Global tax reform: thin end of the wedge for multinational SMEs?

Sara White, Editor, Accountancy Daily

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As G20 leaders approve the final agreement on a corporate base tax rate, Jelle R Bakker, director-global tax group Europe at Kreston Global, considers whether SMEs operating cross border will be caught by the rules

On 8 October 2021, 136 out of 140 members of the OECD/G20 Inclusive Framework officially agreed an international agreement to reallocate some taxing rights to market jurisdictions (Pillar One) and introduce a global minimum effective taxation (Pillar Two). Technical details will be released over the next 14 months, starting with Pillar Two rules in November 2021, while Pillar One rules will be detailed over 2022. The new rules will be gradually introduced from 2023.

In this article, I will reflect on how these new rules might affect small and medium-sized businesses (SMEs) with a global annual turnover in the range of €50m (£42.5m) to €100m.

Pillar One

Pillar One will initially apply only to multinational enterprises with a global turnover of more than €20bn and a pre-tax profit margin above 10%. The €20bn threshold may decrease after eight years to €10bn if the Pillar One implementation is successful and achieves sufficient tax certainty.

All profits of an in-scope multinational would be subject to these new tax rules: there is no longer a specific focus on certain activities / sectors. However, the extractive and regulated financial services sectors are fully out of scope.

The Pillar One rules would allocate more profits to markets with whom the businesses interact, regardless of their physical presence there. This Pillar also aims at developing a new non-physical presence nexus rule not dependent on physical presence but largely based on sales. In addition, new profit allocation methods going beyond the arm's length principle are introduced. These methods include:

1. a modified residual profit split method that would allocate to market jurisdictions a portion of a multinational's non-routine profit (which is not recognised under the current profit allocation rules);

2. a fractional apportionment method, allocating profits based on a formula that may consider relevant factors such as employees, assets, sales and users; and

3. distribution-based approaches that could consider both non-routine and routine profits arising from activities associated with market and distribution.

Pillar Two

Based on the Pillar Two rules, multinational groups with a global annual turnover above €750m should be subject to a minimum effective tax rate of 15% in every jurisdiction where they realise profits.

However, countries may optionally apply the income inclusion rule to multinationals headquartered in their jurisdiction even if they do not reach the €750m turnover threshold. International shipping income will be excluded. This Pillar Two introduces a combination of domestic and treaty-based top-up taxation rules.

These rules are called the Global Anti Base Erosion Rules ("GLoBE") and consist of four different measures. These are the income inclusion rule (IIR), a switch-over rule (SOR, to facilitate the application of the IIR in a treaty context), an undertaxed payment rule (UTPR, which serves as back-stop to the IIR) and a subject-to-tax rule (STTR).

What are the next steps?

The international agreement must be implemented and signed into national law by the members of the OECD/G20 Inclusive Framework prior to being effective. At EU level, on 18 May 2021 the European Commission adopted the ‘communication on business for the 21st century’ in which it states that two new Directives will be issued to implement each of the two pillars in the next two years. In the same communication BEFIT (Business in Europe: Framework for Income Taxation) was introduced which provides for one single EU corporate tax return for an EU multinational group.

How will SMEs be affected by the new rules?

As shown above, high thresholds are set for application of the Pillar One and Two rules. These must ensure that digital giants like Google, Facebook, Apple or Microsoft and, generally speaking, every international blue chip company pay taxes in countries where they make profits rather than in low tax countries chosen to minimise payments.

The new rules will entail that seasoned tax concepts such as the concept of transfer pricing and permanent establishment will be completely rethought and not simply tidied up.

Transfer pricing

The concept of transfer pricing is used to allocate the group’s profit to each multinational legal entity within the group. This concept is at stake because it is premised on an inherent contradiction. It provides that for tax purposes related parties must act on arm’s length terms which means that these parties are deemed to be independent and act in their own self-interest to attain the most beneficial deal.

However, in reality, contrary to the notion of independence, these parties have chosen to be in a relationship in order to maximise their own and the group’s overall profits.

Under Pillar One, established transfer pricing concepts used for profit allocation among related group companies become outdated because of the inner contradiction of the arm’s length principle. However, the downfall of these concepts will be accelerated due to the Pillar One rules.

Permanent establishment

Also, we are slowly moving away from established tax concepts such as ‘the permanent establishment’. This term must be understood to describe that degree of economic penetration which, according to the agreement of double taxation treaty partners, justifies a nation in treating a foreign legal entity for income tax purpose in the same manner as domestic legal entities are treated.

When the foreign legal entity acquires a permanent establishment, the nation of its residence yields taxing jurisdiction to the nation in which it has acquired a permanent establishment, ie, the host state.

For more than a century, the crucial point of economic penetration has been determined on the basis of physical presence of that foreign legal entity in the host country shown by the nature of its business and the level of activities.

Pillar One aims at developing **a new non-physical presence nexus rule** not dependent on physical presence but largely based on sales. That shift changes the landscape. Clearly, most countries' tax administrations will not be able to resist the temptation to adopt this new line of thinking when it comes to the taxation of SMEs operating in their jurisdiction, apart from any thresholds.

IFRS and local GAAP

Finally, in order to remove the tax obstacles to the realisation of a common market, in its above-mentioned 18 May communication, the European Commission proposed the introduction of BEFIT for cross border activities in the EU.

It is likely that it will be considered whether local GAAP can be replaced by International Financial Reporting Standards (IFRS) in designing the common tax base under BEFIT because IFRS provides a common language and some common definitions.

In most EU countries the tax treatment follows the accounting treatment. Therefore, it is safe to assume that IFRS will gain traction at the expense of local GAAP.

As such, it is possible that in due course, the Pillar One and Two rules will be expanded to include all businesses operating in the EU. In particular, if the introduction of BEFIT becomes successful, the tax and accounting rules for SME multinationals and large multinationals in the EU must be the same.

In conclusion

On the face of it, SMEs will likely not be affected by the Pillar One and Two rules, given the high thresholds set for application. However, in the near future Pillar One and Two could prove to be the thin end of the wedge, with the new Pillar standards ultimately becoming the SME standards both in the EU and the world over.

About the author

Jelle R Bakker, partner, international tax at KrestonBentacera is director-global tax group Europe at Kreston Global

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