GattiPavesiBianchiLudovici

M. Galimberti

EU AND INTERNATIONAL TAX POLICY

European Commission and the OECD/G20 Inclusive Framework on BEPS in tandem to deliver rules for ensuring minimum taxation

Following the OECD/G20 Inclusive Framework agreement for a two-pillar solution and its calling for a swift development of model rules to address the tax challenges arising from the digitalization of the economy, the European Commission proposed on 22 December 2021 a draft directive to ensure a minimum level of effective corporate taxation in the EU.
While the draft directive and the OECD framework share many common features, there are some differences and potential interactions vis-à-vis existing policy provisions that will make their adoption a challenging process.

EU GloBE Rules

In order to ensure that the OECD two-pillar package (see our newsletter "*Italy to strike balance between G20bal tax deal and domestic tax agenda*" dated 11 November 2021) is implemented in a coherent and consistent way across EU Member States, the proposed directive closely follows the OECD rules for ensuring minimum level of effective corporate taxation with certain necessary adjustments to guarantee conformity with EU Law. In particular, under the proposed directive, the architecture to ensure minimum level of taxation in the EU consists of the following steps:

- *scope*: the draft directive shall apply to entities or permanent establishments ("**constituent entities**") located in the EU that are part of a multinational group or a large-scale domestic group with an annual revenue of EUR 750,000,000.00 or more in consolidated financial statements in at least two out of four fiscal years preceding the tested fiscal year. *De minimis* exclusion applies where constituent entities have less than EUR 10,000,000 of qualifying revenue and less than EUR 1,000,000 of qualifying profits;

- *effective tax rate*: the effective tax rate ("**ETR**") shall be computed for each fiscal year and for each jurisdiction dividing:
  - *covered taxes*: the covered taxes shall include taxes accrued in the financial accounts including the allocation of taxes charged under controlled foreign company regimes with additional specific adjustments;
    by
  - *GloBE income*: the qualifying income referred to the relevant jurisdiction shall be computed considering all the constituent entities located in that jurisdiction based on financial accounting standard and taking into account certain adjustments *e.g.*, dividends, capital gains, stock-based compensation, asymmetric foreign currency gains or losses, tax credits.
- *top-up tax rate*: where the ETR is below the minimum tax rate of 15% for a fiscal year, the group shall compute the top-up tax rate on a jurisdictional basis as the difference between the minimum tax rate and the ETR. In such a case, the jurisdiction is considered to be low-taxed and the proposed directive creates two interlocked rules (*i.e.*, Income Inclusion Rule or "**IIR**" and Undertaxed Payment Rule or "**UTPR**", together known as the Global anti-Base Erosion rules or "**GloBE rules**") through which the resulting top-up tax should be collected. In particular:
  - *IIR:* this primary rule provides for a top-up taxation for the ultimate parent entity of an MNE that shall compute and collect its allocable share of top-up tax in respect of the low-taxed constituent entities of the group;
  - *UTPR*: this secondary rule serves as a backstop rule to the IIR by increasing the tax at the level of the constituent entities. Under the UTPR, a constituent entity shall collect an allocable share of top-up tax computed by the ultimate parent entity of the group that was not charged under the IIR (this could be the case where constituent entities are located in low tax jurisdictions and owned by entities resident in jurisdictions that have not implemented the IIR or there are no entities in the chain of ownership that can apply the IIR *i.e.*, the ultimate parent entity is resident in a low tax jurisdiction). In this case, the UTPR disallows a deduction or provides for an adjustment of the low-taxed income in the jurisdiction of the constituent entity.

Relevant Changes Compared to the OECD Work

The Directive implements the OECD Model Rules taking into consideration certain specifics of the EU law and the single market. In particular, for the purpose of ensuring compliance with the EU fundamental freedoms and avoid any risk of discrimination, the proposed directive extends:

- its original scope also to large-scale purely domestic groups *i.e.*, groups with all entities located in the same EU Member State; and
- the applicability of the IIR by a Member State not only to foreign subsidiaries (as provided by the OECD) but also to all constituent entities resident in the same Member State. This means that, under the proposed directive, the jurisdiction that applies the IIR should not limit itself to take into account solely the ETR of foreign constituent entities.

In addition, differently from the OECD proposal, the directive does not concern the so-called subject to tax rule ("**STTR**"), a treaty-based rule that allows source jurisdiction to impose limited source taxation on certain related-party low-taxed payments. The STTR will be directly addressed in bilateral tax treaties.

Interactions with Existing Policy Provisions

Notwithstanding the extreme political urgency to proceed with the implementation of the OECD model rules in the EU already from the beginning of 2023, implications for existing policy provisions should not be underestimated.

The first major concern regards the interplay of the new rules with ATAD CFC regime and the expected recasting of the Interest and Royalties Directive ("**IRD**"). In particular:

- ATAD CFC rules shall constitute the primary rule and, therefore, any additional taxes paid under a CFC regime will be taken into consideration in the context of GloBE model rules *i.e.*, additional CFC taxes will be considered for the purpose of computing the ETR; while
- the proposed directive seems to pave the way for agreeing the pending proposal for recasting the IRD aimed at making its benefits conditional on the interest being subject to tax in the destination state. The GloBE model rules should resolve this issue by setting a minimum level of taxation in the destination state.

In addition, the transposition of the GloBE model rules in the EU may impact local policy provisions (*e.g.*, qualified tax credit and other local incentives such as the R&D tax credit or Patent Box regimes, etc.) that under the treatment set forth in the proposed directive could play a major role in the computation of ETR and, consequently, of the top-up tax. For example, certain tax incentives may in fact reduce covered taxes but not the GloBE income, leading to a reduction of the ETR (that may totally or partially offset the top-up tax) *ceteris paribus*. This latter interaction requires countries to perform a comprehensive impact assessment and, potentially, a review of their domestic tax systems.

Next Steps

While EU Member States shall bring into force the proposed directive by 31 December 2022, the OECD has planned to consult stakeholders on a number of aspects of its two-pillar solution over the coming months. On 4th February OECD released for public consultation a first building block under Pillar I – Amount A focused on rules for nexus and revenue source.
The working tandem seems to boost its efforts supporting an effective application of GloBE rules within the political timetable agreed in October 2021.
On the other side of the equation, taxpayers should be up to speed in implementing the new rules in a very limited timeframe with a number of aspects - starting from the Commentary to GloBE rules - still to be addressed.
GPBL transfer pricing team is available to provide any further details or support you in undertaking dedicated analysis.

Gatti Pavesi Bianchi Ludovici
EU and International Tax Policy
Paolo Ludovici paolo.ludovici@gpblex.it
Livio Zallo livio.zallo@gpblex.it
Marlinda Gianfrate marlinda.gianfrate@gpblex.it
Marco Striato marco.striato@gpblex.it

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