Cristal Advocates

Overhauling the current International Taxation Structure

Revolution or evolution

Credit: https://decentra.news/the-tax-revolution-is-underway/

1. Background

In October 2019, we published a summary of some of the key challenges posed to existing tax systems by the internet.
This publication can be found at this link http://cristaladvocates.com/?docs-file=22155. At that time, the Organisation for Economic Co-operation and Development "OECD" had intended to build a broad consensus on the way forward by the middle of 2020. The COVID pandemic has delayed this but July 2021 has seen major progress and the OECD hopes to finalise a detailed implementation plan by October 2021, following endorsement by the G7 and G20. This article provides a brief summary of the key proposals which will fundamentally change the way the international tax system has worked for the last hundred years. It should be noted that many aspects are complex and potentially affected taxpayers are recommended to analyse them in detail.

2. What's the problem?

As discussed in the previous article mentioned above, the development of the internet has enabled some multinational businesses to build revenues via a digital presence in a jurisdiction without the need for a significant physical presence. Without such a physical presence a permanent establishment ('PE') or branch to which revenues and profits are attributable may not exist under current domestic tax rules or double taxation agreements ('DTAs').
At the same time, there has been a growing consensus that many multinationals have been able to minimise the overall tax on their activities because the internet gives them greater flexibility to locate key profit generating activities in jurisdictions with low effective tax rates. Moreover, some jurisdictions, alongside traditional tax havens, have sought to provide low tax environments for certain activities in order to attract foreign investment.

3. A two pillar solution

To tackle these twin problems, the Inclusive Framework[1] has agreed a two-pillar approach to adapt the international tax system to the realities of the digital economy. For countries which adopt this approach, the pillars will require changes to both the domestic tax system and any DTAs to which the country is party

a) How it will work: Pillar One

Pillar One introduces a revolutionary approach to taxing multinationals.[2] Instead of the current approach of computing taxable amounts based on the sources of income and residence of the recipient, the new approach will allocate taxing rights to countries where goods and services are sold/consumed ('market jurisdictions') even where the legal entity generating the revenue is not tax resident in that jurisdiction and does not have a source of income there which is subject to tax under current rules.

This is to be achieved via the computation of 'Amount A' based on the overall accounting profits of the multinational group part of which will be allocated to market jurisdictions based on a pre-determined formula and taxed there. Relief will then be given for the resulting tax in the legal entity's residence jurisdiction via credit or exemption to avoid double taxation.

'Amount B' will be a methodology to define the taxable income of an entity in a market jurisdiction that is involved in marketing and distribution and already taxable there. This will be based on a simplified application of the arm's length principle.
Much of the detail of how this will work, and how the inevitable disputes over allocation will be settled, has yet to be agreed. The important feature is that it overrides the application of the arm's length principle to individual subsidiaries of the multinational. It is planned to prepare a multilateral instrument to makenecessary modifications to the application of DTAs before the end of 2022. This will come into effect in 2023 at the earliest. Changes to domestic tax laws in implementing jurisdictions will also be required.

Rather than focusing on digital businesses specifically, such as Amazon and Facebook, the Pillar One is to apply to multinationals with a turnover in excess of 20 billion euros and pre-tax profits exceeding 10% of revenue. Subject to successful implementation, it is intended to

1 The Inclusive Framework brings together a group of more than 130 countries, including members of the G20, to work with the OECD developing measures to combat BEPS (base erosion and profit shifting). More details can be found on the OECD website. Uganda is not currently a member, though this will not prevent the introduction of changes to domestic tax law, if considered desirable.
2 The OECD's summary of Pillars One and Two can be found here Highlights brochure: Addressing the tax challenges arising from the digitalisation of the economy, July 2021 (oecd.org)

digital services taxes will be withdrawn by countries which adopt Pillar One.

b) How it will work: Pillar Two

Pillar Two is intended to introduce a minimum level of taxation on the profits of multinationals and would apply much more widely than Pillar One. Prima facie, it will apply to the extractive industries and regulated financial services, which are to be excluded from Pillar One.

The proposed minimum effective tax rate is 15% and this will apply to multinationals with a turnover of at least 750 million euros (much lower than that contemplated for Pillar One). The basis for calculating the effective rate will be the tax charge shown in the relevant financial statements, rather than the statutory rate, as the latter can be reduced in practice by incentives, reliefs and exemptions.

Where the subsidiary of a multinational has an effective tax rate below the minimum rate, new tax rules will be applied to tax the parent company on the difference between the actual effective tax rate and the 15% minimum. Where payments are made to an affiliate which is subject to an effective tax rate below the minimum, the amounts will not be deducted in computing the payer's profit tax. These new rules are referred to as the Global anti-Base Erosion ('GloBE') rules and will require changes to domestic law. A second regime (the 'Subject to Tax Rule' – 'STTR') will be introduced to participating jurisdictions' DTAs via a multilateral instrument, to enable source jurisdictions to apply tax (presumably via withholding in most cases) to related party payments which are subject to tax at a rate below a specified minimum which is proposed to be in the range 7.5% - 9%.

Pillar Two is to be implemented via law and DTA changes during 2022 and to apply from 2023.

4. Comments

When we last wrote on this topic in 2019 a global consensus seemed far off, and in particular to attitude of the United States of America (home of most of the largest participants in the digital economy) was seen as obstructing progress. It is impressive that so much has been achieved since the new US administration came to office. As usual, however, the devil is likely to be in the detail, and the OECD's plan for rapid implementation is certain to give rise to further uncertainty and potential conflicts.

The proposals are already being criticised by some NGOs as unduly favouring developed over developing countries. The Tax Justice Network believes that the formula proposed for computing Amount A advantages headquarter jurisdictions over market jurisdictions, particularly those in the developing world.3 They also argue that raising the minimum effective tax rate under Pillar Two to 21% could raise additional tax of US$100 billion.
The proposals seem to have the international political support needed to succeed despite the resistance of a few low tax jurisdictions, notably Ireland and Hungary. We will provide further updates as the implementation phase progresses.

3 See Is today a turning point against corporate tax abuse? - Tax Justice Network

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Denis is the Managing Partner at Cristal Advocates where he also leads the energy and tax practice. He is qualified both as a Lawyer and Chartered Accountant with vast experience serving various industries in Sub Saharan Africa. Before joining Cristal Advocates, he had worked for close to 10 years with Deloitte and Touche where he started his career and rose to senior managerial positions.

At Deloitte, he lived and worked in Uganda, Kenya, Tanzania and the United Kingdom for over 6 years and subsequently became the firm's chief of staff for the Energy and Resources Industry Group seeing him play a lead advisory role in Uganda, Kenya, Tanzania, Mozambique, South Sudan, Somalia and Ethiopia.

Denis is widely published and a regular commentator in the local, regional and international media and speaker at various forums regarding the taxation and financing of energy projects as well as the protection of large capital projects within the framework of international investment law.

He holds a Master of Laws degree in Petroleum Taxation and Finance from the University of Dundee in the United Kingdom, a Post Graduate Diploma in Legal Practice and a Bachelor of Laws degree from Makerere University.

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Bill is a Senior Advisor with Cristal Advocates. He has concentrated on working with energy companies with a particular focus on cross border transactions and M&A since 1989 and is a leading global energy and tax practitioner with wide international experience. Between 1986 and 1998, he worked in London with the UK tax authorities and Big Four accounting firms. From 1998 to 2004, he was based in Kazakhstan working across the Caspian region with Deloitte. He was in the region at the time it was developing its infrastructure for crude oil production with international investment following the collapse of the Soviet Union.

From 2004 to 2008, he worked in Russia where he led Deloitte's oil and gas industry group and established Deloitte's office in Sakhalin. He moved to East Africa in 2009 leading Deloitte's energy and resources industry group in Uganda, Kenya, Tanzania, Rwanda, Ethiopia and Mozambique. He was initially based in Kampala, Uganda later relocating to Dar es Salaam, Tanzania. Bill returned to the UK in 2014 supporting Deloitte UK teams working on outbound projects investing in Africa and was a key member of Deloitte UK's energy and resource practice until his retirement from the firm in September, 2018.

Bill is a graduate of Oxford University and completed his inspectors' training with the UK Inland Revenue in 1989

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John leads the public policy and advocacy practice at the firm and combines unique public and private sector experience.

Prior to joining Cristal Advocates, he had worked as a Private Secretary to the President of the Republic of Uganda. During this time, he participated in several public and private sector engagements that included advising and coordinating activities relating to oil and gas as well as infrastructural projects of national significance. John had earlier worked with the Post Bank Uganda Limited and Shonubi Musoke and Co. Advocates.

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Dickens leads the oil and gas practice at Cristal Advocates. He has an in depth appreciation of Uganda's oil and gas sector having served as the maiden Company Secretary of the Uganda National Oil Company (UNOC) and the Uganda Refinery Holding Company Limited (URHC). UNOC represents the Government of Uganda commercial interests in the oil and gas sector while URHC represents government interests in the refinery project as well as managing the petrol based industrial park.

Dickens was instrumental in UNOC's formation and initial period of operation and also served as its head of Contracts, Negotiations and Advisory until May 2018. Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy playing key legal advisory roles on the negotiation and implementation of PSAs, Joint venture and other oil and gas agreements. He was also part of the team that shepherded the process of enacting the current Ugandan oil and gas Legislations and Regulations including the local content requirements.

He is a certified project control specialist (IFP) and holds a Master of Laws Degree in Petroleum Law and Policy from the University of Dundee in the United Kingdom, a Post Graduate Diploma in Legal Practice and a Bachelor of Laws degree from Makerere University.

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Francis leads the litigation and dispute resolution practice at the firm. He is an Advocate of the High Court of Uganda with expertise in oil and gas, infrastructure and dispute resolution. He has been part of teams advising on projects in Uganda, Tanzania, Mozambique and South Africa. He specializes in regulatory compliance, national content, health and safety and dispute resolution.

He joined Cristal Advocates from Kizza, Tumwesige, and Ssemambo Advocates. He previously worked with the Advocates Coalition for Development and Environment (ACODE). He also undertook a traineeship with the oil and gas division of Webber Wetzel in Johannesburg, South Africa.

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