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## Global Tax Deal: Simplified Features of Pillars One and Two

The global tax deal engenders the paying of more taxes by some of the largest multinationals like Big Tech in their market jurisdictions, i.e. the jurisdiction where their goods and services are purchased or consumed. An example would be when a Malaysian company purchases advertisements from a social media platform, the platform would then need to allocate profits derived from these advertisements to taxes in Malaysia, not merely where its headquarters is located. In this alert, we examine the specific features and details of the deal, which comprises Pillars One and Two.

### PILLAR ONE

Pillar One is essentially a formulary apportionment of part of the profits of a large multinational. It shifts from taxation based on physical presence, i.e. the traditional concept of permanent establishment towards a non-physical presence. It works by reallocating a slice of profits from the largest and most profitable businesses to the market jurisdictions where they pay low taxes.

#### **Amount A**

##### *Scope*

Based on the OECD Blueprint, the proposal is to apply Amount A to two types of businesses, namely automated digital services and consumer facing businesses.

More recently, the OECD has proposed that in-scope companies be made up of multinationals with a consolidated global turnover of above €20 billion and profitability of over 10%. It was further proposed that the turnover threshold be reduced to €10 billion in 2031. Notably, extractives and regulated financial services are expressly carved out.

##### *Nexus*

A market jurisdiction will only be entitled to an allocation of Amount A if there is a nexus. The test for nexus is that countries with a gross

domestic product (**GDP**) of over €40 billion will be entitled to this taxing right once the taxpayer company earns revenue of over €1 million from these countries. For countries with a GDP of less than €40 billion, the taxpayer companies will need to pay taxes into those market countries once their revenues exceed €250,000.

### *Quantum*

The OECD proposed that 20% to 30% of profits in excess of the 10% profitability margin be allocated to market jurisdictions.

### *Safe harbour*

Where residual profits of an in-scope multinational have already been taxed in a market jurisdiction, a safe harbour will come into play to cap the residual profits allocated to the market jurisdiction through Amount A.

### *Elimination of double taxation*

The OECD also proposed that double taxation of profits allocated to the market jurisdictions be relieved by an exempting or credit method.

## **Amount B**

### *Scope*

Amount B is essentially the amount of remuneration of a company in a market jurisdiction that performs baseline marketing and distribution activities for the distribution of products for the multinational group.

Amount B applies to the following controlled transactions:

1. Purchase of products from a foreign related party for resale to unrelated customers in its country of residence; and
2. Performance of baseline marketing and distribution activities by the distribution company in its country of residence, transacting or dealing with a foreign related party.

### *Quantum*

The OECD intends to streamline the fixed returns provided to remunerate marketing and distribution activities. They have stated that this will be determined based on the arm's length principle and the transactional net margin method, or TNMM, is regarded as the most appropriate transfer pricing (TP) method to determine the remuneration. For profit-level indicators, return on sales (ROS) and earnings before interest and tax (EBIT) are recommended to be used. The OECD will also look at applying different fixed returns for different regions and industries as arm's length prices vary across different markets even for the same products.

Fixed return for the in-scope marketing and distribution activities will need to be determined through a benchmarking analysis based on

third-party comparables. A specific search strategy as proposed by the OECD would then need to be adopted and followed to find such comparable companies.

### *Implementation*

The OECD Framework recommended that Amount B should be implemented in a narrow scope to facilitate consensus among its members and to streamline the in-scope marketing and distribution activities to mitigate complexity and areas for potential dispute. A variety of legal and regulatory adjustments will need to be made to ensure a coherent implementation of Amount B across jurisdictions. This includes domestic laws, new treaty-based resolutions between two jurisdictions, and additional guidance complementing the domestic laws.

## **PILLAR TWO**

Pillar 2 is equally a dramatic change in the global tax landscape. It introduces a global minimum tax of at least 15% on a country-by-country basis.

It consists of the Income Inclusion Rule, which imposes a top-up tax on a parent company in respect of the low-taxed income of its subsidiary, and an Undertaxed Payment Rule, which disallows deductions or requires an adjustment of the subsidiary. Further, source jurisdictions are allowed to impose a limited source taxation on certain related party transactions below a minimum rate, and this is known as the Subject to Tax Rule.

### *Scope*

As presently constructed, Pillar 2 will apply to multinationals that have revenues of above €750 million. However, it is also stated that countries are free to apply the Income Inclusion Rule, i.e. top up tax to multinationals headquartered in their country even if they do not meet this threshold.

### *Income Inclusion Rule*

Under this rule, parent companies are essentially required to pay a top-up tax on its proportionate share of the income of its related company located in a low-tax jurisdiction up to the minimum rate. The minimum rate is determined based on the effective tax rate (ETR).

### *Subject to Tax Rule*

The Subject to Tax Rule is essentially a withholding tax mechanism which ensures that a minimum tax is going to be paid at the source country level and it will be limited to certain types of intra-group payments. The minimum rate is between 7.5% and 9% and it applies only to payments between entities under common control and defined categories of payments, typically payments that are subject to withholding taxes, i.e. interest and royalties.

## *Undertaxed Payments Rule*

The Undertaxed Payments Rule is the mirror rule which will only be triggered if the parent company does not implement the Income Inclusion Rule. The Undertaxed Payments Rule allocates top-up tax from low-tax companies. The concept is that this rule would step in and allocate that same amount of top-up tax that would have been derived from the Income Inclusion Rule based on a formulaic approach.

### **Where do we go from here?**

The tax deal is a watershed moment in global tax reform. The deal will most likely be finalised by the end of 2021, complete with an implementation plan to develop model legislation, guidance and a multilateral treaty in 2022, with implementation from 2023, and ratification in 2024.

On the one hand, while Amount A of Pillar 1 is primarily meant for extremely large companies and therefore unlikely to be applicable and relevant to most businesses in Malaysia, it will still have a substantial impact on our country in terms of tax collection.

On the other hand, with the revenue threshold, Pillar 2 is able to apply to a much wider population than Pillar 1. That being said, it will likely affect multinationals operating in Malaysia that have an ETR below 15%. In the face of the revised minimum tax rate, by no stretch of the imagination could Malaysia count on its tax incentives and the like to attract foreign investments. However, taxation is not the sole determining factor considered by multinationals when it comes to making investment decisions. Malaysia has more to offer apart from tax benefits, such as good infrastructure, affordable cost of living and cost of business and a skilled workforce.

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