

## Taxation of the Digital economy: Whatâ€™s in the pipeline?



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At the end of 2020, the OECD aimed at addressing and coming to a successful conclusion on tax challenges arising from globalisation and the digitalisation of the economy, especially on the global minimum tax by mid- 2021. That challenge has been met. Everything sped up at the beginning of June with the G7 and ended with the G20 mid-July. However, it does not mean that they are there yet. Many steps and obstacles remain to be overcome.

Let's go back to the different important steps that have been reached so far.

### G7 Summit

In its communiqué of 5 June 2021, the Ministers of Finance and Central Bank Governors of the G7 (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States) announced their support for the OECD's proposals to address the tax challenges raised by digitalisation and globalisation, which are structured around two pillars. Pillar One aims to reallocate taxing rights between jurisdictions in order to give certain rights to market jurisdictions. Pillar Two (also known as the Global Anti-Base Erosion, "GloBE") aims to introduce a global minimum tax for large multinational

enterprise groups ("MNEs") to avoid profit shifting to countries where they are subject to no or very low tax.

The G7 Ministers committed on 2 points: (1) to reach an equitable solution on the allocation of taxing rights, with market countries awarded taxing rights on at least 20% of profit exceeding a 10% margin for the largest and most profitable multinational enterprises; (2) to a global minimum tax of at least 15% on a country-by- country basis, while the United States initially proposed a global minimum tax at 21%. The G7 Ministers agreed on the importance of progressing agreement in parallel on both Pillars.

## **OECD/G20 combined statement dated 1st July 2021**

On 1 July 2021, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting released a statement outlining revised OECD Pillar One and Pillar Two proposals. On 9 July 2021, this statement was officially joined by 132 jurisdictions members of the Inclusive Framework (including Luxembourg, the United States and China). Few European countries (Estonia, Ireland and Hungary) did not sign this statement. The position of these three countries could undermine the implementation of these agreements in the future.

### **Pillar One: reallocation of taxing rights to market jurisdictions**

In a nutshell, Pillar One deals with the re-allocation of taxing rights on MNE's profits from automated digital services or "consumer facing businesses". Pillar One tries to address the questions of business presence and activities without physical presence, of the place where tax should be paid and on what basis, and of the profits share that could or should be taxed in the jurisdictions where customers and/or users are located.

The key takeaways of the statement released by the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting on Pillar One are summarised below:

**Scope:** The new framework reduces the scope of MNEs covered to MNEs with global turnover above EUR 20 billion and profitability above 10% (i.e., profit before tax/ revenue). The extractive industry and regulated financial services are excluded.

**Nexus – Amount A allocation:** A new special purpose nexus rule will be established. This new nexus permits allocation of a certain share of profits (called "Amount A") to a market jurisdiction only when the in-scope MNE derives at least EUR 1 million of revenues from that jurisdiction. For smaller jurisdictions with GDP lower than EUR 40 billion, the nexus threshold will be set at EUR 250,000.

**Tax base determination:** The relevant measure of profit or loss of the in-scope MNEs will be determined by reference to financial accounting income, with a small number of adjustments. Also, losses will be carried forward.

**Revenue sourcing and quantum:** Revenues will be sourced to the end-market jurisdictions where goods or services are used or consumed. Allocation of profits to end-market jurisdictions with nexus will be made on the basis of 20%-30% of residual profits defined as profits in excess of 10% of revenue, using a revenue-based allocation key.

**Safe harbour:** Where the residual profits of an in-scope MNE are already taxed in an end-market jurisdiction, a marketing and distribution of profits safe harbour will cap the residual profits

allocated to the end-market jurisdiction through Amount A.

### **Tax certainty and elimination of double taxation:**

In-scope MNEs will benefit from dispute prevention and resolution mechanisms, which will avoid double taxation for Amount A, in a mandatory and binding manner. Double taxation of profits allocated to end-market jurisdictions will be avoided using either the exemption or the credit method.

Amount B: The application of the arm's length principle to in-country baseline marketing and distribution activities will be simplified and streamlined, with a particular focus on the needs of low-capacity countries.

Unilateral measures: Coordination between the application of the new international tax rules and the removal of all domestic digital service taxes and other relevant similar measures will be streamlined.

### **Pillar Two: Global minimum tax – GloBE**

In brief, under the OECD proposal on the GloBE rules, the global minimum tax would be determined as follows: the global profits of an MNE group covered by the GloBE rules would be allocated, after various and complex adjustments, to the different countries where the group operates. Then, an effective tax rate ("ETR") calculation would have to be made at the level of each jurisdiction (and not per entity) for the adjusted profits allocated to it.

If the ETR of the MNE's jurisdiction is lower than the agreed minimum rate, the MNE will be liable for additional tax to bring the overall tax burden on the excess profits up to the minimum rate. Thus, the calculation of the ETR serves both as a tax trigger and as a determining factor of the amount of additional tax due. The difference between the adjusted ETR in these countries and the minimum tax rate will constitute an additional tax which can be claimed in principle by the state of residence of the ultimate parent company of the group, if it applies the GloBE rules, based on an income inclusion rule ("IIR"). Otherwise, the taxing rights would be cascaded, on the basis of default rules, to other GloBE jurisdictions in which group companies are established. An undertaxed payment rule ("UTPR") will also aim to deny deductions or to require an equivalent adjustment, to the extent that the low-taxed income of a constituent entity is not subject to tax under an IIR.

A treaty-based rule, i.e., the subject-to-tax rule ("STTR"), will also allow a source jurisdiction which has ceded taxing rights in the context of an income tax treaty to apply a top-up tax to the agreed minimum rate on certain related-party payments where the income which benefits from treaty protection is not taxed or is taxed at below the minimum rate in the other contracting

jurisdiction. The minimum rate for STTR purposes will range from 7.5% to 9%.

The key takeaways of the statement released by the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting on Pillar Two are summarised below:

**Scope:** The rules will apply to MNEs which meet the EUR 750 million threshold, as determined under Country-by-Country Reporting rules. Countries are, nevertheless, free to apply the IIR to MNEs headquartered in their jurisdiction, even if they do not meet this threshold.

**Minimum rate:** The minimum tax rate used for purposes of calculating the ETR under the IIR and UTPR will be at least 15%.

**Effective tax rate calculation:** The GloBE rules will impose a top-up tax using an ETR test calculated on a jurisdictional basis, which uses a common definition of covered taxes and a tax base determined by reference to financial accounting income.

**Carve-outs and exclusions:** The GloBE rules will provide for a formulaic substance-based carve-out provision

which will exclude an amount of income which is at least 5% of the carrying value of tangible assets and payroll, and will establish a de minimis exclusion. International shipping income will also be excluded from the scope of the GloBE rules.

### **What's next?**

Now that the framework reaches the consensus of most of the OECD members, the remaining technical work on Pillar One and Pillar Two must be done and agreed upon. In this respect, the intention of the Inclusive Framework is to finalise the agreement, together with an implementation plan, by October 2021, with a view to being implemented worldwide in 2023. However, this is very ambitious as many political, technical and ideological issues remain to be solved. In the meantime, the EU Commission announced that its directive proposal to introduce a digital service tax would be suspended until October 2021.

### **What is at stake for Luxembourg?**

Taking its scope into consideration, Pillar One should have a very limited impact on Luxembourg. In respect of Pillar Two, some projections tend to show that Luxembourg would benefit from the application of the GloBE rules, at least initially. However, considering that the tax revenue will be significant is a naive approach based on a simplistic analysis of profits and tax rate to calculate the additional revenue for the country. Luxembourg should not find a new financial windfall in this. On the one hand, the inclusion rule gives the right to levy additional tax, where profits of an MNE group have not been subject to sufficient taxation, by priority to the jurisdictions where the ultimate parent companies of the MNE groups are located. There are not many of these in Luxembourg. And, very often, the profits which arrive in Luxembourg have already been taxed

and will not be taxed a second time. On the other hand, Luxembourg currently has a nominal tax rate of 25% for corporate income, and as a result of the various BEPS reforms carried out in recent years, there are not so many companies – if any – which have an effective tax rate of less than 15%.

In practice, there is little desire for companies to leave Luxembourg because of Pillar One and Two. Luxembourg will remain attractive not because of its tax system, but because of its ecosystem. Companies find everything they need here, in addition to an outward-looking and international regulatory framework. This is what makes Luxembourg unique in Europe. Luxembourg has advantages other than its tax system, which will just play a less important role in investment decisions in the future.