

OECD Pillars: full steam ahead

2023 is set to be a year of change for the global tax landscape. After many years of negotiation, development and consultation, implementation of the OECD's Pillar One and Pillar Two reforms to international taxation is now well underway. The two-pillar reforms constitute the carefully negotiated response to concerns about base erosion and profit shifting in the context of an increasingly digitalised global economy.

Broadly, Pillar One aims to reallocate a portion of taxing rights (**Amount A**) over the residual profits of certain large multinational enterprises (**MNEs**) in favour of market jurisdictions (that is, the jurisdictions in which consumers are located). The residual profits would otherwise typically be taxed only in the jurisdictions where the MNEs house their operations or their IP. Pillar One will also introduce a fixed return on baseline marketing and distribution activities (**Amount B**) by way of a new standardised methodology to simplify the relevant transfer pricing calculations. As part of the Pillar One package, it has also been agreed that all jurisdictions will dismantle any unilateral digital services taxes and other similar measures taxing digital profits.

Pillar Two (which is expected to affect a greater number of companies) seeks to impose a 15% effective minimum corporation tax rate on the profits of in-scope MNEs (broadly, MNEs with annual revenue exceeding EUR 750 million) on the income arising in each jurisdiction in which they operate. Pillar Two will ultimately be effected through a series of interlocking measures (together, the global anti-base erosion – or “GloBE” – rules), comprising an “income inclusion rule”, an “undertaxed payments rule” and a “subject-to-tax rule”.

In this update, we reflect on certain key developments from 2022 and look ahead to what 2023 might have in store as these MNEs and their advisers prepare for a significant shift in the global tax architecture.



Development of Pillar One (reallocation of taxing rights) in 2022

Pillar One has, in a number of respects, progressed at a slower rate than Pillar Two. The political imperative for Pillar One appears to have been rather more muted, and the timeline for implementation has been pushed back on a number of occasions. Currently, the intention is for a multilateral instrument to effect Pillar One to open for signature in mid-2023, with entry into force in 2024.

Nonetheless, the OECD published a significant body of work in 2022, and cynics may have been surprised that, rather than falling off the radar completely, Pillar One lives on. Documents of note published during 2022 include the following:

- February 2022: In relation to Amount A, consultations on: (i) draft nexus and revenue-sourcing rules; and (ii) draft tax base determination rules.
- April 2022: Consultations on: (i) rules on the scope of Amount A; and (ii) the extractives exclusion.
- May 2022: Consultations on (i) tax certainty aspects of Amount A; and (ii) the financial services exclusion.

- December 2022: Draft provisions for a multilateral convention to implement Pillar One (including commitments to withdraw unilateral digital taxes and a mechanism to eliminate Amount A allocations for jurisdictions imposing a digital services tax or equivalent).
- December 2022: Consultation on design elements of Amount B of Pillar One. This is the first publication addressing Amount B since October 2021, so is somewhat overdue. Amount B is also significant since (unlike Amount A and Pillar Two) its application is not dependent on any revenue threshold condition. The OECD and Inclusive Framework are currently assessing the possible inclusion of Amount B guidance in the OECD's existing Transfer Pricing Guidelines.

Although progress on Pillar One has continued, it is worth noting that the documents referred to above have been published by the OECD for the purposes of consultation only. They do not constitute the conclusive views of the Inclusive Framework members (unlike the Pillar Two Model Rules published in December 2021, for example).

Development of Pillar Two (global minimum tax rate) in 2022

On 20 December and 22 December 2021, the OECD and EU published Model Rules and a proposal for a Directive (respectively), in each case designed to implement a global minimum corporate tax rate of 15% in a coordinated manner. The publications constituted important milestones, representing the culmination of significant work and negotiation. However, there was an awareness at the time that much work remained to be done, and that it might be difficult to maintain political momentum during 2022. To some extent, this has been borne out.

Nonetheless, important progress on Pillar Two has been made during 2022, in particular thanks to a flurry of activity at the end of the year. Milestones include the following:

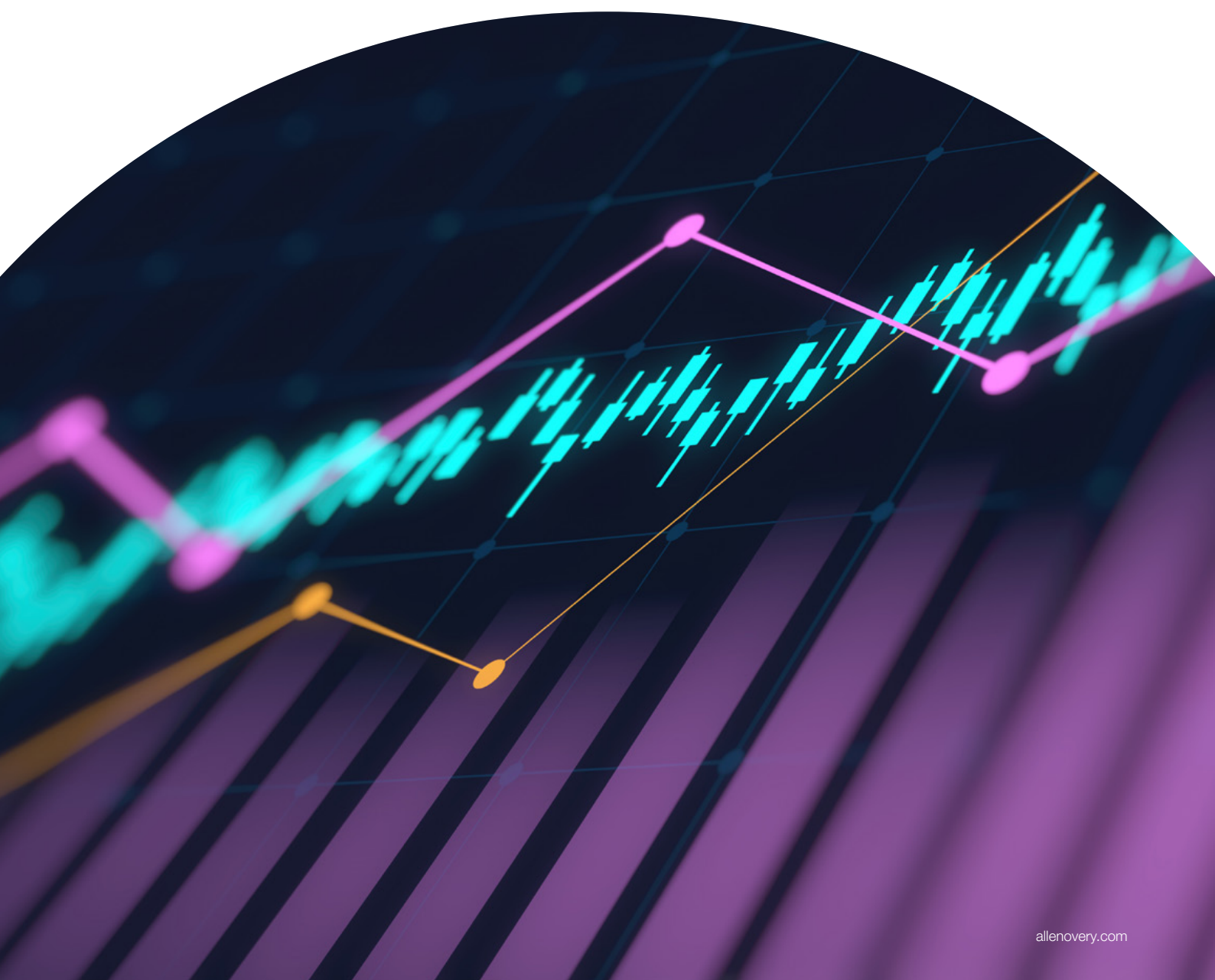
- March 2022: The OECD published its Commentary on the Model Rules.
- December 2022: Nearly a full year after the proposal for the Directive was published, the EU Council formally adopted the Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, implementing Pillar Two. The Directive must be transposed into member states' national law by the end of 2023. Reports suggest that political wrangling continued right up to the wire, with certain member states threatening to use their veto rights, and other jurisdictions (namely, France, Germany, Italy, the Netherlands and Spain) announcing their intention to go it alone in the event that agreement was not ultimately reached.

- December 2022: The OECD published further detail on safe harbours and penalty relief. A commonly expressed concern over Pillar Two has been whether safe harbours will be available, and if so, to what extent. The OECD has previously noted stakeholders' concerns regarding the complexity of the calculations and adjustments to financial income and taxes required under the GloBE rules – in particular, the concern that this could impose a disproportionate compliance burden on certain MNEs in respect of their operations in high-tax and other low-risk jurisdictions. Compliance costs may be considerable even where, ultimately, no tax is payable. It is therefore proposed to include within the rules:
 - a transitional safe harbour provision covering fiscal years beginning on or before 31 December 2026, based on Country-by-Country Reporting rules, which would eliminate an MNE's top up tax liability in a particular jurisdiction where certain tests are met, including (for example) where the MNE reports total revenue of less than EUR 10m and profit before income tax of less than EUR 1m in that jurisdiction; and
 - penalty relief during the transitional period, available where a tax administration considers that an MNE has taken "reasonable measures to ensure the correct application of the GloBE rules".

Consideration is also being given to the possible implementation of permanent safe harbour rules relying on alternative, simplified GloBE calculations, as well as a permanent Qualified Domestic Minimum Top-Up Tax (QMDTT) safe harbour. A QMDTT is a minimum tax rule incorporated into the tax law of a jurisdiction that applies a domestic minimum tax to profits arising in that jurisdiction and calculated in accordance with GloBE principles.

Overall, the announcement of these proposed (and much-anticipated) safe harbour and penalty relief provisions for the GloBE rules will be welcome news for MNEs within scope. It is difficult in any circumstances to write an article on tax policy without using the well-worn phrase, “the devil is in the detail”, but it is surely impossible in this instance. Much remains to be seen as to how the rules (especially the possible permanent safe harbour provisions) will be drafted. These rules are likely to be very significant in practice and we propose to publish a more detailed analysis in due course.

- December 2022: The OECD published [consultation on compliance and tax certainty aspects of the GloBE rules](#), including the GloBE Information Return (that is, the standardised return providing information on an MNE group’s tax calculations for GloBE purposes) and tax certainty measures relating to dispute prevention and resolution.
- Finally, a number of jurisdictions published their own draft domestic implementing legislation during 2022. In particular, the UK government published draft legislation in July, and confirmed as part of its Autumn Statement in November that it would introduce the multinational top-up tax for accounting periods ending on or after 31 December 2023 (aligning with the EU Directive commencement date). The Netherlands also published draft legislation in October, being the first EU member state to do so. It is expected that other member states will follow suit.



2023: What's still to come?

We expect 2023 to be a critical year.

In the context of Pillar One, and despite the plethora of consultation and documentation published during the course of 2022, we are still waiting for substantive agreement by the Inclusive Framework members on the scope and detail of the reforms. Implementation in even the medium term feels considerably less plausible than in the case of Pillar Two, but, as mentioned above, progress continues to be made.

Perhaps the ultimate political incentive for implementing Pillar One will be to avoid the counterfactual which, in the absence of agreement on Pillar One, is likely to constitute a proliferation of uncoordinated (and probably conflicting) unilateral digital tax measures. We can only wait and see.

In relation to Pillar Two, we are expecting a further swathe of domestic implementing legislation across relevant jurisdictions. One important question will be the extent to which individual jurisdictions include a QMDTT (permitted by both the OECD and EU rules). It seems likely that many

jurisdictions will do so, since this will allow an MNE's home jurisdiction to collect any additional tax due as a result of the application of Pillar Two. The UK and the Netherlands have confirmed that they will include such a rule in their legislation.

In fact, the Model Rules and EU Directive comprise only part of the interlocking rules on Pillar Two. In the background, work is also progressing on the finalisation of the subject-to-tax rule and the related multilateral instrument to assist in its implementation. The subject-to-tax rule is expected to be a treaty-based rule, which will permit lower-middle income countries to retain their taxing rights with respect to certain streams of income, notwithstanding existing provisions in double tax treaties.

We are also expecting further administrative guidance from the OECD on the interpretation and administration of Pillar Two on a "rolling basis".

Need to know more?

The Allen & Overy global tax team will continue to monitor developments and consider their ongoing significance for multinational structures going forward, as well as the implications for existing cross-border structures. Please do not hesitate to get in touch with your usual Allen & Overy contact to discuss these developments and their impact on your business

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