6 Income Inclusion and Switch-Over Rules

6.1. Overview

410. The IIR effectively operates by requiring a parent entity (in most cases, the Ultimate Parent Entity) to bring into account its share of the income of each Constituent Entity located in a low-tax jurisdiction and taxes that income up to the minimum rate (after crediting any covered taxes on that income). The IIR imposes a top-up tax only on that portion of the low tax income of a foreign Constituent Entity which is beneficially owned (directly or indirectly) by the member of the group that applies the IIR (the Parent).

411. The IIR operates in a way that is similar to a CFC rule in that it subjects a domestic taxpayer to tax on its share of the foreign income of any controlled subsidiary The IIR is designed to be co-ordinated with the GloBE rules that apply in other jurisdictions where the MNE Group operates to ensure that, in aggregate, these rules do not result in incremental taxation on low taxed profit that is above the agreed minimum rate. The IIR is intended to be implemented consistently in every jurisdiction and operate in a way that produces the same overall result in order to ensure that an MNE Group is subject to a minimum level taxation in each jurisdiction that it operates regardless of where it is headquartered and without giving rise to the risk of double or over taxation.

412. Both the IIR and the UTPR are based on the same effective tax rate calculation. As described in Chapters 3 and 4, the ETR computation is determined on a jurisdictional blending basis taking into account the profits, losses and covered taxes paid by all the Constituent Entities of the MNE Group in the jurisdiction and adjusted for substance carve-outs and the carry-forward of losses and excess tax credits. As described in those Chapters:

a. the ETR is first computed at the jurisdictional level to determine whether the jurisdiction is, in fact, a “low-tax jurisdiction” (i.e. a jurisdiction where the MNE’s jurisdictional ETR is below the agreed minimum rate) and to compute the top-up tax percentage necessary to bring the aggregate amount of tax on the income of that jurisdiction up to the minimum rate.

b. This top-up tax percentage is then applied to the income of each Constituent Entity in that low tax jurisdiction, adjusted for losses of other entities for the same period, loss carry-forwards, and any carve-out amount, thereby ensuring that the total amount of top-up tax arising in that jurisdiction is allocated to each Constituent Entity in proportion to its adjusted income.

413. The computation of the top-up tax in respect of each Constituent Entity is, therefore, undertaken prior to, and independently of, the mechanisms for allocating liability for such top-up tax under IIR (and UTPR) as described in this Chapter. Importantly, when the parent entity applying the IIR is not the Ultimate Parent Entity, the ETR of a jurisdiction is not computed solely by reference to the Constituent Entities owned by that parent entity; instead, the ETR is computed by reference to all the Constituent Entities controlled by the MNE Group in that jurisdiction. See Example 6.1A. of the Annex. The implication of determining the top-up tax in respect of each Constituent Entity based on a group-wide average ETR for

the jurisdiction is that top-up tax may be computed for an entity that would not be a low-taxed Constituent Entity on a standalone basis. See Example 6.1B of the Annex. In this sense, the IIR can be contrasted with the usual structure of CFC rules which typically apply to subsidiaries on a standalone entity basis based on the profits, losses and taxes paid by each controlled-foreign-corporation. The fact that the taxpayer and the controlled foreign corporation are part of a larger MNE Group is not usually relevant to the calculation of income or creditable taxes under a CFC rule.

414. The ETR computation and the mechanism for collecting the top-up tax are separate design features of the GloBE rules. The IIR provides for a mechanism to collect the top-up tax based on the parent entity's direct or indirect ownership of the low-taxed Constituent Entities. The UTPR serves as a backstop to the IIR by providing a mechanism to collect any remaining top-up tax in relation to foreign profits that are not in scope of an applicable IIR.

415. Liability for the amount of top-up tax computed for a low-taxed Constituent Entity is allocated to the parent entity in proportion to the parent entity's equity interest in the income of that entity. As described below, liability for the top-up tax usually falls on the Ultimate Parent Entity of the MNE Group. However, under certain circumstances, the GloBE rules are designed so that the liability for the top-up tax shifts to one or more other Constituent Entities of the MNE Group. This coordination of income inclusion rules among jurisdictions is part of the design of the GloBE rules, whereas CFC rules, though they may have tax credit rules designed to avoid double taxation, typically don't have this level of co-ordination.

6.2. Operation of the Income Inclusion Rule (IIR)

416. The IIR requires a taxpayer that is the "parent" of the MNE Group (or part of the MNE Group) to pay top-up tax on its proportionate share of the income of any low-tax Constituent Entity in which that taxpayer has a direct or indirect ownership interest.

417. The IIR includes an ordering rule that is designed to ensure that the IIR in different jurisdictions cannot be applied to the same interest in low-taxed income. The primary mechanism for co-ordinating the application of the IIR in each jurisdiction is through the top-down approach. This approach gives priority to the application of the income inclusion rule in the jurisdiction of the Constituent Entity that is at or near the top of the ownership chain in the MNE Group, starting with the Ultimate Parent Entity. In the event the Ultimate Parent Entity is not located in a jurisdiction that has implemented the IIR, then responsibility for applying the IIR falls to the Constituent Entity that is directly owned and controlled by that Ultimate Parent Entity, and so on, down the chain of ownership.

418. The application of the top-down approach is subject to a further rule that specifically addresses the application of the IIR in the case of "split-ownership structures". Split-ownership structures are those where a significant portion (e.g., 10% or more) of the equity interests in a Constituent Entity are held by persons outside the MNE Group. This rule pushes the obligation to apply the IIR down to the partially-owned "intermediate" parent. The intermediate parent then applies the IIR to its share of the income of any low-taxed Constituent Entity in which that Intermediate Parent has a direct or indirect ownership interest. This split ownership rule ensures that the IIR captures all the income of the low-taxed Constituent Entity that is beneficially owned by the Intermediate Parent, without imposing a disproportionate tax burden on the MNE Group in relation to income that is beneficially owned by entities outside the group. The operation of the IIR and the ordering rules is set out in the box below.[1]

1. Income Inclusion Rule

A Parent (including a Partially Owned Intermediate Parent) that owns (directly or indirectly) an equity interest in a foreign low-taxed Constituent Entity at the end of a reporting period shall be subject to a top-up tax under the income inclusion rule in respect of its proportionate share of the income of that Constituent Entity for that period.

2. Top-down approach

A Parent is a Constituent Entity that:

- owns (directly or indirectly) an equity interest in another Constituent Entity in the same MNE Group;
- is located in a jurisdiction that has adopted an income inclusion rule; and

is not controlled, directly or indirectly, by another Constituent Entity or Entities that are subject to the income inclusion rule; and also includes a Partially Owned Intermediate Parent.

3. Split-ownership structures

A Partially Owned Intermediate Parent is a Constituent Entity that is located in a jurisdiction that has adopted an income inclusion rule, other than the Ultimate Parent Entity, and X% or more of its equity interests are held directly or indirectly by persons that are not Constituent Entities of the MNE Group. A Constituent Entity that is a Partially Owned Intermediate Parent as a result of indirect ownership by persons that are not Constituent Entities shall not apply the income inclusion rule if all of its equity interests are held directly or indirectly by Constituent Entities required to apply the income inclusion rule.

If the Parent holds all or any portion of its equity in the low-taxed Constituent Entity through a Partially Owned Intermediate Parent, then the Parent will not apply the income inclusion rule to the income of that Constituent Entity to the extent such income has already been brought into account under the income inclusion rule that applies in the jurisdiction where the Partially Owned Intermediate Parent is located.

6.3. Top-Down Approach

419. If each Constituent Entity in the ownership chain were required to apply the income inclusion rule, the rules of multiple jurisdictions could apply to the same low-taxed Constituent Entities, which could give rise to double taxation. Thus, the GloBE rules require a coordination mechanism to prevent overlapping application of the income inclusion rules of different jurisdictions from giving rise to double taxation of income attributable to the same equity interests in low-taxed Constituent Entities. The primary mechanism for co-ordinating the interaction between different income inclusion rules in different jurisdictions is the top-down approach.

420. The top-down approach arises from the interplay of two rules.

a. The first rule is the general income inclusion rule. Under this rule, any Constituent Entity that meets the definition of a Parent is obligated to apply the income inclusion rule but only to its proportionate share of the income of any Constituent Entity in which it holds (directly or indirectly) an equity interest.

b. The second rule defines the term "Parent" in such a way that the income inclusion rule of Constituent Entities that are beneath the Parent applying the income inclusion rule in the ownership chain are not applicable.

421. Together, these two rules ensure that the Ultimate Parent Entity of the MNE Group has the first priority to apply the income inclusion rule and provides for an orderly determination of which Constituent Entity or Entities in the MNE Group will apply their income inclusion rules when the Ultimate Parent Entity is located in a jurisdiction that has not adopted the income inclusion rule. The operation of the top-down approach prevents the application of multiple income inclusion rules to a Parent's equity interest that is indirectly owned through another Constituent Entity or Entities.

422. Starting with the jurisdiction of the Ultimate Parent Entity, the top down approach requires the Ultimate Parent Entity to apply the income inclusion rule in the jurisdiction where it is located. The application of the rule at the Ultimate Parent Entity level will de-activate the income inclusion rule in jurisdictions where the other Constituent Entities are located. If the Ultimate Parent Entity does not apply the income inclusion rule, then the next Parent down the ownership chain applies the rule. The Parent is only required to apply its income inclusion rule and pay top-up tax with respect to the Low-Taxed Constituent Entities in which it has a direct or indirect equity interest. The top-up tax computed with respect to a Low-Taxed Constituent Entity is allocated to the Parent based on its ownership percentage of that entity.

423. Applying the IIR to the Ultimate Parent Entity as part of a top-down approach has a number of benefits from a design perspective:

a. ***Reduces compliance burdens and coordination issues.*** The top-down approach reduces the number of jurisdictions where the IIR can potentially apply and thereby reduces the complexity associated with applying the rule in multiple jurisdictions. This, in turn, reduces the administrative and compliance burden for both tax administrations and the different Constituent Entities within the MNE Group.

b. ***Use of a single accounting standard.*** The top-down approach is compatible with the policy decision to use the accounting standards of the Ultimate Parent Entity of the group for calculating the effective tax rate. The consolidated financial statements of the MNE Group are prepared by the Ultimate Parent Entity as defined by the accounting rules. A top-down approach is compatible with this design element of the GloBE rules because it significantly reduces the instances where the income inclusion rule is applied by an entity other than the one that has prepared the consolidated financial statements.

c. ***Consistent with jurisdictional blending.*** Jurisdictional blending allows that all the profits, losses and taxes of the Constituent Entities of the MNE Group located in the same jurisdiction are blended for purposes of the effective tax rate calculation. Giving priority to the Ultimate Parent Entity to apply the income inclusion rule is conceptually more consistent with jurisdictional blending because the blending is based on the income of all entities in the jurisdiction directly or indirectly owned by the Ultimate Parent Entity, which will in many cases include entities that are not owned or controlled by lower-tiered entities that might apply the income inclusion rule.

6.3.1. Two or more Parents within the same MNE Group applying the income inclusion rule

424. Under the top-down approach, when the Ultimate Parent Entity is not subject to an income inclusion rule, then two or more Constituent Entities in different ownership chains of the same MNE Group may meet the definition of a Parent, and each of these Parent entities can be required to apply the income inclusion rule to Low-Taxed Constituent Entities in which they own an equity interest. Example 6.1B

illustrates this situation in which two intermediate Parents are required to apply their income inclusion rules because the Ultimate Parent Entity of the MNE Group is located in a jurisdiction with no income inclusion rule. In the example, each Parent applying its income inclusion rule separately owns the low-taxed Constituent Entities to which it is applying the rule.

Allocation of top-up tax based on proportionate ownership

425. In some cases two or more intermediate Parents in different ownership chains within the same MNE Group may hold equity interests in the same low-taxed Constituent Entity. The GloBE rules coordinate the simultaneous application of more than one jurisdiction's income inclusion rule to the same low-taxed entity through the top-up tax allocation methodology. Under the ordinary terms of the income inclusion rule, the top-up tax computed for a Constituent Entity is allocated to the Parent based on its proportionate share of the income of the low-taxed Constituent Entity, determined by reference to its equity interest. Accordingly, each Parent applying an income inclusion rule with respect to the income of the same low-taxed Constituent Entity is allocated a proportionate share of the top-up tax of that entity.

426. A Parent applies this income inclusion rule with respect to each Low-Taxed Constituent Entity of its MNE Group that it directly or indirectly owns, regardless of whether, on a standalone basis, it controls that Constituent Entity. In other words, as long as the low-taxed entity and the intermediate Parent are directly or indirectly controlled by the Ultimate Parent Entity of the same MNE Group, the intermediate Parent applies its income inclusion rule in respect of its interest in the Low-Taxed Constituent Entity. However, a Parent does not apply its income inclusion rule in respect of minority interests in entities that are not Constituent Entities of its MNE Group. This rule is illustrated in Example 6.3.1A in which a Parent is required to apply its income inclusion rule even though it directly holds only 40% of the interests of the low-taxed Constituent Entity because the remaining 60% is owned by the Ultimate Parent Entity (located in a jurisdiction with no income inclusion rule). The top-up tax computed in respect of a given Low-Taxed Constituent Entity could be allocated among one, two, or more non-controlling Parents under this rule to the extent those Parents own independent interests in the entity.

Co-ordination with the UTPR where no controlling Parent entity can apply the IIR

427. Generally, the top-up tax allocated to the Parent is based on its proportionate share of the income of the low-taxed Constituent Entity, determined by reference to its equity interest. When all of the equity interests in the Low-Taxed Constituent Entity are owned by a Parent or Parents, all of the top-up tax determined with respect to that entity will be allocated under the income inclusion rule. When some of the equity interests of a Low-Taxed Constituent Entity are owned by Parents and the remainder is owned by Constituent Entities that are not subject to an income inclusion rule, however, all of the top-up tax cannot be allocated under the general rule. In these circumstances, some of the top-up tax that is not allocated under the general rule will be allocated to other Constituent Entities pursuant to the Undertaxed Payments Rule if the Low-Taxed Constituent Entity is not controlled by a Constituent Entity located in a foreign jurisdiction that has adopted the income inclusion rule. Thus, when the Low-Taxed Constituent Entity is not controlled by a single Parent, the undertaxed payments rule applies to the entity. In cases where the income inclusion rule and the undertaxed payments rule apply to the same Low-Taxed Constituent Entity, the undertaxed payments rule provides a credit for taxes paid under the income inclusion rule.

428. Example 6.3.1A illustrates the application of both the income inclusion rule and the undertaxed payments rule to a single Low-Taxed Constituent Entity. In Example 6.3.1A, 60% of the equity interests of a subsidiary in a low tax jurisdiction are directly owned by the Ultimate Parent Entity (which is not subject to an income inclusion rule) and 40% of the equity interests are owned by a Parent. In this case the Low-Taxed Constituent Entity is not controlled by a Parent. Accordingly, the top-up tax of the Low-Taxed Constituent Entity is subject to allocation under the UTPR; however the UTPR provides for a credit for the

taxes allocated to any Parent under the income inclusion rule. This mechanism is further discussed below in Section 7.2.2.

429. Thus, where a Low-Taxed Constituent Entity is subject to the income inclusion rule of non-controlling Parent Entities, all of its top-up tax is subject to allocation under the GloBE rules – part under the income inclusion rule and part under the undertaxed payments rule. Accordingly, no special rule is needed to prevent avoidance of top-up tax in this situation because the normal operation of the income inclusion rule and undertaxed payments rule ensure that the MNE Group's entire share of the top-up tax is within the GloBE rules.

430. However, when a Parent controls the Low-Taxed Constituent Entity, the undertaxed payments rule does not apply in respect to the income of the Low-Taxed Constituent Entity. Thus, under this general rule, if the other equity interests of that Low-Taxed Constituent Entity are owned directly or indirectly by the UPE but are not subject to an income inclusion rule, the related top-up tax attributable to the income arising in respect of that equity interest will not be subject to the GloBE rules. Accordingly, to address this situation, a special rule will be further developed to ensure that this income does not escape taxation under the GloBE rules. In these circumstances, the intermediate Parent that owns a controlling interest in the Low-Taxed Constituent Entity and is tax resident in a jurisdiction that has adopted the income inclusion rule could be required to increase its share of the top-up tax by the untaxed amount. Alternatively this untaxed amount could be subject to adjustment under the undertaxed payments rule. Under either option, all of the top-up tax attributable to low tax income owned beneficially by the UPE will be subject to charge under either the income inclusion or undertaxed payments rule.

Integrity measures to ensure the neutrality of the IIR

431. The GloBE rules are intended to operate in a consistent and coordinated way to ensure a level playing field under the rules regardless of where an MNE Group is headquartered. However, further special rules may be necessary to ensure that the integrity and neutrality of the GloBE rules is not undermined, for example, through structures involving the use of passive holding companies at the top of the ownership chain. Inclusive Framework on BEPS members will explore the development of such special rules that will be designed to preserve the integrity of the GloBE rules while avoiding undue compliances costs and administrative burdens.

432. The overall integrity of the GloBE rules would be undermined if a jurisdiction offered incentives to an MNE Group to move its UPE from one jurisdiction to another where those incentives were directly linked to the application of the IIR. For example, if the jurisdiction of the Ultimate Parent Entity provides a preferential rate of tax for MNE Groups headquartered in its jurisdiction, to compensate them for the additional tax payable under the Income Inclusion Rule, then that jurisdiction should not be treated as having an IIR that was in line with the GloBE rules. Accordingly these types of incentives would be taken into account as part of a determination made under a multilateral review process described in Section 10.5.2 below.

433. Furthermore, as part of a general review of the operation of the GloBE rules, Inclusive Framework on BEPS members could further consider the consequences of GloBE rules on tax motivated inversions and whether further measures are required to address any risk of material competitive distortion arising out of the implementation or application of the GloBE rules.

6.3.2. Split-ownership

434. The preceding Section explained the rules for the top-down approach, which de-activates the income inclusion rule of a Constituent Entity when that entity is controlled by another Constituent Entity that is subject to an income inclusion rule. This Section provides an exception to the top-down approach

in split-ownership structures and requires a Partially Owned Intermediate Parent Entity to apply its income inclusion rule in priority to the income inclusion rule of its controlling Parent.

435. In some cases, not all the income of the MNE Group belongs to the Ultimate Parent Entity because equity interests of the other Constituent Entities of the MNE Group could be held by third parties. One approach to addressing these cases would be to continue to apply the IIR under a top down approach and limit the application of the income inclusion rule to the share of income belonging to the Ultimate Parent Entity. However this approach has two particular problems.

436. The first problem is that it could result in horizontal inequities and economic distortions since the income of two or more entities that operate in the same circumstances would be taxed differently depending upon how their equity interests are held. Specifically, an MNE Group that is structured so that its equity holders own all of the group’s equity through a single corporation will be liable for more top-up tax under the GloBE rules than a similarly situated MNE Group where a portion of the equity interests in its subsidiaries is held directly by some of its shareholders. This disparity creates an economic distortion because it makes a minority interest in a holding company below the Ultimate Parent Entity more valuable, after tax, than an equivalent equity interest in the Ultimate Parent Entity. This horizontal inequity further suggests that in an acquisition, the acquiring MNE Group can reduce the overall tax burden of the MNE Group by acquiring a target corporation or group of corporations (that is otherwise outside the scope of the GloBE rules) with stock of a subsidiary rather than stock of the parent. The existing shareholders of the Ultimate Parent Entity will bear the same level of top-up tax on their interests in the target corporations, the new minority shareholders of the acquiring subsidiary will avoid the top-up tax on their interest in those same target corporations. There are, of course, many factors considered in an acquisition structure. Moreover, the horizontal inequity creates tax planning incentives that conflict with the overall design of the GloBE rules. For example, an MNE Group can simply distribute or spin off a minority interest in its subsidiaries to its existing shareholders and reduce the Ultimate Parent Entity’s top-up tax liability without changing the owners’ economic interests in the underlying corporations. See Example 6.3.2A of the Annex. Split-ownership rules reduce the cases where these horizontal inequities and economic distortions can occur.

437. The second problem is that if Ultimate Parent Entity is located in a jurisdiction that has not adopted the income inclusion rule, the next intermediate parent entity down the ownership chain would need to apply the rule based on Ultimate Parent Entity’s share of the low-taxed income. If the rule was applied by an intermediate parent entity that is not wholly-owned by the Ultimate Parent Entity, then the later would be indirectly subject to a lower tax burden. This outcome would also impact the income belonging to minority interest holders of the intermediate parent entity applying the rule even if the policy was to exclude these minority interests. Example 6.3.2B of the Annex illustrates this situation. Under the top-down approach, an intermediate parent entity (B Co) is required to apply the income inclusion rule with respect to the income of a low-taxed entity (C Co). The Ultimate Parent Entity of the Group (Hold Co) holds 60% of the shares of B Co, while the remaining 40% is owned by minority shareholders. If the top-up tax imposed by B Co.’s jurisdiction is limited to the Ultimate Parent Entity’s ownership percentage of C Co, then Hold Co would not bear the full burden of the top-up tax on the low tax income of the Constituent Entity because it only owns a portion of the intermediate parent entity paying the tax (60% x 60% = 36%). A way to solve this problem would be by applying the income inclusion rule based on the intermediate parent’s proportionate share of the low-taxed income. This ensures that the Ultimate Parent Entity is indirectly subject to the income inclusion rule based on its proportionate share of the low-taxed income. However, the effective tax rate and top-up tax computation cannot be changed depending on which parent entity or entities apply the income inclusion rule because the GloBE rules are based on a single effective tax rate and top-up tax computation for the reasons described at the beginning of this Chapter.

438. To address these issues, the split-ownership rules require Partially Owned Intermediate Parents to apply the income inclusion rule. This avoids any competitive advantages and other distortions in situations where an intermediate parent entity through which the low-taxed entity is held is not wholly-

owned by the Ultimate Parent Entity. It also ensures that the GloBE rules work properly because it ensures that the effective tax rate and top-up tax computation are always computed the same way and that the MNE Group's GloBE liability does not change regardless of whether the Ultimate Parent Entity is located in jurisdiction that has adopted the GloBE rules. These rules also allow the low-tax income of the MNE Group that is beneficially owned by the minority to be taxed at the minimum rate. The split-ownership rules apply to situations where there is a Partially Owned Intermediate Parent that has equity interests in the low-taxed Constituent Entity. It does not apply to the income of a low-taxed Constituent Entity that is directly owned by the minority shareholders. The difference between these two situations is illustrated in Example 6.3.2J.

439. The split-ownership rule operates as an exception to the top-down approach as it gives priority to apply the income inclusion rule to the partially owned intermediate parent entity. This rule ensures that the income inclusion rule applies more comprehensively to the low-taxed income of the MNE Group where a significant portion of that income is not beneficially owned by the Ultimate Parent Entity. By pushing the taxing obligation down to the Partially Owned Intermediate Parent the rule taxes the income belonging to the minorities owners without requiring the Ultimate Parent Entity to pay top-up tax on income that it does not beneficially own and without requiring minorities owners that are not Constituent Entities to apply the income inclusion rule.

440. The Partially Owned Intermediate Parent would apply the income inclusion rule based on that entity's ownership share of low-taxed Constituent Entity. Where the income of the low tax Constituent Entity is subject to tax under an IIR at the level of a Partially Owned Intermediate Parent, the split-ownership rule exempts that income from further taxation further up the ownership chain. This mechanism ensures that the GloBE tax burden is borne proportionally by the Ultimate Parent Entity and the minority owners of the Partially Owned Intermediate Parent based on their ownership percentage.

Methodology

441. This rule applies in cases where a Partially Owned Intermediate Parent holds equity interests of a Constituent Entity located in a low-tax jurisdiction as determined in accordance with Chapter 3. The rule operates by allowing the Partially Owned Intermediate Parent to apply the income inclusion rule in priority to any other parent entities located further up the ownership chain (including the Ultimate Parent Entity).In these situations, the Partially Owned Intermediate Parent is required to apply the rule with respect to its ownership percentage of the low-taxed Constituent Entities. In other words, the Partially Owned Intermediate Parent calculates its top-up tax liability based on the group-wide formula in Section 4.4. This ensures that the low-taxed income is subject to tax at the minimum rate in accordance with the principles of the GloBE rules while avoiding a disproportionate burden on the Ultimate Parent Entity or its shareholders.

442. This rule would not be applied to situations in which the Ultimate Parent Entity holds more than a certain percentage (e.g. 90% or more) of the equity interests of an intermediate parent entity. This limitation is designed to limit the need to co-ordinate the interaction between the IIRs in different jurisdictions in those cases where a relatively small number of equity interest in a group company are held by minority shareholders (such as employees, legacy shareholders from a prior acquisition or financing counterparties) and ensures that the additional complexity only applies in situations where an important percentage of profits would otherwise remain undertaxed. The application of this rule depends on the corporate structure of the MNE Group at the end of the accounting period.

443. The equity interests referred in this rule are those that give rights to the profits of the Partially Owned Intermediate Parent. For example, if minority shareholders outside the MNE Group have no voting rights on the Partially Owned Intermediate Parent but have the right to collect 30% of the profits distributed by such entity, then it should be considered that 30% of the equity interests are held by persons that are not Constituent Entities of the MNE Group.

444. In certain cases, equity holders interest could have a preferred right to collect a specific amount of the distributed profits in preference to that of the other interest holders. For example, minority shareholders could hold cumulative preferred shares that give the right to the first one million euros of profits. The percentage of profits attributable to preferred shareholders will fluctuate annually based on the total earnings of the relevant corporations. For purposes of determining whether a minority shareholder of preferred stock holds a sufficient share of the equity interests to invoke the application of the split ownership rule, the measurement of profit entitlement should be assessed over an average of three years rather than on a year-by-year basis. This average computation will made only with respect to Constituent Entities that issue this kind of equity interests.

445. Although the Partially Owned Intermediate Parent applies the income inclusion rule to its proportionate share of the income of its subsidiary Constituent Entities, the Ultimate Parent Entity or another intermediate parent entity may still be required to apply the income inclusion rule. If the Ultimate Parent Entity wholly owns other Constituent Entities, it would be required to apply the income inclusion rule with respect to the income of such entities. In these cases, the parent entity is required to exclude the income already subject to an income inclusion rule of the Partially Owned Intermediate Parent.

446. The operation of this rule is illustrated in Example 6.3.2C of the Annex. In this example, the Ultimate Parent Entity (Hold Co) owns 60% of an intermediate parent entity (B Co), while the remaining 40% is owned by minority shareholders. This makes B Co a Partially Owned Intermediate Parent because more than a certain percentage of its equity interests are held by persons that are not Constituent Entities. B Co holds 100% of the interests of a Constituent Entity (C Co 1) in a Low-Tax Jurisdiction. The Ultimate Parent Entity (Hold Co) also owns 100% of another Constituent Entity (C Co 2) in a Low-Tax Jurisdiction, through another intermediate parent (B Co 2). The rule requires the Partially Owned Intermediate Parent to apply the income inclusion rule with respect to the income of its subsidiary (C Co 1). The Ultimate Parent Entity (Hold Co) is still required to apply the income inclusion rule with respect to its wholly-owned subsidiary (C Co 2). To avoid double taxation, the Ultimate Parent Entity's income inclusion rule excludes the income of C Co 1.

447. There could be two or more Partially Owned Intermediate Parents in the same ownership chain. These rules give priority to the Partially Owned Intermediate Parent closest to the Constituent Entity in the Low-Tax Jurisdiction provided that all of its equity interests are not held by another Constituent Entities subject to the income inclusion rule. This ensures that the tax burden is distributed appropriately between the Ultimate Parent Entity and the minority shareholders of all the intermediate parent entities in the ownership chain. This also follows the top-down approach because it gives priority to the Constituent Entity in the upper part of the ownership chain when both of them are in the same situation (both of them hold, directly or indirectly, the same equity interests of the low-taxed Constituent Entity and their equity interests are held directly or indirectly by the same persons). This is illustrated in Example 6.3.2D of the Annex. Example 6.3.2E of the Annex illustrates this rule in a situation where one of the Partially Owned Intermediate Parents is itself a low-taxed Constituent Entity.

448. This rule applies where two Partially Owned Intermediate Parents are applying the income inclusion rule with respect to the same income and equity interests of the low-taxed entity. If this is not the case, the Partially Owned Intermediate Parent in the upper tier has to still apply the income inclusion rule to the income that was not subject under the income inclusion rule of the Partially Owned Intermediate Parent of the lower tier. This is illustrated in Example 6.3.2F of the Annex. The same result would follow if the Ultimate Parent Entity or another intermediate parent is required to apply the income inclusion rule with respect to income not subject to the income inclusion rule applied by the Partially Owned Intermediate Parent. This is illustrated in Example 6.3.2G of the Annex.

449. In cases where the Partially Owned Intermediate Parent required to apply the rule is located in a jurisdiction that has not adopted the income inclusion rule, then the next Partially Owned Intermediate Parent down the ownership chain located in a jurisdiction that has adopted the income inclusion rule (if

one exists) is required to apply the income inclusion rule provided that part of its equity interests are held indirectly by persons outside the MNE Group. This is illustrated in Example 6.3.2H of the Annex.

450. If there is no such intermediate parent entity below, then the next Partially Owned Intermediate Parent above the first Partially Owned Intermediate Parent located in a jurisdiction that has adopted the income inclusion rule applies its income inclusion rule. This is illustrated in Example 6.3.2I of the Annex.

451. The rule set out in this Section does not require the Partially Owned Intermediate Parent to have control over the low-tax Constituent Entity. It only requires that the Partially Owned Intermediate Parent owns equity interests that give rights to the profits of the low-tax Constituent Entity. The absence of control by the Partially Owned Intermediate Parent is not relevant because the low-taxed Constituent Entity is already under the control of the MNE Group. This is illustrated in Example 6.3.2F.

452. Further work will need to be undertaken on the design and methodology of the split-ownership rule described above in light of the top-down approach and the development of rules for taxation of Associates and joint ventures in Chapter 8.

6.4. Switch-over rule

453. A jurisdictional blending approach will require each member of the multinational group to determine the appropriate portion of the income derived, and taxes paid, by that group entity in each jurisdiction where that entity operates. Accordingly, a jurisdictional blending approach would require each foreign subsidiary of the multinational group to allocate an appropriate portion of its income (together with the taxes on that income) to a permanent establishment (PE) that may be maintained by that foreign subsidiary in another jurisdiction. The logic of the design of the GloBE proposal means that where the Parent derives PE income that benefits from a tax exemption under the laws of the parent jurisdiction, then the income of that exempt PE should be allocated to the PE jurisdiction (together with any tax on that income) in order to accurately calculate the jurisdictional ETR in the parent and PE jurisdictions.

454. Allocating the income of the parent between the parent and PE jurisdiction will align the measurement of the PE's income and taxes under the GloBE proposal with the domestic tax outcomes under the laws of the parent jurisdiction and ensure equality of treatment of exempt PEs and foreign subsidiaries under the GloBE proposal. Failure to apply such an approach to a parent's exempt PE income would create an unintended difference between the treatment of a parent's PEs and directly-owned foreign subsidiaries. It would allow low-tax income arising in the PE jurisdiction to be blended with high tax income in the parent jurisdiction, thereby understating the amount of low-tax income in the PE jurisdiction and allowing the MNE to avoid a GloBE tax liability by sheltering such low tax income with excess taxes paid in the parent jurisdiction.

455. A parent that seeks to apply the income inclusion rule to the income of an exempt PE will, however, be prevented from doing so where the parent jurisdiction has entered into a bilateral tax treaty that obliges the parent jurisdiction to exempt the income of the PE. A switch-over rule is therefore required in order to allow the state of the parent's residence to tax the income of the PE up to the minimum rate as provided for under the income inclusion rule. Accordingly the Programme of Work calls on the Inclusive Framework to explore options and issues in connection with the design of a switch-over rule in cases where a contracting state had agreed in a tax treaty to use the exemption method. Such a rule would allow a contracting state to limit the application of the exemption method where the profits attributable to a PE in the other contracting state are low tax profits of a Constituent Entity under the GloBE rules. The rule also applies to income derived from immovable property subject to a treaty provision equivalent to Article 6 of the OECD Model Tax Convention (OECD, 2017[8]) if such income is attributable to a PE and subject to the exemption method in accordance with the tax treaty.[2]

456. The aim of the switch-over rule would allow the state of the parent's residence to apply an income inclusion rule to tax the income of the PE in those cases where the income inclusion rule would apply as a matter of domestic law. The switch-over rule would permit the residence state to tax the low-tax profits of a PE up to the agreed minimum rate, using the same ETR test as the income inclusion rule. The rule would, by virtue of its domestic law trigger, only apply when and to the extent that the head office was required to apply the income inclusion rule to the PE.[3]

References

OECD (2017), *Model Tax Convention on Income and on Capital*, OECD Publisher, Paris, https://doi.org/10.1787/mtc_cond-2017-en. [1]

Notes

[1] Coordination between different jurisdiction to apply the top-down approach and split-ownership rules are discussed in Chapter 6.

[2] See Paragraph 9 of the Commentary on Article 5 of the OECD Model Tax Convention (OECD, 2017[8]).

[3] The Inclusive Framework may explore a switch-over rule that is not limited to the situations where the parent jurisdiction is seeking to apply the income inclusion rule to its (direct) foreign permanent establishments but could more broadly be developed on a standalone basis where the income of permanent establishment is subject to an effective tax rate below the minimum rate.

From:

Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint

Inclusive Framework on BEPS

Access the complete publication at:

https://doi.org/10.1787/abb4c3d1-en

Please cite this chapter as:

OECD (2020), “Income Inclusion and Switch-Over Rules”, in *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/86a05393-en