Tax

Toward a Global Tax Reform: The Effect of the Proposed New Profit Allocation Rules and Global Minimum Tax on Israel

Overview

In the last days, 132 member countries (including Israel) of the 139 members of the OECD/G20 Inclusive Framework on BEPS ("**Inclusive Framework**") reached an agreement on a global tax reform which may significantly change the international tax landscape for multinational enterprises ("**MNEs**"). The proposed reform is based on the two pillars developed by the Inclusive Framework to address the tax challenges arising from the digitalization of the economy: (i) *Pillar One* provides new rules for allocating profits of large MNEs to certain market jurisdictions; and (ii) *Pillar Two* provides new rules for achieving a global minimum tax rate for MNEs.

Key Features of the Inclusive Framework Agreement

1. New Profit Allocation Rules. *Pillar One* will apply on MNEs with global turnover above 20 billion Euro (to be potentially reduced to 10 billion Euro in the future) and profitability above 10%. For such MNEs, a new nexus rule will be adopted whereby 20–30% of their residual profits that exceeds a return of 10% of revenue will be allocated to market jurisdictions where the goods or services are used or consumed (so-called "**Amount A**"). Amount A will be allocated to market jurisdictions from which the MNE derives at least 1 million Euro annually (or 250,000 Euro in small markets).
2. Global Minimum Tax. The member countries also committed to implement a global minimum tax of at least 15% on a country-by-country basis. The global minimum tax will be based on *Pillar Two*, which consists of the following two related rules:
    a) The Global Anti-Base Erosion Proposal ("**GloBE**"). The GloBE consists of the Income Inclusion Rule ("**IIR**") and the Undertaxed Payment Rule ("**UTPR**"). The IIR would allow the home jurisdiction of the MNE to tax the income (including business income) of foreign controlled corporations of the group if their income was subject to tax at an effective rate lower than 15%.
    The UTPR will apply only where the IIR has not resulted with a top-up taxation, and will ensure at least 15% effective tax rate for low-taxed entities. The UTPR is expected to apply by way of a deduction denial or a requirement for an equivalent adjustment for certain payments made to low-taxed related foreign companies.
    The GloBE rules will apply to MNEs with global turnover above 750 million Euros. However, member countries would be able to set a lower threshold.

b) <u>The Subject to Tax Rule ("**STTR**")</u>. The STTR is a treaty-based rule and will apply by way of imposing source-based taxation (e.g., withholding tax) on certain payments made to jurisdictions that apply a corporate tax rate lower than a minimum rate which will be between 7.5%–9%. The taxing rights will be limited to the difference between the minimum rate and the tax rate that would otherwise apply to the payment.

The Effect on Israel

The Israeli Ministry of Finance has recently published a statement saying that Israel supports the two-pillar plan. Israel will likely have a net benefit with respect to *Pillar One*, as Israeli MNEs are not expected to be subject to the new profit allocation rules due to the high revenue threshold, while Israel may increase its tax collection due to the new market-based taxation.
However, the global minimum tax proposal may threaten the preferred tax regimes currently offered under the Law for Encouragement of Capital Investments ("**Encouragement Law**"), such as the Special Preferred Technological Enterprise regime and the Preferred Technological Enterprise regime. This may require Israel to make certain adjustments to its laws in order to avoid incremental taxation in foreign countries, which will undermine the effectiveness of the tax incentives offered by the Encouragement Law.

What is Next?

The agreement reached by the 132 member countries in the Inclusive Framework is a big step towards a global tax reform. A detailed implementation plan is expected to be finalized by October 2021. A multilateral instrument for Amount A under *Pillar One* is expected to be developed and become available for signatures in 2022, with Amount A becoming effective in 2023. *Pillar Two* is also expected to be effective as of 2023. Although there is a clear global momentum for the implementation of the two-pillar plan, the suggested timetable seems to be very ambitious.

Foreign-based MNEs with Israeli subsidiaries, as well as Israeli-based MNEs with foreign subsidiaries located in low-tax jurisdictions, should be aware of the proposed global tax reform and consider its potential impact on their business and overall structure.

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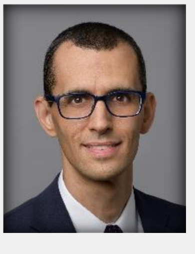

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