Pillar 2 – The Analysis of the tax burden of the affiliate of MNEs from OECD Member Countries – Definition of Corporate Taxes and Tax Benefits

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Pillar 2 – The Analysis of the tax burden of the affiliate of MNEs from IF OECD Member Countries – Definition of Corporate Taxes and Tax Benefits

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Pillar 2 – objectives and structure

Ensuring a **minimum level of taxation** for MNEs, subjecting to tax:

income on which states have not exercised their **taxing rights** or on which they have exercised them by imposing a **level of effective taxation below** the internationally agreed minimum level **(15%)**

certain intra-group payments whose **nominal tax level is below** the internationally agreed minimum level **(9%)**

Global anti-Base Erosion rules (GloBE)

- Income Inclusion Rule (IIR)
- Undertaxed Payments Rule (UTPR)

Subject to Tax Rule (STTR)

Jurisdictional Top-up Tax = **Top-up Tax % (15% - ETR)** × (**GloBE Income of the Constituent Entities in the jurisdiction** – **Substance-based Income Exclusion**)

Excess profits

Pillar 2 – state of the art in Europe

- Council Directive (EU) 2022/2523 to be implemented by **December 31, 2023**
- **IIR** to be applied to tax periods starting from **December 31, 2023**
- **UTPR** to be applied to tax periods starting from **December 31, 2024**

Directives **need to be incorporated in Member States' national legislation**

Draft legislation

- Czech Republic
- Denmark
- Finland
- Germany
- Ireland
- Italy
- Luxembourg
- Netherlands
- Slovakia
- Sweden

Official announcement

- Belgium
- Bulgaria
- Cyprus
- France
- Poland
- Portugal
- Romania
- Spain

- Switzerland: on track to implement Pillar Two with effect from January 1, 2024 (for the QDMTT and the IIR) and from January 1, 2025 (for the UTPR)
- United Kingdom: legislation was enacted on July 11, 2023, introducing an IIR and a DMTT

Pillar 2 – state of the art in South America

Argentina

Although Argentina is a member of Inclusive Framework and has joined the Two-Pillar approach, there has been no implementation of Pillar 2 and no public announcements or drafts. From the experience with BEPS measures, it could take a couple of years for its implementation.

Brazil

No draft legislation or discussions to date on Pillar 2 implementation. Brazil has enacted new transfer pricing rules to align with OECD Guidelines and a VAT reform is under analysis. Discussions about the implementation of Pillar 2 may not be the priority.

Chile

At this point, in Chile, there has been no tax reform aimed precisely at the implementation of Pillar 2 given that in general there are no income tax exempt business activities. In fact, in recent years, the exemptions that could exist for certain sectors of economic activity have been gradually eliminated, for example, for the capital market, or for the real estate-related income or for digital services.
At present, President's Boric government is promoting a new reform that seeks to include the principles of Pillar 2 but whose text is not yet known and only the general statements are known.

Colombia

A 15% Minimum Effective Tax in place since January 1st, 2023. Although Congress referred to Pillar 2 to justify its enactment, it does not implement the Pillar 2 and the rules to determine the minimum tax rate do not necessarily align with the Pillar 2 model rules.

Mexico

Although no law or reform initiative has been formally submitted, representatives of tax authorities confirmed Mexico's intention to implement Pilar 2 during FY 2024 in a new law, rather than incorporating to income tax law.

Pillar 2 – state of the art in North America

Canada

- August 4, 2023: proposed legislation in respect of IIR and QDMTT is released as "stand-alone" piece of legislation. A public consultation is open until September 29, 2023

- Placeholder left for UTPR.
- No adjustments to Income Tax Act incentives were included.
- Includes a general anti-avoidance rule.
- No recent comments have been made on the treaty "subject to tax rule" (STTR) (unusually, Canada was one of only five countries that did not approve the July 11, 2023 outcome statement from the OECD which included references to the MLI that is to implement the rule).

United States

- Build Back Better Act (BBBA): Was intended to adjust the US GILTI in a manner that would permit it to comply with Pillar 2 (serve as an IIR). Main issues:
  - Rate is 10.5% to 13.125%: Was to increase to 15.015%;
  - Imposed on an "overall" basis, rather than jurisdiction by jurisdiction: Was to be changed.
- 2022/2023 Budgets: Proposed replacing BEAT with a UTPR.

- Biden was unable to get Congressional support for BBBA, and it eventually became the Inflation Reduction Act.
- Inflation Reduction Act includes 15% minimum tax on book income (BMT) for US-based groups, but it too does not follow Pillar 2 model (e.g. imposed on "overall" basis).
- Mid-terms gave control of US House to Republicans.
- Expectation is that there will be no further developments until at least after 2024 election.

Pillar 2 – ETR calculation

According to GloBE rules, the **effective tax rate** of a group is calculated for each tax year and each jurisdiction according to the following formula:

$$\text{Effective tax rate} = \frac{\text{Adjusted covered taxes of all Constituent Entities in the jurisdiction}}{\text{GloBE Income of all Constituent Entities in the jurisdiction}}$$

Covered Taxes

- Taxes recorded in the financial accounts of a Constituent Entity with respect to its income or profits or its share of the income or profits of a Constituent Entity in which it owns an Ownership Interest;
- Taxes on distributed profits, deemed profit distributions, and non-business expenses imposed under an Eligible Distribution Tax System;
- Taxes imposed in lieu of a generally applicable corporate income tax; and
- Taxes levied by reference to retained earnings and corporate equity, including a Tax on multiple components based on income and equity.

Pillar 2 – Covered taxes

Canada

Corporate income tax (CIT):

- "General" federal CIT rate is 15%.
- "General" provincial CIT rates vary from 8% (Alberta) to 16% (Prince Edward Island).
- "General" combined rate is between 23% and 31%.

Affected: corporations benefitting from certain Canadian tax incentives.
Not affected: Canadian controlled private corporations (combined rate between 9% and 12.2% on their first CA$500,000 of income).

Brazil

Corporate income tax (CIT):

- CIT rate is 25% (15% + 10%).
- Social contribution is 9%.
- Total CIT nominal rate: 34%.

- STF: Brazilian tax law is constitutional
- STJ: DTTs need to be observed. Supremacy over domestic law?

Chile

- CIT rate is 27% (in case of SMEs, the rate is 25%).
- Dividend WHT is taxed with 35% tax rate, entitled to use the corporate tax as a credit.
- Capital gain on Instruments with stock exchange presence sales, single tax of 10%.
- Special tax regime for investment funds incorporated in Chile with foreign investors.

Does not include WHT for other profits, could range from 0% to 35%.

Argentina

- Federal CIT rate varies between 25% to 35% depending on the taxable gain. Gambling activities are subject to a higher 41.5% rate.
- Extraordinary CIT advance payments (15% to 25%) apply even to taxpayers that may have no taxable base.
- Dividend WHT: dividend and profits distributions to non-residents are subject to a 7% WHT.
- Net equity tax: an annual 0.5% tax levied on net equity of companies (not branches).

Does not include:

- Turnover Tax (from 0,5% to 9% on gross revenues) because it is not imposed "*in leu of an income tax*" but in addition to CIT (i.e., deductible as an expense in taxable net gain calculation)
- Income WHT on non-residents: (3.5% to 35%) on Argentine source income.

Pillar 2 – Tax incentives

Qualified Refundable Tax Credits (QRTC)

Shall be treated as income

- Tax credits whose Law provides for:
  1. the possibility that they may be paid in **cash or cash-equivalent** means, and
  2. their full repayment in the first **four tax periods** from the time the Constituent Entity meets the conditions under the laws of the jurisdiction granting the credit
- QRTCs are **government incentives** delivered via the tax system. Any amount of tax creditable or refundable under an **imputation credit regime** is not included

Non-Qualified Refundable Tax Credits (NQRTC)

Shall NOT be treated as income

- Tax credits that **do not meet** the QRTC requirements

Pillar 2 – Impact of tax incentives on ETR

Qualified Refundable Tax Credits (QRTC)

Shall be treated as income. By increasing the denominator only, they have a blander impact on ETR

$$\text{ETR} = \frac{\text{Adjusted covered taxes}}{\text{GloBE Income}}$$

Non-Qualified Refundable Tax Credits (NQRTC)

Shall not be treated as income, but as a reduction of covered taxes. They have a stronger impact on ETR

$$\text{ETR} = \frac{\text{Adjusted covered taxes}}{\text{GloBE Income}}$$

Pillar 2 – Argentina's tax incentives

- Argentine tax incentives are generally low-risk incentives, applicable to specific substantive activities and require compliance with several substance (i.e., minimum number of employees, minimum level of investments) and formal requirements (i.e., formal approval, registration as beneficiary).
- Special custom area: activities and operations carried out in the National Territory of Tierra del Fuego are exempt from all national taxes (in the case of some specific taxes, reduced rates may apply).
- Main tax incentives are not CIT-oriented but related to non-Covered Taxes under GloBE rules (VAT, import duties, export duties).
- NOLs may be carried forward up to five years but not refunded. Adjustment for inflation of NOLs is controversial.
- Common tax incentives:
    - Accelerated depreciation: may lead to temporary differences compared to accounting methods, that could cause the ETR to fall below the minimum rate, unless a deferred tax liability is created.
    - Issuance of tax credit bond to offset tax liabilities. Generally, creditable against federal tax liabilities (not always against CIT) and not refundable in cash or equivalents. Unless statutorily excluded (case-by-case basis), the tax credit bond is regarded as taxable gain.
    - Investment tax allowances, whether regarded as expenses or investments for accounting purposes.

- Although Argentina has high statutory rates that suggests it would not be regarded as a low-taxed jurisdiction for GloBE purposes, there are certain distortions (i.e., complex foreign exchange issues, adjustment for inflation) to address when calculating the tax basis under GloBE to ensure an ETR lower than 15%.
- Traditional tax planning strategies consisting of reducing tax burden at source may have to be redefined on a case-by-case basis in order not to suffer top-up tax at upper levels.

Pillar 2 – Argentina's tax incentives: examples

Promotional regime	Tax incentives relating to Covered Taxes	Impact on GloBE rules
Mining activities	Double CIT deduction of exploration expenditures until the feasibility study is completed. (Depreciation + deduction).	Reduce Covered Taxes. Riksy in first years of operations.
	Accelerated depreciation on investments	Neutral (to the extent temporary differences computed as deferred taxes).
	Exemption on dividend WHT deriving from the contribution of mines and mining rights	Reduce Covered Taxes. Unlikely to bring the ETR below 15% considering current CIT rates (25% to 35%).
Knowledge-Economy	Non-refundable tax credit bond up to 70% of social security liabilities to offset other federal tax liabilities (CIT only available to exporters up to amount of exports). Specifically excluded from determination of taxable gain.	QRTC. Unlikely to bring the ETR below 15% considering current CIT rates (25% to 35%).
	20% reduction of the CIT amount determined on gains derived from promotional activities.	Reduce Covered Taxes. Unlikely to bring the ETR below 15% considering current CIT rates (25% to 35%).
Manufacturers of capital goods, computers and telecommunications (including design, engineering, installation and assembly services)	Non-refundable tax credit bond to offset federal tax liabilities equivalent to 40% of the value resulting from multiplying (i) the total amount of the previous fiscal year CIT, (ii) by the percentage of sales of promoted activities.	QRTC. Unlikely to bring the ETR below 15% considering current CIT rates (25% to 35%).
Generation of renewable energy integrated to the public grid.	Non-refundable tax credit bond available to users-generators to offset federal tax liabilities, for the injection of renewable energy to the public grid, based on avoided costs to the electricity system.	QRTC. Unlikely to bring the ETR below 15% considering current CIT rates (25% to 35%).

Pillar 2 – Canada's tax incentives

Accelerated tax depreciation for clean energy investments

- Gives rise to deferred tax liability to the extent it exceeds accounting depreciation;
- Deferred tax liabilities are included in "adjusted covered taxes" (section 4.4.1);
- Therefore, there is no impact for purposes of the IIR.

7.5% federal tax rate reduction for "zero-emission technology manufacturing profits"

- Generally ok, as lowest combined rate is 23% (23% - 7.5% = 15.5%).

Non-Refundable ITCs for R&D activities

- Non-QRTC;
- Problematic, to the extent they reduce adjusted covered taxes, bringing the ETR below 15%.

Non-Refundable ITCs for certain investments in economically disadvantaged areas of Canada (Atlantic provinces):

- Non-QRTC;
- Problematic, to the extent they reduce adjusted covered taxes, bringing the ETR below 15%.

Refundable ITCs for clean energy investments (major incentive introduced in 2022/2023) (30% of cost incurred)

- QRTC;
- May be problematic for renewable energy producers, as amount of ITC is not included in income for Canadian tax purposes. Rather, it reduces the cost of the relevant asset acquired;
- Most renewable energy projects do not produce income for several years due to the availability of accelerated depreciation;
- Accordingly, they may have no Canadian income or tax payable, but they will have GloBE income for Canada.

Pillar 2 – Chile's tax incentives

Accelerated tax depreciation for fixed assets acquired new or imported into to the country

Tax credits or deductible expenses related to donations for educational, cultural, research, social, sporting and other purposes.

Tax credit for the expenses incurred in employee training programs that have taken place within the national territory, in the amounts that are authorized under the law

Development and research expenses, certified by Chilean Production Development Corporation

- Tax credit equivalent to the 35% of the total amount of the payments in cash realized in accordance with duly certified research and development contracts concluded with registered research and development centers.

Special rules for the determination of mining operational taxable income, providing for the deduction of income not derived directly from the sale of mining products

Tax benefits for investments carried out in extreme zones

- Austral Law,: tax credit for investment projects intended for the production of goods or the provision of services in Aysen and Magallanes Regions against CIT, for a range of 10-32% determined over the amount of the investment.
- 30% credit shall be equivalent to 30% of the value of certain physical fixed assets, in case of investment projects intended for the production of goods or the provision of services in Arica and Parinacota Province.
- CIT exemption for companies located in free zones, and entitlement of the partners or shareholders to a credit equivalent to 50% of the CIT that would have been payable by the company in the absence of this franchise.

Pillar 2 – Brazil's tax incentives

Regional incentives

Income tax exemptions or reductions are mainly available for companies set up in specified regions within Brazil, primarily the north and northeast regions. These incentives are designed to accelerate the development of certain less-developed regions and industries considered to be of importance to the economy.

The main benefit, which can have an impact on Pillar 2, is **SUDAM** (Superintendence for Development of the Amazon – North Region) and **SUDENE** (Superintendence for Development of the Northeastern Region) incentives.

This tax incentive applies to companies that are part of specific economic sectors, considered by the Executive Power as priorities for regional development, such as mining and electrical, and are located in the regions covered by SUDAM and SUDENE, that have projects that fall under one or more of the following categories: implementation, expansion, modernization and diversification.

As a result, there is a 75% reduction in corporate income tax (IRPJ).

As long as the CIT rate is above 15%, there will be no impact under Pillar 2

Other incentives.

Pillar 2 – Brazil’s tax incentives (cont.)

Foreign Subsidiary in Brazil

Brazilian tax incentives, such as SUDAM and SUDENE benefits

ETR > 15%

Pillar 2: no complementary tax to be collected in the Parent´s Company Country

ETR < 15%

Pillar 2: an effect in Brazil due to Pillar 2 and a complementary tax to be paid in Parent´s Company Country

Pillar 2 – Example 1

Argentina

Example A: Argentine CE registered in the knowledge-economy promotional regime

Taxable net income	
Percentage of sales of promoted activities	70%
Total net income	200.000
Net income derived from promoted activities	140.000
Tax credit bond	
Tax credit bond (70% of contributions paid for employees dedicated to promoted activities)	10.000
Tax credit bond creditable against CIT (up to percentage of exports)	5.000
CIT Calculation	
Standard rate	35%
CIT on non-promoted activities	21.000
CIT on promoted activities (reduction of 20% of CIT amount)	39.200
Total CIT	60.200
GloBE Calculation	
GloBE Income	200.000
Adjusted Covered taxes	60.200
ETR (60.200/200.000)	30,10%

Example B: Argentine CE registered in the manufacturers of capital goods promotional regime

Requirements	
Percentage of sales of promoted activities	70%
Annual expense on salaries and SS contributions on employees dedicated to promoted activities with respect to sales	15%
Net income (includes tax credit bond)	200.000
Tax credit bond	19.600
CIT Calculation	
Standard rate	35%
CIT on net income	70.000
Tax credit bond creditable against CIT	19.600
Payable CIT	50.400
GloBE Calculation	
GloBE Income	200.000
Adjusted Covered taxes	70.000
ETR (70.000/200.000)	35,00%

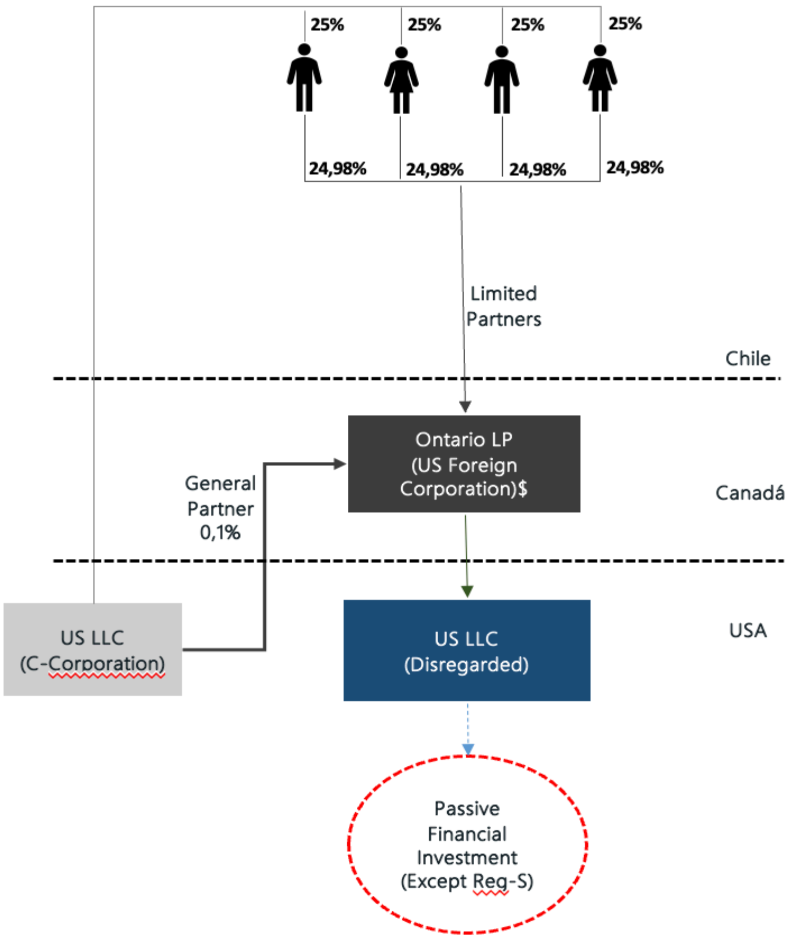
Pillar 2 – Example 2

Canadian refundable ITCs for clean energy investments

- Foreign-based group creates a Canadian subsidiary to create a renewable energy project.
  - Cost of project assets = $300M;
  - Gross revenue = $30M;
  - Salaries = $1M;
  - Interest expense = $10M;
  - Accounting depreciation (2.5%) = $7.5M;
  - Tax depreciation = $19M (accelerated depreciation);
  - Deferred taxes = ($19M - $7.5M) = $11.5M;
  - ITC (30% of $300M) = $90M.
- Income for tax purposes = ($30M - $1M - $10M - $19M) = $0 (<u>ITC not included in income in Canada, reduces cost of asset</u>);
- Tax actually payable = $0;
- Adjusted covered taxes = $11.5 (deferred taxes are treated as adjusted covered taxes);
- GloBE income = ($30M - $1M - $10M - $7.5M + $90M) = $101.5M;
- Effective tax rate for Canada = $11.5M/$101.5M = <u>**11.3%**</u>.
- Excess profit = GloBE income - substance based income exclusion (5% of carrying cost of assets and salaries) = $15.05M.
- Top-up tax = (15% - 11.3%) * ($101.5M - $15.05M) = <u>**$3.2M**</u>.

Pillar 2 – Example 3

Transparent entities



❖**<u>Ontario Limited Partnership ("Ontario LP")</u>:**

- **Transparency:** in Canada it is not considered as an entity different from its partners. In Chile the IRS has recognized that it is a separate entity.
- **Canadian Taxes**: Ontario LP's are fiscally transparent in Canada, with certain exceptions are not taxed in that country for foreign source income nor is it subject to withholding tax on distributions made to its foreign partners.
- **US Tax Treatment:** Ontario LP's may choose to be treated as US Foreign Corporations *(Check-the-box-election),* which allows and implies that:
    i. Acts as a blocker for purpose of US estate tax.
    ii. It is subject to US reporting and tax return obligations.
    iii. Being a Foreign Corporation, capital gains from financial assets in the US are not taxed in that country, as they are considered foreign source income (foreign seller).

❖ **<u>US Limited Liability Company ("US LLC")</u>:**

- **Legal Personality:** unlike Ontario LPs, US LLCs are legal entities distinct from their partners. The legal ownership of the assets is maintained under this legal entity.
- **US Tax Treatment:** LLCs are by default treated as fiscally transparent (disregarded in case they are a sole-member LLC), so their income is directly attributed to their members.
- **Withholding Tax**: does not apply since the income is imputed directly to its foreign members (fiscally it is understood that they do not pass through the US).

❖ **<u>Chilean CFC Rule</u>**: in this structure, the Chilean CFC Rule would not be applicable since:

- **Property:** none of the Ontario LP has 50% or more of the capital or the right to profits or votes.
- **Administration/Amendments**: none may unilaterally amend the bylaws, appoint or remove directors and managers.

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