



Cyprus Tax News

OECD Inclusive Framework agrees on the design components of Pillar One and Pillar Two

Since 2017, the 140 member countries of the OECD Inclusive Framework (IF) have been jointly developing a ‘two-pillar’ approach in an effort to address the tax challenges arising from the digitalization of the economy. Two detailed “blueprints” were published back in October 2020 on each pillar, namely, Pillar One that focuses on new nexus and profit allocation rules and Pillar Two for the global minimum tax rules.

Pillar One aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the largest and most profitable multinational enterprises (MNEs), while Pillar Two introduces a global minimum corporate tax rate (recently agreed at 15%) which countries can use to protect their tax bases (the GloBE rules).

In June and July 2021, a political agreement on the key aspects of the proposals was reached by the G7, G20, and many of the OECD IF countries.

On 8 October 2021, the OECD/G20 IF published a Covered Statement on the two-pillar solution (Statement), which is an update to the [statement](#) published in July 2021 and has been agreed by 136 IF member countries.

This alert sets out a summary of the components agreed by the IF members for Pillar One and Pillar Two and the implementation plan as per the Statement.

Components of Pillar One as amended

Pillar One offers market jurisdictions new taxing rights over MNEs profits, irrespective of physical presence and beyond the arm’s length principle. The respective components that have been agreed upon are summarised below:

Amount A

- **Scope:** Amount A reallocates taxing rights of the largest and most profitable businesses in favour of the market jurisdictions. In essence, a share of a group's global residual profit will be reallocated to market countries using a formulaic approach. No physical presence is required in a market country to create an Amount A taxable nexus.

According to the statement, in scope are MNEs with global turnover above EUR 20 billion and profitability above 10%. Such profitability would be calculated using an averaging mechanism.

Extractives and Regulated Financial Services are excluded.

- **Nexus:** There will be a new special purpose nexus rule permitting allocation of Amount A to a market jurisdiction when the in scope MNE derives at least EUR 1 million in revenue from that jurisdiction (the nexus for smaller jurisdictions with GDP lower than EUR 40 billion, such as Cyprus, will be EUR 250 thousand).
- **Quantum:** It was agreed that in-scope MNEs, will reallocate 25% of residual profit (defined as profit in excess of 10% of revenue), to market jurisdictions.
- **Tax certainty:** In-scope MNEs will benefit from dispute prevention and resolution mechanisms, avoiding double taxation for Amount A, including all issues related to Amount A (such as transfer pricing and business profits disputes), in a mandatory and binding manner. Disputes on whether issues may relate to Amount A will be solved in a mandatory and binding manner, without delaying the substantive dispute prevention and resolution mechanism.

The IF clarified that the elective binding dispute resolution mechanism for Amount A will only be applicable by developing economies that are eligible for deferral of BEPS Action 14 Peer Review and have no or low levels of mutual agreement procedures for disputes. The conditions to access this mechanism will be reviewed on a regular basis at the level of each country.

Amount B

- Amount B is the amount of profit that is aimed to reward the baseline marketing and distribution functions in the market jurisdiction. 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:** Amount A will be implemented through a Multilateral Convention (MLC) which will require that parties commit to remove of all digital services taxes (DSTs) and similar measures to all companies, and to not introduce such measures in the future. No newly enacted DSTs or similar measures will be imposed on any company from 8 October 2021 until 31 December 2023, or the coming into force of the MLC.

Components of Pillar Two as amended

Pillar Two provides a minimum tax on corporate profit, putting a floor on tax competition. Pillar Two's goal is to ensure that a much broader range of MNEs pay a minimum level of tax, while preserving the ability of all companies to innovate and be competitive. The main components of Pillar Two may be summarized as follows:

- **Scope:** The GloBE rules will apply to MNEs that meet the EUR 750 million threshold as determined under BEPS Action 13 (country by country reporting). Countries are free to apply the IIR (explained below) to MNEs headquartered in their country even if they do not meet the threshold.

Government entities, international organisations, non-profit organisations, pension funds or investment funds that are Ultimate Parent Entities (UPE) of an MNE Group or any holding vehicles used by such entities, organisations or funds **are not subject** to the GloBE rules.

According to the statement, Pillar Two will apply a minimum rate on a jurisdictional basis. In that context, to ensure a level playing field, consideration will be given to the conditions under which the US GILTI regime will co-exist with GloBE rules.

- **Overall design/Rules:** Two interlocking domestic rules (together the Global anti-Base Erosion Rules (GloBE) rules) and a treaty-based rule:
 - The **Income Inclusion Rule (IIR)**, which imposes top-up tax on a parent entity in respect of the low taxed income of a constituent entity.
 - The **Undertaxed Payment Rule (UTPR)**, which denies deductions or requires an equivalent adjustment to the extent the low tax income of a constituent entity is not subject to tax under an IIR.

The UTPR allocates top-up tax from low-tax constituent entities including those located in the UPE jurisdiction.

- The **Subject to tax rule (STTR)**, a treaty-based rule, that allows source jurisdictions to impose limited source taxation on certain related party payments subject to tax below a minimum rate. The STTR will be creditable as a covered tax under the GloBE rules.

The Statement sets out an exclusion from the application of the UTPR for MNEs that have a maximum of EUR 50 million tangible assets abroad and operate in less than 5 other jurisdictions. This exclusion is limited to a period of 5 years after the MNE comes into the scope of the GloBE rules for the first time. For MNEs that are in scope when the rules come into effect, the period of 5 years will start at the time the UTPR rules come into effect.

IF members that apply nominal corporate income tax rates below the STTR minimum rate to interest, royalties and a defined set of other payments, would implement the STTR into their bilateral treaties with developing IF members when requested to do so.

The taxing right will be limited to the difference between the minimum rate and the tax rate on the payment. The minimum rate for the STTR will be 9%.

- **Minimum Rate:** The Global Minimum Tax rate used for the purposes of the IIR and UTPR has been set at 15%.
- **Effective Tax Rate (ETR) calculation:** The GloBE rules will operate to impose a top-up tax using an effective tax rate test that is calculated on a jurisdictional basis and that uses a common definition of covered taxes and a tax base determined by reference to financial accounting income. However, the Statement has clarified that for existing distribution tax systems earnings distributed within 4 years would not trigger the top up tax. Previously, a timeframe of 3 to 4 years was provided.

- **Exclusions:** Two exclusions are considered for the purposes of calculating the ETR and GloBE Income – these would allow countries to continue to offer tax incentives to promote business activity with real substance. The Statement considered the following:

- **Substantial activity exclusion:** MNEs are allowed to exclude certain income from the computation of the ETR, based on a percentage of its tangible assets and payroll expenses. The amount of exclusion of substantial activities has been set at 5%.

In a transition period of 10 years, the amount of income excluded will be 8% of the carrying value of tangible assets and 10% of payroll, declining annually by 0.2 percentage points for the first five years, and by 0.4 percentage points for tangible assets and by 0.8 percentage points for payroll for the last five years.

- **De minimis exclusion:** A de minimis exclusion will apply at a jurisdictional level, if the following two conditions are met: (i) MNE has revenues of less than EUR 10 million, and (ii) has profits of less than EUR 1 million.
- **Other exclusions:** The GloBE rules also provide for an exclusion for international shipping income using the definition of such income under the OECD Model Tax Convention.

Implementation plan

The Statement sets out an implementation plan. Below is a summary of the key aspects:

- **Nexus and profit allocation rules (Pillar One)**

A multilateral convention to implement Amount A will be developed by early 2022, and available for signature in mid-2022. The Amount A rules will enter into force **in 2023** once a critical mass of countries have ratified the multilateral convention.

Model rules for domestic legislation to implement Amount A will also be developed by early 2022. Final deliverables will be released by the **end of 2022** for Amount B.

- **Global minimum tax (Pillar Two)**

Model rules to define the scope, mechanics, and administration of the GloBE rules, and a model treaty provision to give effect to the subject to tax rule, will be developed by the end of **November 2021**. A multilateral convention to facilitate the adoption of the subject to tax rule in bilateral treaties will be developed by **mid-2022**.

All rules should come into force as of 2023, except for the UTPR which would be effective as from 2024. However, the OECD clarified that Pillar Two should be brought into law in 2022, to be effective in 2023, with the UTPR coming into effect in 2024.

Finally, the OECD is expected to develop a detailed implementation framework by the **end of 2022**. This framework would facilitate the coordinated implementation of the GloBE rules. The IF is expected to evaluate the possibility of utilising a multilateral convention to implement GloBE rules.

Next steps

- The Ministry of Finance of Cyprus (MoF) welcomed the agreement on a global minimum tax rate applicable to the largest global multinationals but stressed the importance of maintaining (national) control over its fiscal and tax policy. Cyprus intends to actively and constructively participate for the ratification of the global minimum tax rate at an EU level while we expect a holistic and thorough review of our current tax system and implementation of new measures and incentives so as to remain a competitive and attractive business jurisdiction.
- Tax and finance teams should prepare for the upcoming changes in the existing tax landscape and understand the potential challenges that businesses would face when Pillar One and Pillar Two are introduced. It is imperative to start preparing an effective roadmap for change.

Deloitte can help

In conjunction with regular tax alerts and updates, Deloitte will host a webinar to discuss the Model Rules and commentaries for the implementation of Pillar Two rules that will be released by the end of November 2021 and its implications for businesses.

Deloitte's OECD Pillar One and Pillar Two modelling service offering combines the deep expertise of Deloitte tax specialists with the analytical power of our technology solution to help companies assess and evaluate the potential implications of Pillar One and Pillar Two on their tax profile.

In addition, our team of International Tax experts can support you in understanding the potential impact of Pillar One and Two, and how this may affect your business. This could involve the following:

- Deliver a dedicated workshop to your financial and tax teams to discuss the implication of Pillar Two rules on your business and help develop a roadmap in preparation for potential changes to the Corporate Income Tax (CIT) system.
- Evaluate of the applicability of Pillar One and Pillar Two to define whether a particular business would be considered within the scope of the rules and impact analysis to determine the high-risk subsidiaries, based on their location.
- Scenario planning and looking at the different responses that countries may adopt and the impact of each of these responses to your business.
- Modelling of tax costs and impact on cashflow.
- Advising on appropriate tax governance, tax function design and resourcing models.

Contact

If your business requires further support in order to navigate the tax challenges arising from the digitalization of the economy, please get in touch with our International Tax team listed below:

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