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Pillar Two and the Gulf States

Minimal impact or Tax environment transformation?

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Introduction[1]

Since 2017, the member countries of the G20/Organization for Economic Co-operation and Development (OECD) Inclusive Framework (IF) on Base Erosion and Profit Shifting (BEPS) (the Inclusive Framework) have been jointly developing a Two-Pillar Solution to address the Tax challenges arising from the digitalization of the economy. In October 2020, two detailed "blueprints" were published on the potential rules for addressing the Nexus and profit allocation challenges (Pillar One) and for Global Minimum Tax (GMT) rules (Pillar Two).

Political agreement on key aspects of the proposals was reached by the G7, G20, and many of the inclusive framework countries by July 2021. On 8 October 2021, the inclusive framework published another statement on the components of global tax reform, agreed by over 135 of its members as of November 2021. On 20 December 2021, the inclusive framework published model rules for the global minimum tax, with the commentary and examples to these model rules published on 14 March 2022[2]. On 4 and 18 February 2022, the OECD released draft rules for specific items under Amount A of Pillar One for public consultation.

The majority of countries located in the Gulf Cooperation Council (GCC)[3] , including the United Arab Emirates (UAE), Bahrain, the Kingdom of Saudi Arabia (KSA), Qatar and Oman, are part of the IF. However, will the Two-Pillar Solution transform the Tax environment in the GCC or is there likely to be minimal impact? How likely is it that these countries will implement the Two-Pillar Solution, and if so, what will the potential impacts be?

In this article, we provide an overview of the background and potential impacts of the Two-Pillar Solution in the GCC, specifically by focusing on the following aspects:

- The background of the OECD/G20 BEPS Project and the Two-Pillar Solution; and
- The potential impacts in the GCC and how companies can prepare

The background of the OECD/G20 BEPS Project and the Two-Pillar Solution to address the Tax challenges arising from the Digitalization of the Economy[4]

The OECD has been leading international efforts since the 1990s which help enable countries to prevent Corporate Tax (CT) evasion and avoidance. Early work in the 2000s sought to identify standards and obtain commitments from countries to establish a global level playing field. In the aftermath of the global financial crisis in 2008/09, world leaders resolved to end bank secrecy and stop Tax evasion by individuals. Subsequently, the international community turned its attention to CT, leading to the launch of the project on BEPS in 2013.

The BEPS Project brought more coherence, substance, and transparency to the international tax system with the introduction of 15 actions to ensure that profits are taxed where economic activities generating the profits are performed and where value is created. A key part of the OECD/G20 BEPS Project is addressing the Tax challenges arising from the Digitalization of the Economy (Action 1).

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[1] https://www.taxathand.com/article/20306/Australia/2021/Inclusive-framework-updates-agreement-on-taxing-digitalized-economy-minimum-tax-rate

[2] https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm.

[3] These countries include: the United Arab Emirates, the Kingdom of Saudi Arabia, Qatar, Oman, Kuwait and Bahrain.

[4] OECD (2021) Base Erosion and Profit Shifting Project, Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, highlights brochure.

Large multinational enterprises (MNE) may be able to earn significant revenue in foreign markets without being taxed in those markets due to the following reasons:

1. The old rules state that the profits of a foreign company can only be taxed in another country where the foreign company has a physical presence; and
2. Most countries only Tax domestic business income of their MNEs, but not foreign income on the assumption that foreign business profits will be taxed where they are earned.

The OECD estimated that the CT costs are anywhere from USD 100-240 billion annually, or 4-10% of the global Corporate Income Tax (CIT) revenues that are not taxed by countries. A country's inability to Tax MNE profits has given rise to unilateral measures at the national level, such as Digital Services Taxes (DST), and the prospect of retaliatory tariffs.

The OECD/G20 Inclusive Framework, which has 141 members, all participating on an equal footing, was mandated to provide a solution to these two problems in 2021. As of 4 November 2021, 137 member countries and jurisdictions joined the Two-Pillar Solution to ensure that large MNEs pay Tax where they operate and earn profits.

The Two-Pillar solution is also strongly supported by the European Commission, as they published a proposal for a directive to implement the Pillar Two model rules in a coherent and consistent way across the member states, with some adjustment to guarantee conformity with the European Union (EU) law.

Two-Pillar Solution[5]

Pillar One

The current CT framework and the treaty agreements were mostly designed in the early to mid-1900s considering traditional business models. They do not take into consideration how businesses have evolved as a result of digitalization. The fundamental principle of the Nexus is related to a physical presence which corporates have been able to overcome as a result of digitalization. Nowadays, it is possible to have an economic footprint for a corporate by digital means without having any physical presence.

Pillar One offers market jurisdictions new taxing rights over MNEs, whether there is a physical presence or not

- Under Pillar One, 25% of profits of the largest and most profitable MNEs above a set profit margin of 10% (residual profits) would be reallocated to the market jurisdictions where the MNE's users and customers are located; this is referred to as 'Amount A'
- Pillar One also provides for a simplified and streamlined approach to the application of the arm's length principle to the in-country baseline marketing and distribution activities; this is referred to as 'Amount B'
- Pillar One includes features to ensure dispute prevention and dispute resolution are in place in order to address any risk of double taxation, but with an elective mechanism for some low-capacity countries
- Pillar One also includes the removal and standstill of DSTs and similar relevant measures, to prevent harmful trade disputes

Amount A

Pillar One's "Amount A" proposal reallocates taxing rights in favor of market countries through the creation of a new taxing right. In-scope businesses will reallocate 25% of their residual profit above a 10% profit level to market countries using a formulaic methodology. The 10% profit level will be calculated as the ratio of profit before Tax to revenue. Interestingly, it seems for the first time, the OECD is suggesting an approach which is not necessarily based on the arm's length principle as far as the allocation for Amount A is considered.

5The sources of footnotes 1 and 2 are used to describe the Two-Pillar Solution.

Amount A will apply to MNEs with a global annual turnover above EUR 20 billion (or equivalent) and profitability above a 10% margin, calculated using an averaging mechanism. Businesses in the extractive and regulated financial services sectors are excluded from Amount A. The global annual turnover threshold will be reduced to EUR 10 billion (or equivalent) in the future, depending on the successful implementation of Amount A, including Tax certainty. A review to determine whether a successful implementation of Amount A has materialized will be undertaken seven years after the rules enter into force which is expected to be in 2030.

Segmentation rules will apply only in circumstances where a segment disclosed in financial statements meets the scope of the rules. A market country will be entitled to an allocation of Amount A if revenues of at least EUR 1 million (or equivalent) are generated in that country. For countries with a Gross Domestic Product (GDP) lower than EUR 40 billion, this threshold will be EUR 250,000 (or equivalent). Revenues will be sourced to the end market country where goods or services are used or consumed. Detailed sourcing rules will be developed for specific categories of transaction.

A marketing and distribution profits safe harbor will limit the Amount A allocation to market countries where residual profits are already taxed.

To eliminate double taxation, any Amount A liability will be allocated to entities that earn residual profit and relieved via either an exemption or credit.

The OECD published public consultation documents titled:
• "Pillar One – Amount A: Draft Model Rules for Nexus and Revenue Sourcing" on February 4, 2022; and
• " Pillar One – Amount A: Draft Model Rules for Tax Base Determinations" on February 18, 2022.

With the issuance of the public consultation documents, the OECD said that it will issue Pillar One rules in stages and that it will discuss with stakeholders on both Pillar One and Pillar Two in the coming months.

Amount B

Amount B provides for a simplified and streamlined approach to the application of the arm’s length principle to in-country baseline marketing and distribution activities. Further work will be undertaken to simplify and streamline the pricing of “baseline marketing and distribution activities” undertaken by related party distributors, starting with work to define the scope.

<u>Tax certainty</u>

Mandatory and binding dispute resolution mechanisms will be available in respect to all issues related to Amount A, including Transfer Pricing (TP), business profits, and determination of whether an issue falls within the scope of the Amount A dispute resolution mechanism. Some small developing economies that have few or no mutual agreement procedure cases will have access to an elective (rather than mandatory) dispute resolution process.

Implementation

A multilateral convention to implement Amount A will be developed by early 2022 and will be 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.

Pillar Two

Pillar Two provides a minimum 15% Tax on corporate profit, putting a floor on Tax competition. A carve-out allows countries to continue to offer Tax incentives to promote business activity with real substance (i.e., tangible assets and personnel).

Income inclusion rule and undertaxed payment rule[6]

In general, the new rules ensure that large multinational businesses pay a minimum effective rate of Tax of 15% on profits in all countries. The income inclusion rule will result in additional "top up" amounts of Tax being payable by a parent entity of the group to its Tax authority.

The undertaxed payment rule will apply as a secondary (backstop) rule where the income inclusion rule has not been applied. The top up Tax is allocated to countries which have adopted the undertaxed payment rule based on a formula that is related to the number of employees and the value of the tangible assets. The top-up Tax is implemented either by denial of a deduction for payments or by making an equivalent adjustment. Groups that are newly expanding internationally are exempt from paying top up Tax under the undertaxed payments rule for up to five years. Such groups must have entities in no more than six countries and the net book value of their "international" tangible assets must not exceed EUR 50 million (or equivalent) (excluding tangible assets in the country with the most tangible assets).

MNEs with consolidated revenues of at least EUR 750 million (or equivalent) will be in scope, but countries will be free to apply lower thresholds to groups headquartered in their country. The base criteria of Pillar Two are aligned with the Country-by-Country-reporting rules, such as the threshold. However, the model rules have 10 specific chapters that describe the specific rules for the GMT, which will be supplemented by commentary to be published in early 2022.

The Pillar Two rules will have the status of a common approach: countries will not be required to adopt them, but if they choose to, implementation must be in a manner that is consistent with the model rules and IF guidance.

Effective Tax rate calculations use a Tax base determined by reference to financial accounts, subject to adjustments and mechanisms to address timing differences (with the model rules referencing the deferred taxes). TP adjustments may also be required where amounts are not consistent with the arm's length principle.

A formulaic substance carve-out will exclude income that is a 5% return on tangible assets and payroll. A transition period will apply during which 8% of the carrying value of tangible assets and 10% of payroll initially will be excluded, declining gradually over a ten-year period to 5%.

6 https://www.taxathand.com/article/20635/OECD/2021/OECD-inclusive-framework-publishes-Pillar-Two-global-minimum-tax-model-rules-.

The model rules also stipulate a de minimis exclusion in respect of countries where a group has revenues of less than EUR 10 million and profits of less than EUR 1 million. International shipping income is excluded from the Tax base (due to tonnage regimes that are not based on profits).

Additional rules are also set out in respect of corporate restructuring, including mergers, demergers, group members joining and leaving a group, transfers of assets and liabilities, permanent establishments, etc.

Companies will be required to prepare a 'GloBE information return' based on a standard template. The ultimate parent company (or an appointed group member) will file the return with its local Tax authority, who will then exchange the agreement with other Tax authorities where a qualifying competent authority agreement is in place. Each constituent entity located in a country applying the model rules will need to notify its local Tax authority of the group member filing the return and in which country it is located. Group members located in a country which had adopted the rules but does not have the necessary exchange relationships in place will be required to file a copy of the return with their local Tax authority. Domestic laws will apply with respect to penalties and the confidentiality of information.

Safe harbors may be considered to reduce the number of countries for which detailed effective Tax rate calculations are required. However, this may be included in the implementation framework, if agreed.

Subject to Tax rule

The subject to Tax rule will allow limited source taxation on related party interest, royalties, and a defined set of other payments. The rule will be incorporated into bilateral Tax treaties by countries that apply nominal rates of Tax below a minimum rate to such receipts, if requested by developing country members of the IF.
The taxing right will be limited to the difference between the subject to Tax minimum rate of 9% and the Tax rate on the payment.

Implementation

A multilateral convention to facilitate the adoption of the subject to Tax rule in bilateral treaties will be developed by mid-2022. A framework for the coordinated implementation of the income inclusion rule and undertaxed payment rule will be developed by the end of 2022, potentially alongside a multilateral convention to facilitate consistency. The income inclusion rule is expected to take effect from 2023, with the undertaxed payment rule deferred by one year to 2024.

From a European perspective, the European Union Council of Finance Ministers discussed the draft Directive on 15 March 2022 to implement the Pillar Two rules in the European Union. Unanimous agreement was not reached. A compromise text was published which indicated a start date for Pillar Two in the EU of 31 December 2023 (for the Income Inclusion Rule) and 31 December 2024 (for the Undertaxed Profits Rule). This is the first formal indication that the European Union timetable for implementation is deferred by a year. Other countries outside the EU are expected to follow this as well, although it is not clear whether how all governments will respond. This would allow time to consider complexities of the Pillar Two model rules.

Transformation of the Tax environment in the GCC?

To understand the impact for the GCC, it is essential to understand the current Tax environment for these states. The below table shows the current situation in relation to CIT and TP regulations in the GCC countries. The majority of the GCC countries are part of the IF, which are the UAE, Bahrain, KSA, Qatar and Oman. Kuwait is not part of the IF.

Country	Statutory tax rate	Transfer Pricing rules
UAE	CIT 0%	Country-by-country- reporting and economic substance rules
KSA	2.5%/2.78% (Zakat) CIT 20%	Full-fledged TP rules
Kuwait	1% (Zakat) CIT 15%	No formal TP regulations, but only reference to intra-group transactions in local tax law
Qatar	CIT 10%	Full-fledged TP rules
Bahrain	CIT 0%	Country-by-country- reporting and economic substance rules
Oman	CIT 15%	Country-by-country- reporting. No full-fledged TP regulations, but reference to arm's length pricing in Tax Law

As shown, the UAE and Bahrain currently have no CIT and TP regulations in place. Qatar has a CIT regime, but the rate is 10% (which is below the 15% minimum of Pillar Two). Qatar has also implemented extensive TP regulations. Although Oman and Kuwait do have CIT which is at the 15% minimum of Pillar Two, there are no formal TP regulations (but only minor references to intra-group transactions and to arm's length pricing in their respective Tax laws).

With these GCC countries (except for Kuwait) being part of the IF, the Two-Pillar Solution may have significant consequences in the region. More specifically, on 31 January 2022, the Ministry of Finance of the UAE announced the introduction of CT, including references to TP (the actual CT law is still pending publication). Bahrain may also announce the introduction of CT and TP regulations, and Qatar may consider a potential increase of the CIT rate to the minimum rate of 15%.

Impact of Pillar One

The background of Amount A is to reallocate profits to the market jurisdictions where the MNE's users and customers are located. Amount A of Pillar One only applies for the most profitable MNEs (above 10% margin) with a revenue above EUR 20 billion. According to the OECD, Amount A will apply to about 100 companies. Therefore, the impact of Amount A will be limited.

However, in practice, there are some examples where countries apply the philosophy of Amount A and effectuate this with the recognition of a 'virtual' permanent establishment in certain cases where the profit is allocated to a country without any physical presence in that country. In other cases, the local Tax authorities may also use the philosophy of Amount A to allocate higher profits to activities which are performed physically in the local countries. Although the impact of Amount A itself may be limited, countries may choose to adopt local regulations or practices which effectuate the impact and philosophy of Amount A on a smaller scale. However, any unilateral measures should be considered in light of the standstill and removal of unilateral measures, such as DST, with the goal to end trade tensions.

Amount B will apply for all MNEs with baseline marketing and distribution activities in these countries. For the countries that already have extensive TP regulations, this will be merely a simplification for marketing and distribution activities. Examples of such simplifications could be the indication of remuneration for various industries for in-country activities, which may end lengthy and costly discussions with the Tax authorities. The IF (and the mandated Working Party) is working on defining the in-country baseline marketing and distribution activities that are in scope of Amount B.

In addition, although extractives and regulated financial services are out of the scope of Pillar 1, there is some ambiguity as to whether the downstream entities of extractives (for example, sales and marketing companies of an oil producing company) are completely excluded or not. We can expect more clarity on this in the near future.

Impact of Pillar Two

Pillar Two results in a GMT of 15% for MNEs that have a presence in countries that will adopt the rules. In practice, this means that if a MNE has a presence in a low Tax country (and below 15%) and a country that adopted the Pillar Two rules (and so applies the income inclusion rule or the undertaxed payment rule), any difference between the GMT of 15% and the taxes in the low taxed country will be levied at the level of the country that adopted the rule. The simplified example below illustrates the principle of Pillar Two.

UPE — Implements Pillar Two Rules CIT

A
High tax jurisdiction (ETR>15%)
Implement Pillar Two rules

B
Low tax jurisdiction (ETR<15%)
Does not Implement Pillar Two rules

Note: This is a simplified example. The specific facts and circumstances need to be analyzed on a case-by-case scenario.

- Company B would be considered a low tax entity, triggering a top up tax.
- Top up tax would be the difference between the GMT and the effective rate ("ETR").
- Based on the income inclusion rule, UPE will need to pay the top up tax.
- In the scenario where UPE does not implement the income inclusion rule, the top-up will be collected through the undertaxed payment rule.

A top up Tax for the low taxed profits of the MNE will be levied if it has a presence in one country that adopts the rules. However, if a local country has a current Tax rate below 15%, then that country may adopt a qualified domestic top-up Tax upon the implementation of the Pillar Two rules to ensure that there are no (top up) Taxes levied in other countries. As the IF has 141 members, of which 137 have committed to the Two-Pillar Solution, it is likely that MNEs will be impacted by the GMT globally. So, what does this mean for the GCC and MNEs that are located in the region?

The impact of the GMT for MNEs is inevitable, even in cases where they may currently be located in countries with no or low CIT rates, such as the UAE, Bahrain and Qatar. Effectively, the Pillar Two rules would result in the taxation of local profits that arise in, e.g., the UAE, Bahrain, and Qatar (partially), or elsewhere, namely, in the country of the Ultimate Parent Entity (in case the income inclusion rule applies). Why would these countries give up their taxing right if there will be no difference in the Tax cost for the MNEs? Under the Pillar Two rules, only the location of the Tax payment will change if the GCC countries implement CIT or increase their CIT rates. As such, the UAE announced the introduction of a CT which will become effective for the financial year starting on or after 1 June 2023. This ensures that the UAE keeps its taxing right of the profits that arise in the UAE.

Considering the above, it is likely that Bahrain will introduce a CIT regime and that countries with lower rates (e.g., Qatar) will increase its CIT rate to protect the local Tax base from foreign Tax claims. Such an implementation could be based on a "bifurcated"/threshold-based Tax system whereby a 15% GMT would apply to companies forming part of an MNE group that meets the EUR 750 million threshold. However, it should be noted that countries may choose to apply a lower threshold locally in order to cover a broader scope. Free zones will also be covered under the Pillar Two rules.

7 https://www.mof.gov.ae/en/resourcesAndBudget/Pages/faq.aspx

As an example, the Frequently Asked Questions (FAQs)[7] available on the UAE Ministry of Finance website describes such a threshold-based Tax system, whereby the CT rate for taxable income above AED 375,000 is 9%, with a note that a different Tax rate will apply for large multinationals that meet specific criteria set with reference to Pillar Two. The UAE Ministry of Finance has also sighted specific considerations in relation to Free zones.

The introduction of the CT regime in the UAE also covers TP regulations to allocate profits based on the arm's length principle (i.e., in line with the OECD TP Guidelines). This is also likely to be the case for Bahrain when it announces its CT related regime, as every country will start safeguarding their own Tax base in order to levy the GMT. Countries that currently do not have extensive TP rules, could introduce these as well, such as Kuwait and Oman. This may also result in increased activity from the Tax authorities in terms of TP assessments and challenges, as we have seen in the past with some countries that introduced CIT and TP rules.

With the imminent introduction of CIT rules and the implementation of Pillar Two, companies will also need to file specific returns and notifications for Pillar Two. The new rules increase the burden on companies as they will need to understand the rules, access data, perform calculations, and understand the associated accounting treatments.

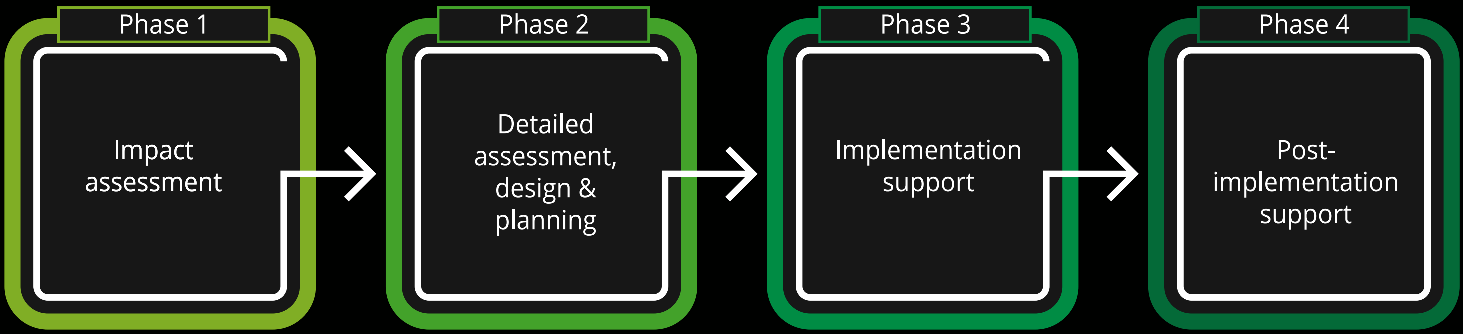
For the subject to Tax rule, a process to assist in implementing the rule will be agreed on, where a multilateral instrument will be developed by the IF to facilitate the swift and consistent implementation in relevant bilateral treaties.

These developments have far-reaching Tax and non-Tax/operational implications for affected businesses related to legal structures, business models, contracting and TP, accounting, profit, and systems, as well as data organization, and the organization of the Tax function with a potential impact for various stakeholders within organizations.

Considering the timeframe left to prepare for the implementation of Pillar Two, companies should start assessing the impact for their business and what they need do in order to be prepared given the complexity of these rules.

As each MNE is different, this assessment may start with the identification of key focus areas within the business. MNEs should prepare a roadmap for these areas to determine the best way forward in order to deal with the implications and to ensure that they are prepared for the implementation of the Two Pillar Solution across the region. With the announcement of CT for the UAE, MNEs with a presence in the UAE should also consider the interaction of Pillar Two and UAE CT implementation as of 1 June 2023.

Deloitte Middle East has developed a phased framework to help assist businesses with effectively managing their preparation and transition for the implementation of the Two Pillar Solution (and CT in the UAE) with a holistic approach. This covers areas such as CIT advisory and compliance, TP modeling and planning, the organization of the Tax function, and the use of technology to effectively manage these areas. This is illustrated below, and we would be happy to have a conversation to discuss the potential impacts on your business.



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