BEPS 2.0

Pillar One and Pillar Two - A Middle East perspective

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pwc

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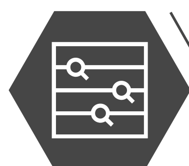
Highlights



Highlights

As of September 2 2021, 133[1] countries of the 140 members of the G20/OECD Inclusive Framework on Base Erosion and Profit Shifting ("IF") have committed to fundamental changes to the international corporate tax system through the adoption of a two-pillar plan.[2]

Pillar One

Pillar One introduces new rules for the (re)allocation of a portion of the consolidated profit of a multinational enterprise ("MNE") to jurisdictions where sales arise under a formulaic approach (Amount A). The work on Amount B has been postponed and is expected to be completed by the end of 2022. Amount B aims to standardise the remuneration of related party distributors that perform in-country baseline marketing and distribution activities.

Pillar One (Amount A) will initially apply to MNEs with profitability above 10 percent and global turnover above EUR 20bn.[3] The profit to be reallocated to market jurisdictions will be between 20 and 30 percent of the profit in excess of a 10 percent profit margin (calculated as profit before tax/revenue).

Two sectors have been excluded from the requirement to reallocate excess profits to market jurisdictions: extractive industries and regulated financial services.

The new nexus and profit allocation rules (Amount A) are scheduled to come into effect in 2023.

Pillar Two

Pillar Two introduces a global minimum effective tax rate ("ETR") of 15 percent. This is to be achieved through (a) two interlocking domestic rules, an income inclusion rule ("IIR") and an Undertaxed Payment Rule ("UTPR") (together known as the Global anti-Base Erosion ("GloBE") rules) and (b) a treaty-based rule (known as the "Subject to Tax" rule ("STTR")).

MNEs with global turnover above EUR 750m will be within the scope of Pillar Two, although jurisdictions could decide to apply the rules to smaller MNEs headquartered in their country.

There are only very limited, and narrow, exemptions available from Pillar Two. From a sector perspective, only government entities, investment or sovereign wealth funds and non-profit entities that are Ultimate Parent Entities of an MNE Group or any holding vehicles used by such entities will be excluded from Pillar Two. A small amount of income may also be excluded from Pillar Two through a formulaic substance carve-out mechanism based on tangible assets and payroll costs.

Importantly, adopting the Pillar Two proposals does not require countries to change their domestic rules; adoption could merely mean that countries accept that other countries levy a 'top-up' tax. Where a country decides to implement and administer the GloBE rules, they will have to do so in accordance with draft rules and guidance to be agreed and issued by the IF (i.e. a 'common approach').

Where IF members apply a corporate income tax rate below the proposed STTR minimum rate (of 7.5% - 9%) to the receipt of (amongst others) interest and royalties then the STTR is applicable (assuming it has been implemented into the bilateral treaties).

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[1] The 133 countries include the G7 members (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States), emerging economies like Brazil, China and India, and jurisdictions like Switzerland, Singapore, Bermuda, and the Cayman Islands. However, Ireland, Hungary, Estonia, Kenya, Nigeria,and Sri Lanka have not yet signed on to the consensus.

[2] The Statement of the IF ("the Statement") summarising the two-pillar plan can be accessed here https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf, accessed on August 5, 2021.

[3] EOR 20bn will be reduced to EUR 10bn after 7+1 years from implementation if a year-long review establishes that the new system was successfully implemented in the first seven years, including achieving a satisfactory level of tax certainty on Amount A.

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Practical considerations for Middle East MNEs

Practical considerations for Middle East MNEs

Will the Middle East implement Pillar One and Pillar Two?

Historically, Middle East countries have responded to global tax initiatives / measures to ensure that they meet their international commitments and obligations. This includes implementing the four BEPS minimum standards and the necessary economic substance regulations[4] and transparency measures[5] to ensure relevant countries and tax regimes are not considered to be 'harmful' by the OECD or 'non-cooperative' from the perspective of the EU.

Oman, Saudi Arabia, the United Arab Emirates ("UAE"), Qatar, Egypt, Jordan and Bahrain are members of the IF, and they have all joined the consensus expressing their agreement to the two-pillar solution. Whilst this means the countries have committed to adopt the BEPS 2.0 initiatives, the exact extent of reaction remains to be seen.

Furthermore fiscal balance and revenue diversification remains high on the Middle East governments' agenda (noting that to the extent that countries that do not implement Pillar Two may be foregoing significant tax revenues to other countries that do).

Table 1: Middle East countries that are IF members, their agreement to the Statement, and current corporate tax and transfer pricing ("TP") regimes

IF Members	Agreed to the Statement	Corporate Income Tax ("CIT") and/or similar regime[6]	Statutory CIT rate above/below the proposed 15% minimum rate	TP regime	
				Action 13 requirements and / or local additional requirements	CbCR Only
Egypt	Yes	Yes	Above	Yes	
Saudi Arabia	Yes	Yes	Above for CIT Below for Zakat	Yes	
United Arab Emirates	Yes	Limited	Below (with exceptions for certain activities)		Yes
Jordan	Yes	Yes	Above	Yes	
Oman	Yes	Yes	Same		Yes
Qatar	Yes	Yes[7]	Below	Yes	
Bahrain	Yes	Limited	Below (with exceptions for certain activities)		Yes

[4] As the UAE and Bahrain are considered to be 'no or nominal tax jurisdictions', they are required to introduce economic substance regulations by the OECD Forum of Harmful Tax Practice and the EU.
[5] For example, common reporting standards.
[6] https://taxsummaries.pwc.com/
[7] No corporate income tax is levied on a Qatari corporate entity that is wholly owned by Qatari nationals and Gulf Cooperation Council ("GCC") countries' nationals which are resident in Qatar.

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Impact of the Pillars

Impact of Pillar One

Through the application of Amount A, profits could be reallocated to jurisdictions with higher tax rates. For MNEs in the UAE / Bahrain, if profits move out of the UAE / Bahrain or other low or no-tax jurisdictions due to the application of Amount A, this will likely result in a higher ETR for the group . It will also be interesting to further analyse how the impact of Pillar One would be different for Middle East headquartered MNEs and non-Middle East headquartered MNEs that are undertaking business in the Middle East.

Please see a simplified illustration of Amount A's impact on a MNE group's corporate tax in table 2 below.

Group A has a centralised operating model, in which a Principal (resident in Jurisdiction 1) owns the group's trade and marketing intangibles and realises the entire residual profit of the group. Jurisdiction 1 is a large market for Group A, generating EUR 10,000 million in third party revenues that are booked by the Principal.

It is assumed for the purpose of this illustration that the profitability threshold will be 10 percent and the reallocation percentage will be 20 percent.

Table 2: Simplified illustration of Amount A's impact on a MNE group's corporate tax[8]

in Eur million	Principal	Distributor 2	Distributor 3	Distributor 4	Distributor 5	Total
	Jurisdiction 1	Jurisdiction 2	Jurisdiction 3	Jurisdiction 4	Jurisdiction 5	
Revenue	15,000	2,000	4,000	3,500	1,250	
Third party revenue	10,000	2,000	4,000	3,500	1,250	20,750
Intragroup revenue	5,000	-	-	-	-	
Profit before tax (PBT)	5,000	60	120	105	38	5,322
Profit margin (%)	33%	3%	3%	3%	3%	26%
Tax rate	0%	15%	20%	25%	20%	
Tax	0	9	24	26.3	7.5	**66.8**

in Eur million	Principal	Distributor 2	Distributor 3	Distributor 4	Distributor 5	Total
	Jurisdiction 1	Jurisdiction 2	Jurisdiction 3	Jurisdiction 4	Jurisdiction 5	
Calculation of Amount A						
PBT (P)	5,000	60	120	105	38	5,322
Revenues (R)	10,000	2,000	4,000	3,500	1,250	20,750
(R*10%)						2,075
Residual profit (RP) = P - (R*10%)						3,247
Allocable profit to jurisdictions (20%)						650
Amount A - Allocation %	**48%**	**10%**	**19%**	**17%**	**6%**	100%
Amount A allocated to jurisdictions	313	63	125	110	39	650
Total profit allocated to jurisdiction	4,663	123	245	215	77	5,322
Tax	0	24.4	65.1	71.2	20.3	**181.0**

In the above simplified illustration, assuming that Distributors 2 - 5 engage in routine marketing and distribution activities and are not earning a fixed return under the arm's length principle, additional amounts could get taxed under Amount B in Jurisdictions 2 - 5, respectively.

[8] Amount B's impact is not considered in this simplified illustration.

The scope for Pillar One (Amount A) is more restrictive.[9] As such, even if the companies in the region fall out of scope for Amount A, it is not yet clear that they will also fall out of scope for Amount B as the scope rules are not yet as clear for Amount B.[10] It is hoped that this will become clear as part of the technical work being undertaken in the run-up to the October IF and G20 meetings.

Middle East MNEs that do not meet the EUR 20bn revenue threshold would still need to closely monitor the developments in the lead up to Pillar One implementation and afterwards. They should prepare for the potential application of Pillar One under a reduced revenue threshold of EUR 10bn, which it has been suggested would be applicable from 2030 onwards.

Table 3: Summary of Pillar One Building Blocks - Amounts A and B[11]

	Amount A	Amount B[12]
Objective	• Changing the allocation of taxing rights for business profits in a way that expands the taxing rights of market jurisdictions; and • Creates a special purpose nexus rule that will reallocate profits from residence to market countries.	• Simplify the administration of TP rules for tax administrations and reduce compliance costs for taxpayers; and • Enhance tax certainty and reduce controversy between tax administrations and taxpayers.
Scope	**All businesses** that meet the thresholds (revenue and profitability). Please see below.	All businesses that perform certain routine marketing and distribution activities.
Exclusion in Scope	Extractives and Regulated Financial Services are excluded.	N/A
Revenue and Profitability Thresholds	• MNEs with global turnover above EUR 20bn (may be reduced to EUR 10bn); **and** • Profitability above 10%.	"The Report on Pillar One Blueprint" accounted for a revenue threshold of EUR 750m but it is not clear whether this might still apply. Expect further details in the coming months.
Summary of the Rule	Uses non-arm's length price/formula (uses profitability threshold) to reallocate taxing rights to jurisdictions where revenues are sourced (where goods or services are used or consumed).	Provides certain guaranteed/assured returns for engaging in routine marketing and distribution of products. The amount would be different for various industries and regions.
Implementation and Timeline	The multilateral instrument through which Amount A is implemented will be developed and open for signature in 2022, with Amount A aiming to come into effect in 2023.	It is unclear what the exact scope of Amount B will be. The Statement indicates that work on Amount B will be completed by the end of 2022 and implemented by 2023.

[9] The scope is restrictive considering the applicable revenue threshold as well as the industry-specific exclusions (e.g. it excludes extractive industries and regulated financial services).
[10] Amount B details are based on "Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint", which may be modified as part of the ongoing work to be finished in 2022.
[11] Tax certainty is the third building block of Pillar One.
[12] Amount B details are based on "Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint", which may be modified as part of the ongoing work to be finished in 2022.

Impact of Pillar Two

The introduction of a global minimum tax of at least 15 percent under Pillar Two could significantly increase the effective tax rate of Middle East businesses, especially those operating in countries with no or low statutory tax rates and businesses that currently benefit from preferential taxation on the basis of local or GCC ownership.

The tax that is due under Pillar Two could be collected by:

- the jurisdiction in which the MNEs ultimate parent entity ('UPE') is headquartered (assuming that jurisdiction adopts the GloBE rules) under the IIR, or
- the jurisdiction of the constituent MNE entity in the event that the jurisdiction where the MNE UPE is located does not apply the IIR, this gives the UTPR the right to make adjustments to the tax paid in that jurisdiction, or
- if the MNE group has a split ownership model, an intermediate parent company may be given the taxing right in its jurisdiction of residence, or
- the sourcing jurisdiction for selected payments under the Subject to Tax rule.

The impact of this is that regardless of whether or not Middle East countries decide to adopt Pillar Two into national legislation, additional tax could be due by Middle East entities (even if they continue to not be subject to corporate income tax under domestic law).

The Pillar Two rules, as currently drafted, provide very limited exemptions with the main exclusions focusing on government entities, investment and sovereign wealth funds.

The limited exemptions and substance carve-out (which allows for at least a 5% deduction to be taken for payroll component and certain fixed assets) mean most large businesses operating cross-border should prepare to face top-up taxes, even if they have genuine economic reasons / satisfied economic substance requirements to operate in low tax jurisdictions. The formulaic substance carve-out also focuses on tangible assets and payroll. As such, companies that are heavy on intangible assets / labour, e.g. banking, digital, etc. may not be able to significantly benefit from the carve-out.

Given the various rules underpinning Pillar Two and the potentially significant impact it could have on Middle East businesses, it is strongly recommended to perform an impact assessment for MNEs that meet the scope criteria, including certain government entities and sovereign wealth funds given the limited exclusions. While the variables that will ultimately determine the exact impact of Pillar Two are still under discussion at various OECD technical panels, carrying out an impact assessment using the October 2020 blueprints and IF Statement from July 2021 is advisable so that businesses are as prepared as possible and can provide an estimated impact assessment to the business' relevant stakeholders.

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What's next?

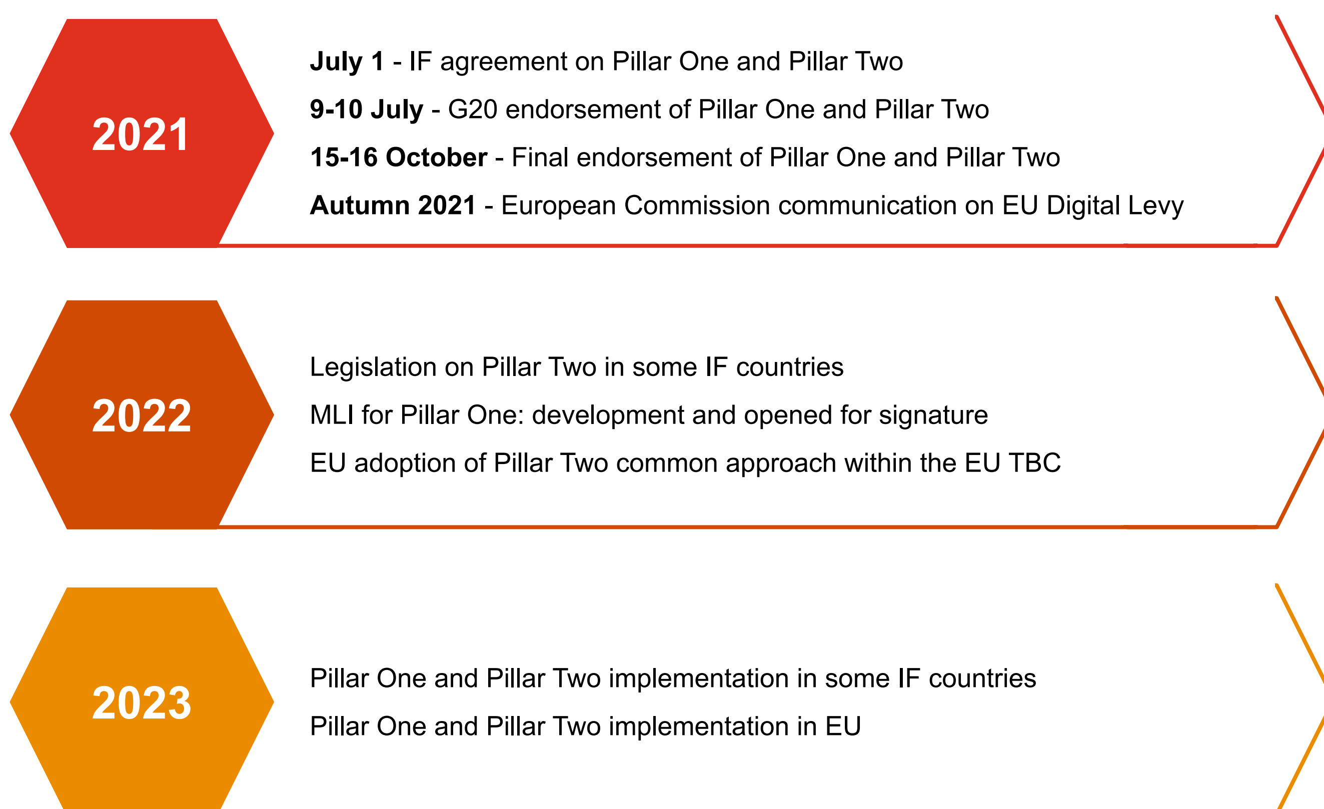
What's next?

The IF members and the G20 are meeting in the first and second week of October, respectively, where a further update on both Pillars is expected.

A significant amount of political and technical work still remains to be completed by October 2021, with key design issues still to be resolved. Please see figure 1 below for a possible timeline for Pillars One and Two.

Businesses have limited time to get ready, given the ambitious proposed timeframe. More detailed information is expected in October 2021. However, actual legislative instruments will not be released until 2022, with a go-live date of 2023 onwards. This is a tight timeframe, and businesses need to be organised and ready to respond.

Figure 1: Possible timeline for Pillars One and Two



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How can PwC help?

How can PwC help?

PwC can assist clients in the following ways:

Pillar One - High-level economic impact assessment
- Helping with better understanding of how revenues would be re-allocated to local jurisdictions

Pillar Two - Tax impact assessment (all industries)
- Providing an overview of what would be the tax paid across the group assuming a range of different minimum tax rates

Pillar One and Pillar Two - Support on modelling prepared by clients
- Review and provide advice on modelling prepared internally by clients

Advice on business structure and value chain (e.g. remuneration model and strategy review and updates / Structuring)
- Potential implications related to Pillar One and Pillar Two

Comments on Public Consultation Document
- Provide support in preparing public consultation comments and engage with relevant stakeholders (government, trade unions, other like-minded organisations) to share perspective, etc.

Please also be on the lookout for

PwC's easily accessible podcasts (English and Arabic) on Pillar One and Pillar Two updates soon

Up-to-date communication on the most recent developments in respect of BEPS 2.0

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PwC BEPS Team

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Jochem Rossel

Partner, Middle East Specialist Tax Services Leader

jochem.rossel@pwc.com

Safae Guennoun

Partner, Transfer pricing Middle East Leader

safae.guennoun@pwc.com

Hanan Abboud

Partner, International tax

hanan.abboud@pwc.com

Thank you

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