions in which an MNE Group can be subject to an IIR, and thus appears significantly more administrable than a bottom-up approach would be. The situations in which multiple Constituent Entities within the same MNE Group pay the IIR should be limited to the split-ownership situation described below and the situation in which the UPE of an MNE Group has not implemented an IIR in accordance with the GloBE rules.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

KPMG observation

For U.S. MNE Groups, assuming the GILTI regime is ultimately treated as a qualified income inclusion rule for purposes of the GloBE rules, the top-down approach appears to be the simplest way to give effect to that decision. Note, however, that the Pillar Two Blueprint flags for further consideration the interaction of the GloBE rules with the GILTI rules for U.S. intermediate parent companies of foreign groups headquartered in countries that apply an IIR.

Split ownership rules

The Pillar Two Blueprint provides an exception to the top-down approach for a "Partially Owned Intermediate Parent", which is a Constituent Entity (other than the UPE) located in a jurisdiction that has adopted an IIR, if more than a specified percentage of the equity interests of the entity are held directly or indirectly by persons that are not themselves Constituent Entities of the MNE Group.

If a Parent holds any portion of its equity in a low-taxed Constituent Entity through a Partially Owned Intermediate Parent, then as a general matter, the IIR applicable to the Partially Owned Intermediate Parent is given priority over the IIR applicable to the Parent. A Partially Owned Intermediate Parent that is treated as such solely because it is indirectly owned by persons that are not Constituent Entities will not, however, apply the IIR if all of its equity interests are held directly or indirectly by Constituent Entities required to apply the IIR. The percentage of equity interests owned by a shareholder is not determined based on level of control, and instead is determined based on the percentage of distributed profits to which the shareholder is entitled, subject to a three-year averaging rule in the case of preferred shares or similar equity interests granting a right to collect a specified amount of distributed profits in preference to the other shareholders.

KPMG observation

While the Pillar Two Blueprint does not reach a decision about the amount of ownership by persons that are not Constituent Entities required for an entity to be treated as a Partially Owned Intermediate Parent, 10% is used as an example numerous times.

Where there are two or more Partially Owned Intermediate Parents in the same ownership chain, priority in applying an IIR with respect to a low-taxed Constituent Entity is generally given to the lowest-tier Partially Owned Intermediate Parent in a jurisdiction that has implemented an IIR, provided that its equity interests are not held entirely by other Constituent Entities that are subject to an IIR. Where a Partially Owned Intermediate Parent is itself a low-taxed Constituent Entity, however, an upper-tier Partially Owned Intermediate Parent will still be required to apply the IIR with respect to any income that was not subject to the IIR of the lower-tier Partially Owned Intermediate Parent.

KPMG observation

As illustrated in numerous examples in an Annex to the Pillar Two Blueprint, the Partially Owned Intermediate Parent rules add significant complexity to the operation of the IIR in the case of split ownership. This was done to prevent MNE Groups owned entirely through a single corporation from being subject to more top-up tax than MNE Groups in which a portion of the equity interests in one or more subsidiaries is held directly by one or more shareholders.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

The Pillar Two Blueprint states that further work will be undertaken on the design of the split-ownership rules in light of the top-down approach and the development of rules for taxation of Associates (discussed below).

Switch-over rule

The Pillar Two Blueprint notes that where a foreign subsidiary of an MNE Group maintains a PE in another jurisdiction, an appropriate portion of the income and taxes of that subsidiary would be allocated to the PE jurisdiction for purposes of calculating the jurisdictional ETR in the foreign subsidiary and PE jurisdictions. Where a Parent directly derives PE income that would otherwise be exempt under the Parent jurisdiction's laws, absent other considerations, absent a treaty obligation to the contrary, the Parent jurisdiction could, for purposes of calculating the Jurisdictional ETR in the parent and PE jurisdictions, allocate the income and tax with respect to PE to the PE jurisdiction. For countries that are unable to override treaties through domestic law, however, such an approach would not be permitted where a bilateral tax treaty requires the Parent jurisdiction to exempt the income of the PE.

The Pillar Two Blueprint notes that a "switch-over" rule is being explored to ensure that a parent entity's jurisdiction of residence would be permitted to apply its domestic law IIR to tax the profits attributable to a PE of the parent, even where a tax treaty would otherwise exempt those profits.

KPMG observation

The switch-over rule would require changes to bilateral tax treaties. The Pillar Two Blueprint suggests that such changes could be implemented through bilateral negotiation, through amending the existing Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "MLI"), or through a new multilateral convention. It is not yet clear whether adoption of such treaty changes would be considered mandatory or optional.

UTPR

The Pillar Two Blueprint would provide that the top-up tax computed in relation to an MNE's profits is collected either through the IIR or through the UTPR. If the UTPR applies, the UTPR would require a Constituent Entity that is located in a jurisdiction that has implemented the UTPR (a "UTPR Taxpayer") to make an adjustment in respect of any top-up tax that is allocated to that taxpayer from a low-tax Constituent Entity of the same group. The UTPR is intended to serve as a backstop to the IIR and to reduce the incentives for tax-driven inversions. The UTPR also is intended to address base erosion through deductible intragroup payments.

KPMG observation

The UTPR has been compared to the U.S. BEAT, but the UTPR differs from the BEAT in fundamental ways. Perhaps most importantly, the application of the BEAT does not depend on the tax treatment of the recipient of deductible payments made by a U.S. taxpayer, while the UTPR is applied only to allocate an amount of top-up tax with respect to a Constituent Entity that has an ETR below the minimum agreed rate.

Interaction with IIR

The IIR has priority over the UTPR. That is, no top-up tax is allocated under the UTPR if the low-tax Constituent Entity is controlled, directly or indirectly, by a foreign Constituent Entity that is subject to an

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

IIR that has been implemented in accordance with the GloBE rules. However, as described in more detail in Part II.F.2 below, a top-up tax may be allocated under the UTPR from Constituent Entities located in the UPE jurisdiction if the MNE Group's ETR in that jurisdiction is below the agreed minimum rate.

The UTPR and IIR would use the same mechanics to determine the amount of top-up tax with respect to a low-tax Constituent Entity. The IIR and UTPR also would use the same application of loss carryforwards and excess taxes to address timing differences and calculate the ETR in each jurisdiction.

KPMG observation

Assuming that the GloBE rules treat GILTI as a qualifying IIR, the UTPR generally would not apply to non-U.S. Constituent Entities of a U.S.-parented MNE Group, because they would be controlled foreign corporations as defined in section 957 of the Code ("CFCs") and would be deemed to be subject to a qualifying IIR. However, U.S. Constituent Entities of the group could give rise to top-up tax if the U.S. Constituent Entities are subject to an ETR below the agreed minimum rate due to book-tax differences. In that case, the top-up tax would be allocated to non-U.S. Constituent Entities that are UTPR Taxpayers, and those entities would be subject to additional tax under the UTPR based on the allocation described below.

If the IIR does not apply at the UPE level but does apply at a sub-holding level, the low-tax Constituent Entities located in a given jurisdiction may not all be owned by the same parent entity applying the same IIR. Whether the income of a low-tax Constituent Entity is covered by an IIR or the UTPR therefore would be determined on an entity-by-entity basis. If an IIR applies to a controlling shareholder of the low-tax Constituent Entity, no UTPR applies; if no IIR applies, then the UTPR applies. If an IIR is applied by a minority shareholder of the low-tax Constituent Entity, the UTPR also applies, but is reduced by the amount of top-up tax that is imposed by the IIR.

Application to UPE jurisdiction

Neither the IIR nor the UTPR apply to capture low-tax income from a Constituent Entity in the same jurisdiction as the taxpayer. In order to ensure that a group does not gain a tax advantage by being parented in a low-tax jurisdiction that has implemented an IIR, the UTPR would apply to a Constituent Entity that is located in a different jurisdiction than its UPE. If the jurisdiction of the UPE has implemented an IIR, the IIR and UTPR could both apply, but they would apply to different low-tax income. The IIR would cover the MNE Group's low-tax income in all the subsidiary jurisdictions, while the UTPR only would apply to the profits in the UPE jurisdiction, and only if those profits are subject to an ETR below the agreed minimum rate.

The Pillar Two Blueprint notes that the application of the UTPR to the earnings of Constituent Entities in the UPE jurisdiction may give rise to disproportionate compliance burdens, particularly if the business of the MNE Group is mostly in the UPE jurisdiction. The Pillar Two Blueprint notes that the caps discussed in Part II.F.3 may mitigate those burdens, but that further work will be done to explore other options to address those challenges, including a credit for UTPR taxes paid due to timing differences or a top-up tax mechanism for in-scope taxpayers.

Allocation keys

If the UTPR applies, the Pillar Two Blueprint would use two allocation keys to allocate the top-up tax among UTPR Taxpayers. Under the first allocation key, if a UTPR Taxpayer makes any deductible payments to the low-tax Constituent Entity during the relevant period, the top-up tax of such Constituent Entity is allocated to the UTPR Taxpayer in proportion to the total of deductible payments made to the low-tax Constituent Entity by all UTPR Taxpayers. Each UTPR Taxpayer would be allocated a portion of

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

the top-up tax that is computed in relation to the income of each low-tax Constituent Entity equal to the following:

> (Direct intragroup payments from the UTPR Taxpayer to the low-tax Constituent Entity) / (All direct intragroup payments from all UTPR Taxpayers of the group to the low-tax Constituent Entity).

The amount of top-up tax allocated to a UTPR Taxpayer under the first allocation key cannot exceed the domestic covered tax rate applicable in the jurisdiction of the UTPR Taxpayer multiplied by the amount of the deductible direct payments that are taken into account in applying the first allocation key.

The second allocation key applies if not all of the top-up tax has been allocated under the first allocation key. Under the second allocation key, if a UTPR Taxpayer has net intragroup expenditure, the remaining top-up tax is allocated in proportion to the total amount of net intragroup expenditure (including payments to Constituent Entities in the same jurisdiction) incurred by all UTPR Taxpayers. Net intragroup expenditure is net of related party income derived by the relevant UTPR Taxpayer. For this purpose, the intragroup payments made by a UTPR Taxpayer include payments that were taken into account under the first allocation key. The second allocation key is intended to enable the UTPR to function as a backstop to the IIR and to address potential attempts to structure around the UTPR without needing to trace the destination of all payments made by UTPR Taxpayers. It uses a fungibility of money approach that effectively deems the amount of net profit shifted out of each UTPR Taxpayer as funding a proportionate share of the remaining low-tax profit of the MNE Group. Under the second allocation key, each UTPR Taxpayer is allocated a portion of the total top-up tax that was not allocated under the first allocation key equal to:

> (Net intragroup expenditure of the UTPR Taxpayer) / (Sum of all net related party expenditure of UTPR Taxpayers).

The top-up tax allocated to a UTPR Taxpayer under the second allocation key cannot exceed the domestic covered tax rate multiplied by the gross amount of deductible intragroup payments taken into consideration in applying the second allocation key (which do not include the payments taken into account in computing the cap under the first allocation key).

KPMG observation

While the UTPR is intended to result in an allocation of the same amount of top-up tax as the IIR, the caps on the UTPR may mean that the full amount of the top-up tax cannot be allocated under the UTPR in some situations. The rules therefore could incentivize MNE Groups to structure out of the IIR and to arrange their intragroup transactions such that the full amount of the top-up tax cannot be collected under the UTPR.

KPMG observation

As noted above, the second allocation key includes the payments taken into account under the first allocation key, but the cap on the second allocation key excludes payments taken into account in determining the cap on the first allocation key. Thus, top-up tax can be allocated to a UTPR Taxpayer under the second allocation key even if that UTPR Taxpayer has a zero cap under the second allocation key because all of its intragroup payments are already taken into account under the first allocation key. It is not clear if this result is intended, but it could significantly reduce the amount of top-up tax that can be effectively allocated under the UTPR in some circumstances.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

No top-up tax is allocated to UTPR Taxpayers that are located in a jurisdiction in which the MNE Group's Jurisdictional ETR is below the agreed minimum rate. The Pillar Two Blueprint suggests that jurisdictions that want to ensure that they can apply the UTPR in every year with respect to every MNE Group operating in their jurisdiction could impose a domestic minimum tax with the same tax base and tax rate as the GloBE rules.

KPMG observation

The suggestion of a domestic minimum tax based on the GloBE rules would expand the GloBE rules from a minimum tax on cross-border income into a truly global minimum tax with a single global base.

For purposes of applying the allocation keys, intragroup payments are deducible payments made by a Constituent Entity to another Constituent Entity of the MNE Group. Deductible payments include all current expenditure and receipts, including rents, royalties, interest, and fees paid for services, and also would include amounts included as inventory costs (*i.e.*, payments that for U.S. federal income tax purposes generally are treated as a reduction in gross income rather than as a deduction). Deemed or notional payments between a PE and its head office or between PEs also would be taken into account. Deductible payments would be taken into account on an accrual basis. Specific limitations on deductibility such as limitations on deductibility of interest or anti-avoidance rules would not be taken into account for purposes of identifying deductible payments.

KPMG observation

Unlike the BEAT, the UTPR would be applied with respect to expenses that are included in cost of goods sold ("COGS"), as well as to payments for which no actual deduction is allowed for a tax year due to limitations such as section 163(j) of the Code.

Limitation on application UTPR to UPE jurisdiction

As noted above in Part II.F.3, the maximum amount of top-up tax that can be allocated to a UTPR Taxpayer under either of the allocation keys is the domestic covered tax rate multiplied by the gross deductible intragroup payments taken into account in the relevant allocation key.

A further limitation applies to the top-up tax that can be allocated from low-tax Constituent Entities in the UPE jurisdiction. The maximum amount of top-up tax that can be allocated from low-tax Constituent Entities in the UPE jurisdiction cannot exceed the top-up tax percentage (defined below) multiplied by the total amount of deductible intragroup payments received by the low-tax Constituent Entities in the UPE jurisdiction from foreign Constituent Entities. Specifically, the maximum top-up tax allocable in respect of Constituent Entities in the UPE jurisdiction is:

> (The top-up tax percentage) x (Foreign intragroup revenue of all low-tax Constituent Entities in the UPE jurisdiction).

For this purpose, the "top-up tax percentage" is the difference between the minimum agreed ETR and the ETR as calculated for the UPE jurisdiction in the relevant period under the GloBE rules after adjusting for any excess taxes (as defined in Part II.C.2) in the UPE jurisdiction.

When the cap on top-up tax for the UPE jurisdiction applies, the amount of adjusted GloBE income of each Constituent Entity in the UPE jurisdiction is computed on an entity-by-entity basis as:

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

(Adjusted GloBE income of the relevant Constituent Entity) / (Adjusted GloBE income of all low-taxed Constituent Entities in the UPE jurisdiction) x (Foreign intragroup revenue of all low-taxed Constituent Entities in the UPE jurisdiction).

The amount of top-up tax allocable under the UTPR in respect of each low-tax Constituent Entity in the UPE jurisdiction is then:

(Adjusted GloBE Income of low-tax Constituent Entity after limitation) x (Top-up tax percentage).

KPMG observation

The Pillar Two Blueprint points out that an entity in the UPE jurisdiction cannot be subject to the IIR, and thus it cannot take advantage of the simpler compliance mechanism of the IIR. The Pillar Two Blueprint also points out that the application of the UTPR to the UPE jurisdiction may be disproportionate if the MNE Group has relatively limited operations outside the UPE jurisdiction by allocating a large top-up tax burden to those limited operations. However, the cap does not simplify the application of the UTPR, nor is it limited to MNE Groups that have limited operations outside the UPE jurisdiction. This cap, like the other caps, therefore may create incentives for MNE Groups to have their UPE in a low-tax jurisdiction.

Mechanism to collect UTPR

A UTPR Taxpayer that is allocated top-up tax under the UTPR either would be denied a deduction for an intragroup payment or would be required to make an equivalent adjustment under domestic law that results in the UTPR Taxpayer having an incremental tax liability equal to the allocated top-up tax amount.
Because the IIR takes priority over the UTPR, a taxpayer would be offered the possibility to certify that the low-tax profits of a Constituent Entity are subject to a qualifying IIR, in which case the UTPR would not apply. The Pillar Two Blueprint suggests that the Inclusive Framework may develop and publish a list of qualifying IIRs for this purpose.

Similarly, the Pillar Two Blueprint suggests that a UTPR Taxpayer can certify that the UTPR does not apply because (i) all of the Constituent Entities in the MNE Group have an ETR at least equal to the minimum agreed rate or (ii) intragroup payments cannot result in an allocation of top-up tax due to the caps.

If the UTPR does apply, the taxpayer would be required to provide the information necessary to apply the UTPR to each relevant taxing authority in a standardized format. The required information is likely to include for each period:

- A list of all jurisdictions in which the MNE Group has Constituent Entities and the MNE Group's Jurisdictional ETR in each of those jurisdictions, as well as the balances in the pools of carryforwards for losses, local taxes, and IIR tax credits;
- The total amount of top-up tax arising in that period for jurisdictions where the MNE Group's Jurisdictional ETR is below the agreed minimum rate;
- The total amount of intragroup payments made by each UTPR Taxpayer to each low-tax Constituent Entity;
- The total amount of top-up tax imposed in the year as a result of the first allocation key; and
- The net intragroup expenditure of each UTPR Taxpayer.

The Pillar Two Blueprint contemplates that the tax allocated under the UTPR generally would be payable for the same year in which the ETR of the MNE Group is below the agreed minimum rate in the relevant

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

low-tax jurisdiction. If the top-up tax cannot be imposed in the year of adjustment, the adjustment could be carried over and imposed in a subsequent year provided the rule is likely to result in an incremental tax liability within a reasonable period of time.

KPMG observation

The Pillar Two Blueprint suggests that one reason the top-up tax could not be imposed in a given year is that the UTPR Taxpayer may not have a sufficient amount of deductible related party expenses to support the adjustment. The caps on the amount of top-up tax that can be collected under the UTPR are also based on deductible related party expenses, but it is not clear whether the proposed carryforward rule would apply in the case of the application of a cap. The carryforward rule may be intended to apply instead to cases in which the UTPR Taxpayer has related party expenses, but they are not deductible in the current year due to, e.g., limitations on the deductibility of interest.

Special rules for joint ventures and orphan entities

Overview

The Pillar Two Blueprint includes special rules for joint ventures ("JVs") and orphan entities. The special rule for JVs applies a simplified IIR to the income of an MNE Group that is attributable to ownership interests in entities or arrangements that are reported under the equity method. The special rule for orphan entities is designed to extend the application of the UTPR to arrangements that could otherwise be used to extract profit from the MNE Group, giving rise to a BEPS risk.

Joint ventures

An MNE Group's share of the income of JVs is included in the group's financial accounting income under the equity method, but is excluded from the GloBE Tax Base as a permanent difference. The Pillar Two Blueprint points out that this creates a risk of leakage and unfairness, but concludes that it would be very challenging to apply the full set of IIR rules to the income of JVs.

Accordingly, the Pillar Two Blueprint adopts a simplified IIR for the income of an MNE Group attributable to ownership interests in entities or arrangements that are reported under the equity method. The simplified IIR determines the ETR for the income attributable to each such entity based on the MNE Group's equity method income attributable to each investment in the entity and the MNE Group's proportionate share of the income taxes accrued by the entity and its subsidiaries, if any, for the year (including for this purpose, consideration of loss carry-forwards or similar adjustments). This computation departs from the general IIR in three respects: (i) it is effectively based on worldwide blending of the income and taxes of the entity and all its subsidiaries; (ii) the income taxes are determined based on the financial accounting rules, including deferred tax accounting, (iii) it only takes into account taxes that are treated as income taxes for financial accounting purposes.

If the ETR computed for a JV is below the minimum rate, the MNE Group's equity method income attributable to the ownership interest in the entity is multiplied by the top-up tax percentage (the difference between the minimum rate and the ETR) to determine the top-up tax attributable to that ownership interest. The simplified IIR does not apply, however, in the case of a JV organized in a jurisdiction that has adopted the GloBE rules and has an ETR above the minimum rate.

Orphan entities

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

The Pillar Two Blueprint expresses concern that entities or arrangements that are not Constituent Entities, but are controlled by the same shareholder(s) as the Constituent Entities forming the MNE Group (so-called "Orphan Entities"), could be used to extract profit from the MNE Group. Thus, the Blueprint proposes that the profits of Orphan Entities be subject to the UTPR under certain circumstances. Specifically, an Orphan Entity will be treated as a Constituent Entity for purposes of the UTPR when such Orphan Entity is a "connected person" and derives more than a certain amount or a certain percentage of its annual turnover from deductible intragroup payments that were made directly by Constituent Entities of the MNE Group. In addition, an Orphan Entity is included in the scope of the UTPR only if it would result in an increase in the total amount of top-up tax that can be collected under the UTPR.

Two persons are considered "connected persons" for purposes of this rule if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons. In any case, a person or enterprise shall be considered to be connected to another person if: (a) one possesses directly or indirectly more than 50% of the beneficial interests in the other (or, in the case of a company, more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or (b) if another person possesses directly or indirectly more than 50% of the beneficial interests (or, in the case of a company, more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in each person.

Subject to tax rule

The STTR would act as a complement to the GloBE rules and would target intragroup payments that exploit certain treaty provisions to shift profits from a source jurisdiction to the other contracting jurisdiction where the payment is subject to a low nominal tax rate. The STTR is premised on the rationale that a source jurisdiction that has ceded its right to tax particular items of income under the treaty should nevertheless be able to apply a top-up tax to the agreed minimum rate if as a result of certain structures the income is taxed at below the minimum rate in the other contracting jurisdiction.

As currently contemplated, the STTR would apply only to certain deductible intragroup payments. Similar base erosion concerns may exist in respect of certain gains, including in transactions between entities that are not connected persons. Further consideration will be given to whether the STTR should apply to such transactions.

The STTR will not be implemented through changes in the OECD Model Tax Convention. Rather, a standalone treaty provision is proposed to codify the STTR and each of its design elements. Consistent with the GloBE rules, the STTR will not apply to payments made to or by individuals.

KPMG observation

Because the STTR applies prior to the GloBE rules, treatment of GILTI as a qualifying IIR will not preclude the STTR from applying to Constituent Entities of U.S.-parented groups.

Connected persons

The STTR will apply to covered payments between connected persons. Two persons are "connected" if one has control over the other or the two are controlled by the same person. The control requirement is generally met if there is a more than 50% direct or indirect ownership of the beneficial interests of an entity—i.e., it is the same control test used for Orphan Entities.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

The control test may be supplemented with anti-abuse rules targeting conduit structuring to be developed in future work.

Covered payments

The current Pillar Two Blueprint applies only to "covered payments", defined as:

- Interest and royalties;
- A franchise fee or other payment of the use of or right to use intangibles in combination with services;
- Insurance or reinsurance premium;
- A guarantee, brokerage or financing fee;
- Rent or any other payment for the use of right to use moveable property;
- An amount paid to or retained by the payee that is consideration for the supply of marketing, procurement, agency or other intermediary services.

This exclusive list of covered payments is intended to include payments that present greater base erosion risk because the value of the payment is primarily compensation for mobile factors, such as capital, assets, or risk, that are owned or assumed by the person entitled to the payment rather than for functions performed by the person entitled to payment.

The STTR would not apply to payments that are included in the income of a PE in the source state, because the source state already has taxing rights over that income. The STTR also would not apply to payments that generate a low return such as cost-plus transfer pricing adjustments.

Excluded entities

The STTR is proposed not apply to certain entities that are outside the scope of the IIR and UTPR. Currently, the following entities are proposed to be excluded:

- Investment funds;
- Pension funds;
- Governmental entities (including sovereign wealth funds);
- International organizations;
- Nonprofit organizations.

Materiality threshold

The STTR is focused on the most material profit shifting risks without creating undue administrative and compliance burdens. Without a threshold, an MNE Group would potentially need to determine the nominal tax rate on thousands of covered payments made to connected persons.

To achieve the proper balance, the STTR will include a materiality threshold to discourage MNE Groups from establishing structures with significant base erosion risk, while excluding *de minimis* tax advantages. The Pillar Two Blueprint acknowledges that the appropriate materiality threshold may vary from jurisdiction to jurisdiction and outlines potential approaches that may be used in isolation or in combination.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

The first approach would be a threshold based on the size of the MNE Group, such as the CbCR revenue threshold.

The second approach would be a threshold based on a tiered value of covered payments made to connected persons in the other contracting state. The threshold could be lower for smaller economies to recognize the difference in what small and large jurisdictions consider a significant risk.

The third approach would be a threshold based on a ratio. Under this approach, the STTR would not apply when the covered payments to connected persons fall below a certain ratio in comparison to total expenditures. The ratio would be computed without regard to cost of goods sold.

The latter two approaches raise administrative and compliance concerns because the payor needs to determine on the date of payment whether the STTR applies, but the threshold would be determined based on payments made during the entire year. Both of these approaches may also need an anti-fragmentation rule to prevent MNE Groups from splitting payments between multiple payors to avoid the threshold.

Nominal rate test

The STTR would apply on a payment-by-payment basis and would be triggered when a payment is subject to a nominal tax rate that is below an agreed upon minimum rate after making certain adjustments. Applying an ETR test was rejected, because it often is not possible to determine the ETR of a particular payment, and the overall ETR of the recipient may not be established when the payment is made.

As a treaty rule, the covered taxes that are taken into account for purposes of determining the nominal rate are those defined by the treaty in provisions that are equivalent to Article 2 of the OECD Model Tax Convention. These may differ from covered taxes for purposes of the GloBE rules.

The nominal tax rate is determined based on the statutory rate in the payee jurisdiction, with certain adjustments to reflect any preferential rate or exemptions that apply to particular payment or the payee. For example, with respect to an item of income, the nominal rate would be adjusted for any—

- Application of preferential rate;
- Exclusion of a certain percentage from tax;
- Application of a lower rate to an amount greater than the income; or
- Allowance of deductions for a deemed expense associated with the payment.

Applying the nominal rate test to an adjusted nominal rate would not take into account deductions that are not directly linked to the covered payment or category of payee. Additionally, any exemption or credit provided in a treaty elimination article, such as paragraph 1 of Article 23A of the OECD Model Tax Convention, should not be included in computing the nominal tax rate.

KPMG observation

The U.S. foreign-derived intangible income (“FDII”) regime appears to be caught by the STTR, depending on the minimum rate that is agreed. FDII provides for a deduction based on the amount of the income, which appears to be taken into account as an adjustment for purposes of the STTR.

Further work is needed to ensure the STTR is applied properly in jurisdictions that calculate the tax base by reference to something other than the payee’s income.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Top-up tax

When a covered payment is subject to a low nominal rate in the payee jurisdiction, the STTR would allow the payor jurisdiction to “top-up” the tax to the agreed minimum rate. That is, the payor jurisdiction could impose a tax on the gross amount of the payment at a rate equal to the difference between the minimum rate and the adjusted nominal rate. Because the top-up tax would be applied to the gross amount of the payment, it is expected that the agreed minimum rate for purposes of the STTR will be lower than the agreed minimum rate for purposes of the GloBE rules.

KPMG observation

Even if the agreed minimum rate under the STTR is lower than that of the GloBE rules, the top-up tax under the STTR could still be larger than that under the GloBE rules because the STTR is applied on a gross basis. Taxpayers therefore may be incentivized to forgo potential tax benefits in order to avoid the application of the STTR.

The Pillar Two Blueprint also notes that collecting the top-up tax under the STTR through withholding may result in temporary over-withholding, if withholding agents apply withholding at too high of a rate (such as the full domestic withholding rate). The Pillar Two Blueprint recommends that an approach be adopted that limits the collection of the top-up tax to that which is due after computing the adjusted nominal rate and that minimizes the delay in obtaining refunds of taxes withheld in excess of the top-up tax. In particular, the Pillar Two Blueprint states that further work will be done on potentially applying the top-up tax as an ex-post annualized charge; certification systems for providing reduced rates of withholding tax; and the application of contingent withholding taxes set at a level that would generally result in an annual ex-post balancing payment by the taxpayer (rather than over-withholding).

Implementation and rule coordination

The Pillar Two Blueprint discusses questions of implementation, including the treaty compatibility of the GloBE and other Pillar Two rules with existing tax treaty obligations, as well as mechanisms to promote effective coordination and to address disputes that may arise as to the application of the rules.

Need for treaty changes

Both the STTR and the SOR conflict with existing bilateral tax treaties, which would need to be modified to make implementation possible for most countries. As noted above, consideration is being given to implementing these changes on a multilateral basis, either by amending the existing MLI, or through a new multilateral convention. It is not yet clear whether adoption of such treaty changes would be considered mandatory or optional.

In contrast, the Pillar Two Blueprint states that the IIR and UTPR could both be implemented in domestic law, and the mechanism for doing so is left to individual jurisdictions, subject to the need to ensure that implementation is consistent with the agreed terms of the GloBE rules. The Pillar Two Blueprint further notes that while some jurisdictions may wish to apply the IIR to MNE Groups headquartered in their jurisdiction that do not meet the consolidated revenue threshold, consideration is being given to whether the overall agreement on the GloBE rules should restrict that right, given that a similar right is not available with respect to the UTPR.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

KPMG observation

Although the Pillar Two Blueprint sets out a detailed argument for treating the IIR and UTPR as compatible with treaty obligations, the answer to that question is by no means certain. As noted below, however, consideration is being given to a multilateral convention to create a legally binding framework for the GloBE rules. Such a convention could also explicitly address any interaction of the IIR and UTPR with existing tax treaties.

Mechanisms for coordination of the GloBE rules

The Pillar Two Blueprint announces that model legislation setting out detailed rules for the IIR and UTPR will be developed to serve as a template that jurisdictions could use as the basis for domestic legislation. In addition, the Inclusive Framework will develop guidance to respond to questions of interpretation as they arise.

In addition, to provide certainty as to the situations in which the UTPR should not apply, a multilateral review process would be established to determine whether a jurisdiction has introduced an IIR in line with the GloBE rules. This review process would use as its basis the model legislation and guidance described above. Consideration is also being given to a more general review of the GloBE rules following their implementation, to ensure that they are working as intended, including whether the use of particular accounting standards results in material competitive distortions.

Consideration is also being given to a multilateral convention, which could contain the key elements and high-level principles of the GloBE rules, including in particular the rule order and the top-down approach for the IIR, as well as any rules that require common defined terms. The Pillar Two Blueprint notes that this multilateral convention would be a standalone legal instrument addressing the "consistent, coordinated, and comprehensive" application of the GloBE rules, and coexisting with the existing tax treaty network. The multilateral convention could address compatibility with existing double tax treaties explicitly, and could provide mechanisms for exchange of information and dispute resolution. It would thus differ from the MLI, which focused solely on modifying existing treaty provisions.

Dispute prevention and resolution

In general, the Pillar Two Blueprint suggests that risks of double taxation are expected to be addressed through the existing international tax framework. For example, because the STTR and SOR would need to be incorporated into existing tax treaties in order to operate, the expectation is that existing tax treaty dispute resolution mechanisms would be available where a taxpayer believed that either rule had been applied in a way that violated the terms of the treaty.

In the case of the IIR and UTPR, the Pillar Two Blueprint notes that the design of the IIR and UTPR, as well as the development of model legislation and guidance and other tools, such as standardized returns, is intended to prevent disputes from arising. Some additional tools may also be available to address double taxation due to inconsistent application of the GloBE rules, including using the Convention on Mutual Administrative Assistance in Tax Matters to exchange information and initiate simultaneous tax examinations, or relying on treaty mechanisms that in some cases permit resolution of disputes in cases not otherwise covered. In addition, if a multilateral convention is developed, it could contain explicit provisions for dispute prevention and resolution regarding the GloBE rules. Such a convention could also provide for exchange of information to ensure that jurisdictions can access information on Constituent Entities that might otherwise be outside of the control of local resident companies.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

KPMG observation

While the IIR and UTPR are intended to be coordinated so that the UTPR would not apply where the IIR applies, it seems inevitable that disputes would arise in any system as complicated as the GloBE rules. Using a multilateral convention to create a dedicated dispute resolution mechanism would thus seem to be an important component of ensuring certainty for taxpayers.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Contact us

For more information, contact a KPMG tax professional:

Michael Plowgian
T: +1 202 533 5006
E: mplowgian@kpmg.Com

Jesse Eggert
T: +1 202 533 5512
E: jeggert@KPMG.com

Stephanie Robinson
T: +1 202 533 4049
E: stephanierobinson@kpmg.com

Rose Jenkins
T: +1 202 533 3959
E: rosejenkins@kpmg.com

Manal Corwin
T: +1 202 533 3127
E: mcorwin@kpmg.com

Matthew Herrington
T: +44 207 6944348
E: matthew.herrington@kpmg.co.uk

Gloria LaBerge
T: +1 713 319 2000
E: glaberge@kpmg.com

www.kpmg.com

kpmg.com/socialmedia

The information contained herein is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 147 countries and territories and have more than 219,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

© 2020 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization. NDPPS 811721