

# The BEPS Monitoring Group

## COMMENTS ON PROGRESS REPORT ON AMOUNT A OF PILLAR ONE

These comments by the [BEPS Monitoring Group](#) (BMG) respond to the public consultation document issued by the OECD Secretariat on behalf of the Inclusive Framework on BEPS, on the proposed Pillar One Amount A Tax Certainty Framework. The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, and Oxfam. This report has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. It has been drafted by Jeffery Kadet and Sol Picciotto, with contributions from Abdul Chowdhary and comments from Attiya Waris.

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### Summary

Pillar One marks a historic paradigm shift in international taxation, rightly described as ‘revolutionary’ by the OECD Secretary-General. For the first time it will allocate rights to tax multinational enterprises (MNEs) on a portion of their global profits among the countries from which they derive revenues, regardless of physical presence. Furthermore, the technical work that has now been done provides the methodologies to define for tax purposes the consolidated profits of MNE corporate groups, rules to determine the source of revenues from sales (including for services), and definitions and quantification of physical assets, employee numbers and employee remuneration.

We now therefore have the building blocks to ensure that MNEs can be taxed in accordance with the business reality that they are unitary enterprises, by apportioning their global profits for taxation by countries in which they have real economic activities, as mandated by the G20 in 2013.

Regrettably, however, the current proposals for implementation are designed to apportion only a part of the so-called ‘residual’ profit of less than one hundred of the largest and most profitable MNEs. This leaves in place the current defective rules for attributing the remaining profit of these in-scope MNEs, as well as for all others. Hence, instead of replacing the present flawed and complex rules with this new and simpler approach, it simply adds a new layer of complexity.

This discussion draft provides ninety pages of highly abstruse rules intended to be applied directly in the domestic law of participating countries, and to form the basis of a multilateral

convention that must be approved by national legislatures to enable ratification by all relevant countries where these MNEs operate. This would be unprecedented, and in our view is highly unlikely to occur. However, the detailed rules could and should begin to be introduced to facilitate a more coordinated taxation of MNEs and a transition by some or all countries to a more comprehensive adoption of the new paradigm.

## **A. GENERAL COMMENTS**

### **1. The Transition to a New Paradigm**

Pillar One marks a historic paradigm shift in international taxation, as we have previously stated.<sup>1</sup> It is rightly described as ‘revolutionary in its concept’ in the OECD Secretary-General’s recent Report to the G20 Finance Ministers.<sup>2</sup> For the first time it will establish a methodology to treat multinational enterprises (MNEs) in accordance with the business reality that they operate as unitary enterprises, and to allocate rights to tax a portion of their global profits among the countries from which they derive revenues, regardless of physical presence.

The implementation of this new approach entails considerable effort in designing and agreeing the components of the methodology. As the Update states, significant progress has been made to ‘stabilise’ the design of these building blocks from a technical perspective. We are grateful for this opportunity to comment on these, particularly as we have long been strong advocates for the adoption of this new paradigm for MNE taxation.

As we have also pointed out, the current proposals for the actual implementation of this new approach are fundamentally flawed. They would apply only to a very small number (under one hundred) of the largest and most profitable MNEs, and Amount A would allocate only a small part of their profits, excluding also profits from certain carved-out business sectors from the so-called ‘residual’ profits. For the remainder of their profits, as well as for all the profits of all other MNEs, the current rules on ‘transfer pricing’ would continue to apply, although they entail a diametrically different approach. Even the possible future extension of its scope would be deferred for at least eight years, and would only lower the turnover threshold to €10 billion.

This attempt to combine rules embodying two incompatible approaches is a basic structural fault. It would result in relatively little benefit in tax revenues (an estimated \$10-15b) while, far from improving the system, it would only add a new layer of complexity. Preliminary country-level revenue estimates by the South Centre and the Coalition for Dialogue on Africa show minimal benefits for the 84 combined Member States of the African Union and the South Centre, all of which are developing countries.<sup>3</sup>

The proposal is designed to be implemented through a multilateral convention that would require actual ratification by most or all of the states that are both home and host countries of the MNEs that would be affected. The reallocation of taxing rights it entails would result in both winners, which are likely to ratify quickly, but also losers, which would have little motivation to do so. A rapid ratification by so many states of a binding treaty to create such a global system for taxing large MNEs would be unprecedented, and is in our view highly unlikely to occur. The current consultation document provides some ninety pages ‘presented

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<sup>1</sup> See our comments in July 2021 on the Inclusive Framework’s Statement on a Two Pillar Solution, available [here](#).

<sup>2</sup> OECD Secretary-General Tax Report To G20 Finance Ministers And Central Bank Governors, Indonesia, July 2022, p. 5.

<sup>3</sup> See: <https://www.southcentre.int/research-paper-156-1-june-2022/>

in the form of domestic legislation’, but intended to provide the basis for the binding international obligations to be included in the multilateral convention. Once these rules have been agreed at the international level, it would be difficult or impossible for significant changes to be made by national legislatures, so they would in effect be expected to rubber-stamp the agreement in all its details. It is hard to see how this attempt to enact global legislation on a matter so central to national sovereignty as tax could succeed, or why such an effort should be made only to create a special regime for a small number of enterprises.

Digitalisation has been a great disrupter of all business models, and has also exacerbated the problems with the current rules for the two main elements of international tax: the definition of taxable presence, and the principles for apportioning MNE profits among the countries where they do business.<sup>4</sup> Hence the emergence of this new paradigm. We applaud the considerable efforts that are being devoted to designing fair and effective methods to apply this new approach, and congratulate those involved for the progress that has been made. Despite these successes, in our view, the revised timetable for completing this work remains unrealistic.

It is important to point out that the work that has now been done on the technical building blocks for both Pillar One and Pillar Two will provide the essential elements for what we hope will be a future implementation by some or all countries of formulary apportionment of MNE profits. These essential elements include methodologies to define for tax purposes the consolidated profits of MNE corporate groups, rules to determine the source of revenues from sales (including for services), and definitions and quantification of physical assets, employee numbers and employee remuneration. We suggest that it is possible, and indeed necessary, to begin to apply these techniques now, as part of a gradual but more general adaption of existing international tax rules towards the new paradigm of taxing MNEs as the unitary enterprises that they are.

Hence, the design of the building blocks should be done with a view to both their application to resolve current problems, and to the gradual adoption of the new approach more generally, regardless of the fate of Pillar One as currently envisaged. We will not repeat in detail here the suggestions we have previously made for the pragmatic adoption of methodologies for apportionment of MNEs’ global profits, for example by building on the existing profit split method, but will briefly outline some other suggestions further below.

It should finally be pointed out that the flaws in and limitations of the current proposals are also because their formulation has been driven primarily by the OECD countries. Since 2019 proposals have been made for more comprehensive changes based on a simpler approach by developing countries, particularly the G24 and ATAF. These have helped to spur the shift to a new paradigm, and brought some concessions on details, but their impact has been largely negated by the limited scope of these proposals, and the retention of the existing defective separate entity concept and transfer pricing rules for most purposes. A more comprehensive reform is essential to ensure that *all* states, particularly the less developed countries, can access their fair share of tax revenue. This is critical to stopping the deepening of global inequality.

## **2. Complexity**

These flaws also result in unnecessary complexity in the detailed rules now published for comment. While we welcome the opportunity to comment, we must also point out that the

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<sup>4</sup> This was the central conclusion of both the reports, in 2015 and 2018, from the Task Force on the Digital Economy set up under Action 1 of the BEPS project, which has been continuing to lead the work on this issue. It was also the central point made in [our submission](#) on Action 1 in December 2013.

consultation is inadequate and unsatisfactory. We have been provided only with the proposed detailed rules, with no commentary, explanation of the policy aims, or data to enable an impact assessment. It seems that the intention is only to solicit specific technical comments from MNEs and their tax advisers, to help avoid unexpected practical implementation hitches. In the absence of explanations, it is mind-numbingly difficult to puzzle out the meaning and effects of these complex rules. Yet, in view of the implementation process that seems to be envisaged, this may be the only opportunity for an evaluation. Once the rules are agreed by the Inclusive Framework, and embodied in the draft multilateral convention, it would not be possible to make any material change without unravelling the package, and hence restarting negotiations.

Much of the complexity could be avoided if the new approach had been applied in a simpler and more comprehensive way, as we and others have urged. First, limiting the scope of the new rules to a very few of the largest and most profitable MNEs requires additional special rules on Segments, to deal with Groups that combine different businesses, only some of which are highly profitable.

Next, Amount A applies only to the so-called ‘residual’ profits, defined as that part of the profits exceeding a 10% return on revenue; Amount A consists of 25% of that excess profit, and is allocated to eligible countries in proportion to the sales revenues attributable to them by applying the sourcing rules. This, together with the retention of the existing ‘transfer pricing’ rules for allocation of the remainder, requires the inclusion of the Marketing and Distribution Safe Harbour (MDSH). The application of Amount A only to the residual rejected the proposal for a simpler approach apportioning a portion of the whole profit made by the African Tax Administration Forum in 2021.<sup>5</sup>

The concept of ‘residual’ profit is flawed, since the excess profits of large MNEs result from their overall size, and the synergy of combining different activities in various locations, benefiting from economic globalisation. Their ability to access markets around the world enables economies of scale and scope, due to the large volume of sales. Hence, even countries where they have relatively low sales contribute to the total volumes, which boosts the marginal return. In our view this justifies the allocation of one-third of their total revenues based on sales, regardless of physical presence. The remainder should be allocated based on physical assets and employees, which could be done by applying the methodology for defining the return on depreciation and payroll (RoDP) provided in this discussion draft.

The inclusion of the presently proposed MDSH computation adds considerable complexity. While we understand the theoretical argument for the MDSH adjustment due to the current design of Amount A, we believe that the added complexity far outweighs the benefits, since the adjustment is only an estimate. It would be best to eliminate this MDSH adjustment. The next-best would be to specify a very high Elimination Profit threshold in Article 6.4, greatly reducing the need for such an adjustment. This would ease considerably the complexity with which all developed and developing countries must deal.

The MDSH is only applicable where a Covered Group has a taxable presence in a jurisdiction where it has sales. The reasoning is that in such circumstances there is likely to be some taxation, even if small, of the Covered Group’s residual profits. Since a share of those residual profits will also be notionally included within that country’s Amount A, in theory some amount of the residual profits would be taxed twice by the jurisdiction. To eliminate this theoretical double taxation by the market country, the MDSH adjustment reduces

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<sup>5</sup> See ‘ATAF Sends Revised Pillar One Proposals to the Inclusive Framework’ 12 May 2021, available [here](#).

Amount A for the specific market jurisdiction by an amount deemed to represent the residual portion of the income of the taxable presence.

As for the complexity of the MDSH mechanism, Article 6.5 includes a multi-factor formula that calculates this residual portion. In short (and ignoring several factors not yet agreed upon), the financial accounting profit of the taxable presence (referred to as ‘Elimination Profit’) is reduced by a formula intended to define a routine level of profit that can be retained, eliminating the theoretical residual profit through the MDSH adjustment. The deemed routine level of profit is a theoretical estimate based on the ‘Elimination Threshold Return on Depreciation and Payroll’, calculated on a Group-wide basis as 10% of the total Group’s Revenues divided by the total Group’s Depreciation and Payroll (Title 7 definition 31). This ratio is then applied to the Covered Group’s depreciation and payroll within the market jurisdiction to estimate how much routine profit has been included in the Elimination Profit of the taxable presence in the market jurisdiction.

Similarly, the complexity of the rules in Title 5 for the allocation of the obligation to ‘relieve double taxation’ result from the flawed decision to retain the existing approach based on the separate entity concept and the transfer pricing rules. This uses a similar ratio to that for the MDSH, the ‘Return on Depreciation and Payroll’ (‘RoDP’), determined for each jurisdiction by dividing its Elimination Profit by the Depreciation and Payroll amounts for that jurisdiction. This is used in the mechanism in Title 5 (Articles 7-11) to determine which ‘Relieving Jurisdictions’ provide compensation for the allocation of Amount A (relieve double taxation) through a foreign tax credit or income exemption. The rules aim to ensure through a banding of country Tiers (Article 9) that relief will be provided first by the jurisdictions with the highest RoDP ratio.

The decision to base this allocation on the rate of RoDP rightly recognises that physical assets and employees are the appropriate criteria for determining real presence in a jurisdiction, in addition to sales. We commend the approach adopted in Article 9 for allocating the obligation primarily to countries in which under current rules MNEs can attribute very high levels of profit incommensurate with their real activities, as measured by physical assets and employees. It is difficult for us to comment on the suitability of the proposed banding of countries for these purposes, since we do not have access to appropriate data. These are known of course to the affected MNEs themselves, but we hope that all countries involved in the negotiations have also been provided with suitable data, and help to analyse the effects of the proposals.

Complexity is multiplied by the layering of the new Amount A structure on the top of the existing system that is based on the separate entity concept and transfer pricing rules. Both simplicity and certainty can only be attained by agreeing on the apportionment of the total profits among countries in line with where MNEs have real activities, based on these factors (sales, as for Amount A, physical assets and employees). As we have repeatedly pointed out, the existing transfer pricing rules require ad hoc and subjective judgments, so their retention is a recipe for continuing conflict and uncertainty. Together with the complexity of these rules, we fear that the administration of Amount A will prove burdensome for all, even though it will apply to only a relatively small number of MNEs. We doubt that joining the scheme will be cost-effective for small and low-income countries, which would be better served by deploying scarce skilled personnel on alternative measures more appropriate to their circumstances.

### 3. Applying the New Methodologies

Although we consider the current proposals for Amount A unsuitable, and very unlikely to be implemented, the excellent work that has been done on the new approach should lay the basis for continuing moves in this direction.

First, we urge that appropriate parts of the technical rules should be applied in a revision of the methodologies for country-by-country reporting (CbCR). CbCR was introduced in 2016, and was a significant outcome of the first phase of the BEPS project. It provides tax administrations for the first time with a comprehensive overview of each MNE's worldwide operations, as well as its activities in each country. It nevertheless has significant limitations: (i) CbCRs have so far only been available to tax administrations, and few lower-income countries have yet obtained access to them; and (ii) the data they provide rely on MNEs' financial accounts, and are in many respects unsuitable for the purposes of defining their global taxable profits and quantifying their real presence in each country, even for the purposes of assessing the extent of BEPS practices. The CbCR system, including the template for the reports, was reviewed in 2020, but that review has still not concluded. In our comments to that review, we urged that the design of the system should be adapted to take account of the new rules then under negotiation under the two Pillars. We hope that one reason that the work on the revision is still continuing is that this has been under consideration.

As a first step, the CbCR template should be revised to incorporate these new technical standards. This would greatly facilitate the implementation of changes already internationally agreed, and the adoption of new reforms. For example, the model rules for the global minimum tax (GloBE) under Pillar Two include a 'carve-out' for substantial activities, based on assets and payroll expenses. It would greatly facilitate both implementation and monitoring of the GloBE if CbCRs provided data based on the methods agreed in Pillar Two for defining and quantifying assets and employees, including their remuneration costs. It should be noted that CbCRs at present only include employee numbers, and not costs.

Another key element is the provision of data on revenues from sales. The data currently provided in CbCRs are highly deficient because the MNE's revenues from sales to third parties are attributed to the country of residence of the MNE Constituent Entity receiving the income, and not to the countries from which the revenues are derived. Under Pillar One, and indeed in the draft text of this current discussion document, detailed and well-thought-out rules are provided to define the source of revenues from finished goods, components, digital content, a wide range of services, the alienation of both intangible and tangible property, and government grants (Article 4 and Schedule E).

These sourcing rules are closely linked to the Nexus Test, which under Article 3 requires specific threshold levels of revenue that are considered to derive from the jurisdiction (at least €1m, or €250k for those with a GDP below €40b). Yet it is virtually impossible for jurisdictions to verify if this is the case, under current reporting requirements. As just one example of why this is the case, when a Covered Group or Covered Segment earns revenues from the licensing, sale, or other alienation of intangible property that relates to finished goods or components, paragraph 9.a.i. of Article 4 sources the revenue in the jurisdiction of the final customer of the related finished goods, including finished goods into which a component has been incorporated. Source jurisdictions will be totally unaware of even the existence of these revenues from licensing, sales, and other alienations of intangible property. Revision of the CbCR template to require reporting of sales revenue data based on the specific sourcing rules in this draft is essential for the effective administration of this type of nexus requirement.

The sourcing rules could also be important in facilitating agreement on the taxation of net profits from services. Many if not most countries assert a broad right to tax all income deriving from activities taking place within their borders. Indeed, the mandate for the BEPS project from the G20 leaders was to ensure that MNE profits could be taxed ‘where activities occur and value is created’. However, it is particularly difficult to agree a definition of where cross-border services should be regarded as being performed, since some elements of the activity may take place at the location of the provider and others at the location of the recipient of the service. To remedy this, some countries apply a withholding tax to all payments for services, and provisions have been included in many treaties to allow this. However, such taxes on the gross amounts of payments bear little relationship to profitability, are easily passed on directly to the customer, and may apply even if the service is performed outside the jurisdiction of residence of the service recipient.

Hence, countries are now seeking to devise methods to tax net profits from services that are actually performed in the jurisdiction.<sup>6</sup> Without agreement on sourcing rules there could be conflicts, for example over the eligibility of such taxes for relief from double taxation. In particular, the US has recently revised its foreign tax credit rules and guidance to apply a jurisdictional test to determine the place of performance of services, and to deny a credit for ‘extraterritorial’ taxation. The sourcing rules now developed multilaterally in this work on Amount A seem to provide a better basis for international application than such unilaterally proclaimed rules.

## **B. SPECIFIC COMMENTS**

Although more time has been allowed for public comments on this Progress Report than in the previous consultations on Pillar One this year, the discussion draft is far longer. It is also unnecessarily difficult to comment on sections that were previously issued because no indication has been provided of what if any changes have been made in this draft. All interested parties would undoubtedly appreciate in the future when previously released sections are reissued that red-lined versions be provided that clearly show deletions and newly added language.

We would also wish to reiterate our concerns about the extraordinary complexity and technical opacity of these rules. They are extremely difficult to understand even for a seasoned specialist, which makes them difficult or impossible to apply with confidence by countries lacking the resources of highly skilled and experienced staff. The reliance on such detailed and complex rules, in a misguided attempt to provide precision, will in practice create more uncertainty and conflict.

### **1. Scope**

#### *Growing MNEs*

We understand the rationale in the initial roll-out of Pillar One for there to be a limited number of MNEs within scope so that the tax administrations of participating countries can cope with the new mechanisms and procedures. This is accomplished through the very high revenue test. While this may be appropriate for the initial one or two years, it can be expected that by the third year, if not earlier, most countries will have become very adept at dealing

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<sup>6</sup> Notably, Nigeria under its Companies legislation requires non-residents doing business in the country to do so through a local entity, and has now enacted a Significant Economic Presence test for taxable nexus. This is combined with provisions to specify a deemed profit of 20% of turnover, which at a corporate income tax rate of 30% equates to a tax at 6% of turnover (M. Ndajiwo (2020) *The Taxation of the Digitalised Economy: An African Study*. ICTD Working Paper 107, p. 15).



with the application of Pillar One, whether they are home countries of MNEs, market countries for MNEs, or both.

Given this situation, in our view both Article 1 and Schedules A and D seem to make it too difficult for a growing MNE to become subject to Pillar One. First, such a group by definition will not be a Covered Group for potentially the first several Periods in which it meets the revenue test. Second, even if there is, and has been for several years, a Disclosed Segment that meets both the revenue test and the profitability test, there are additional conditions that will often prevent such a Disclosed Segment from becoming a Covered Segment. This apparent excessive concern to prevent Pillar One from applying to such groups seems misplaced. Any MNE that meets this extremely high revenue threshold and/or has one or more relevant Disclosed Segments should be appropriately covered from that Period forward.

#### *Treatment of a Disclosed Segment in the first Period in which a Group Meets the Conditions in Article 1(2)*

Section 1 of Schedule A concerns the treatment of a Group that meets the revenue test and the profitability test for a Period, but was not a Covered Group in any prior Period. In the case of such a group, the Group itself will not be treated as a Covered Group. However, a Disclosed Segment of the Group will be a Covered Segment for the Period if four conditions are met.

One of the conditions that must be met for the Disclosed Segment to be a Covered Segment is:

- d. the Adjusted Segment Profit Before Tax of the Disclosed Segment that would be calculated under Section 5(1) of Schedule D for each Period that follows the two or more Periods referenced in subparagraph (b) is higher than the Adjusted Profit Before Tax of the Group calculated under Article 5 in each respective Period.

We do not see any need for this fourth condition which compares the Profits Before Tax of the Disclosed Segment with that of the Group. A Group may have several segments which vary in profitability from year to year. Such variability would affect whether this fourth condition is met, but that will not change the fact that a particular Disclosed Segment has met the other three conditions for the relevant periods. These other three conditions are what should be important in designating a Disclosed Segment as a Covered Segment.

It should be more than sufficient for a Disclosed Segment to be treated as a Covered Segment if that Disclosed Segment on its own meets the segment revenue test and the segment profitability test for the Period and the other two conditions are met.

## **2. Sourcing Rules**

### *The Knock-Out Rule*

We have noted that the Knock-out Rule remains unchanged in this Public Consultation Progress Report. In our submission of 28 February 2022, we provided strong reasons why this rule should be eliminated, saying in summary that the rule is ‘highly prejudicial to developing countries and results in zero simplification.’

If our recommendation to eliminate this rule were not accepted, we recommended that this rule be made optional. We stated the following in this regard:

If it is decided to retain the Knock-out Rule, then it must not be a pre-condition for application of an Allocation Key. Rather, it should be optional, but with the caveat that it should be used only in the circumstances, which are expected to be rare, where



there is actual documented knowledge that the good or service is not provided in one or more specific jurisdictions. We appreciate that footnote 39 states that any application of the Knock-out Rule should be justified by “actual knowledge”. Given the likely liberal interpretation that too many MNEs will make, actual documented knowledge must be the standard.

Considering the importance of this to market countries generally and to developing countries in particular, we request that this be reconsidered.

#### *Sourcing Revenue During the Initial Transition Phase*

The Initial Revenue Sourcing Transition Phase is defined as the first three Periods beginning on or after the date on which the Multilateral Convention enters into force. During these first three Periods, Covered Groups may apply certain revenue allocation rules set out in Schedule E, Section 11, notwithstanding any other relevant rules, including whether the conditions set out in Section 2(6) have been met.

Since this Initial Transition Phase would last three Periods, the potential effects of understated or overstated revenues for many market countries will be material.

We note in particular Schedule E, Section 11.1.a. (as supplemented by Section 11.2), which deals with Revenues from the sale of Finished Goods to a Final Customer through an Independent Distributor. Under the primary rule set out in Section 11.1.a., 85 per cent of Revenues are treated as arising in the jurisdiction which is the Location of the Independent Distributor, while only 5 and 10 per cent, respectively, are allocated under the Low Income Jurisdiction and Global Allocation Keys.

There will be many cases, perhaps a majority, where an independent distributor’s territorial coverage is regional rather than national. As such, where a Covered Group uses this 85/5/10 per cent approach inappropriately, there will be highly distorted results, and the principal losers will be small and developing countries that are commonly serviced by distributors in other countries. This is because these distorted results may often cause such countries to miss meeting the Nexus thresholds, meaning that they would completely miss out on receiving any Amount A benefit.

We applaud the inclusion of the alternatives set out in Section 11.1.b. and Section 11.2. It is also laudable that Section 11.2 requires that a Covered Group use actual knowledge or ‘has a reasonable basis to conclude’ that Section 11.1.a. with its fixed 85/5/10 per cent figures is inappropriate.

We are very concerned that during these three Periods of the Initial Transition Phase too many Covered Groups will be less than rigorous in applying Section 11.2. Hence, we suggest that the language in Section 11.2 be significantly strengthened to *require* that Covered Groups must apply Section 11.2 in the absence of actual knowledge that its Finished Goods sold through Independent Distributors are primarily delivered to Final Customers within the Jurisdiction of the Location of its Independent Distributor.

#### *Finished Goods sold to a Final Customer through an Independent Distributor*

Para. B.5. of Schedule E, Section 3 provides what may be termed a residual rule that applies to Revenues associated with particular Independent Distributors that remain unsourced after the operation of higher tier rules. Under this residual rule, 85 per cent of that excess is treated as arising on a pro rata basis in the Jurisdiction which is the Location of each Independent Distributor. The Global Allocation Key is applied to the remaining 15 per cent, though with

the exclusion of any Jurisdictions that already received an allocation due to its status as the location of an Independent Distributor.

Consistent with our earlier comments in the section on ‘Sourcing Revenue During the Initial Transition Phase’, this will cause distorted results in too many cases. As such, para. B.5. should be deleted. Para. B.6. should then be amended to provide that Covered Groups must apply the Low Income Jurisdiction Allocation Key, a Regional Allocation Key, or the Global Allocation Key, whichever is most appropriate based on the territory of the applicable Independent Distributor, as understood by the Covered Group. In the absence of any knowledge by the Covered Group of an Independent Distributor, then the Global Allocation Key must be used for Revenues relevant to that Independent Distributor.

If it is decided to retain para. B.5. without change, then para. B.6 must be significantly strengthened. It must be rewritten to *require* that instead of para. B.5., where the Covered Group does not have actual knowledge that the primary or sole territory of the Independent Distributor is the jurisdiction of the Location of that Independent Distributor, then the Covered Group must apply the Low-Income Jurisdiction Allocation Key, a Regional Allocation Key, or a Global Allocation Key, whichever is most appropriate based on the territory of the applicable Independent Distributor, as understood by the Covered Group. In the absence of any actual knowledge of the territory of an Independent Distributor, the Global Allocation Key must be used for Revenues relevant to that Independent Contractor.

### **3. Marketing and Distribution Safe Harbour (MDSH)**

#### *Simplification*

As we have explained in Part A above, in our view the MDSH adds unnecessary complexity. In our view, it should be eliminated. Alternatively, we support the inclusion of a de minimis absolute threshold test, as suggested in Article 6.4 of the draft, for application of the MDSH. This would considerably simplify the application of Amount A. Furthermore, many countries, particularly low-income countries, are likely to receive quite small allocations of Amount A. It would not be appropriate to reduce this allocation further if the sales revenues are disproportionate to the level of physical assets and payroll.

#### *Methodology*

The method proposed in this draft to determine the routine profit threshold for marketing and distribution is the RoDP. The effect of this is to further reduce the level of Amount A allocated to jurisdictions where significant sales are made with relatively little expenditure on physical assets or employees. We note the indication in footnote 3 on p. 17 that some members of the Inclusive Framework are concerned that this method could result in inappropriate outcomes.

While the RoDP may be a suitable method for some business models, it seems unsuitable for others. We suggest that in many cases a more appropriate method for a routine return for marketing and distribution would be a return on sales (RoS). This is particularly true for any local taxable presence that conducts marketing and sales with the intercompany pricing being determined using a resale pricing method or the TNMM that involves pricing based on sales. Indeed, it is the RoS that is used for the initial step of separating residual profits from which Amount A is allocated.

Applying the RoDP to determine the MDSH adjustment that reduces Amount A may be consistent with situations where, for example, a Covered Group uses a cost-plus pricing method to determine intercompany pricing for a local taxable presence. However, in

situations where the intercompany pricing is based on sales and the sales revenues and arm's length profits are high in relation to local physical assets and payroll, the use of RoDP produces a non-sensical result that is highly problematic. This is an issue for not only developing countries, but also for many developed economies.

Hence, we suggest that the MDSH should be based on a suitable combination of the RoDP and the RoS. This should be designed so that it is appropriate to all business models.

#### *Order of Developing Amount B and MDSH Adjustment*

Amount B and any MDSH adjustment (used in calculating Amount A) are closely related. This is because of the need to identify for a market country any portion of income taxable under Amount B that is also included within the Amount A formula prior to the effect of any MDSH adjustment.

Work on Amount B is ongoing and, we understand, is being carried out by a different group from that working on Amount A. While we are unaware of the exact status of work on Amount B, we presume that that work will include consideration of issues such as: (i) the definition of baseline marketing and distribution activities, (ii) the arm's length charges for such activities, and (iii) whether to have one simplified worldwide definition of baseline and one arm's length charge that encompass all sectors, or whether to define the 'baseline' for each sector and the arm's length charge approach to be applied to each sector.

If, for example, the TNMM pricing method is applied to some number of sectors, then there theoretically will be some amount of profit in excess of solely routine profits since in many uncontrolled marketing and distribution situations, a local marketing and distribution company will have its own network, customer relationships, and the like, all of which represent intangible assets that will command higher returns. Alternatively, maybe under some other pricing mechanism applied to a sector, only routine returns will be included.

The MDSH adjustment is meant to prevent market countries from taxing the same income twice. With Amount A by definition including only residual profits and no routine profit, in any case where Amount B includes solely routine profits, there could be no double-inclusion requiring an MDSH adjustment. On the other hand, where Amount B does include an element of residual profit, then there is a need to prevent a double inclusion of income.

The point is that a formula for the MDSH adjustment should only be determined *after* an agreement has been reached on Amount B. We suggest that this be made clear and that at the appropriate time following agreement on Amount B that a new MDSH adjustment be issued along with a request for comments from the public.

#### **Withholding Taxes**

The Overview mentions the relation of withholding taxes to the elimination of double taxation and the possibility of double counting. Amount A is a new taxing right based on pre-tax profits. The MDSH is also a pre-tax factor that should not be affected by actual tax paid.

We of course understand that actual withholding taxes will affect a Covered Group's application of the foreign tax credit mechanism and potential Articles 7 - 11. However, we fail to understand this suggestion in the Overview of a potential for 'double counting'. This implies a relationship between withholding taxes and Amount A. There is no relationship.

It is understood that withholding taxes have never been a part of any of the political agreements such as the July or October IF Statements. Suggesting that there might be an adjustment that would reduce an already minuscule Amount A to reflect withholding taxes is unfair in principle and in practice. Any consideration of this must cease.

## 4. Definitions

### *Eligible Employee Costs*

‘Eligible Employee Costs’ are relevant for the MDSH adjustment and the Article 9 allocation of ‘Amount A Profit’. These costs are also important for the Pillar Two formulaic substance-based carve-out. The definition should be consistent for both Pillar One and Pillar Two applications.

We have made similar suggestions to the following in prior Pillar Two submissions.

As defined in this Progress Report, the Payroll amount for a jurisdiction in a Period is generally equal to the Eligible Payroll Costs of Eligible Employees that perform activities for the Covered Group in that Jurisdiction. Eligible Payroll Costs includes ‘payments in respect of services provided by independent contractors.’ Also, Eligible Employees includes not only direct employees, but also ‘independent contractors and outsourced personnel engaged through independent contractors and acting under the direction and control of a Group Entity that is a member of the Covered Group’. A further condition is that these ‘independent contractors and outsourced personnel ... participate in the ordinary operating activities of the Covered Group.’

We are aware that MNEs will sometimes artificially overstate their activities within a zero or low-tax jurisdiction. They can do this, for example, by engaging independent contractors and outsourced personnel within that jurisdiction, while directing their work from another jurisdiction. This may be from the jurisdiction of the Ultimate Parent Entity (UPE), or a third jurisdiction, such as a regional management centre, or the jurisdiction of the Group’s worldwide operating headquarters. This will be the case where the MNE has structured its UPE to be in a jurisdiction such as Ireland while their operating headquarters remain in another country such as the United States.

If a Covered Group maintains its own employees within a zero or low-tax jurisdiction, then the Eligible Payroll Costs of those Eligible Employees are appropriate. However, where such a Covered Group artificially increases its local ‘personnel’ costs through employment of independent contractors and outsourced personnel that are directed in their activities from outside the jurisdiction, those personnel should not be treated as Eligible Employees, and the costs should not be included in Eligible Payroll Costs.

We strongly recommend that Schedule J be amended (and Pillar Two rules be similarly amended) to affirmatively state that the costs of independent contractors and outsourced personnel within a jurisdiction may only be included in Eligible Payroll Costs for that jurisdiction *if, and only if*, they are factually directed by relevant Covered Group officers or management employees who regularly work in an office or other facility of the Group within that same jurisdiction. Such officers or management employees must have the knowledge, capacity, and authority to direct such independent contractors and outsourced personnel with only normal management stewardship and oversight coming from management personnel located outside that jurisdiction.

In the absence of clear rules on this issue, there will be strong incentive for all Covered Groups to initiate tax motivated arrangements that seek to maximize the Pillar Two substance-based carve-out and reduce the Amount A Profit allocated to tax haven group members under Article 9.

### *Blanket Exclusion of Other Comprehensive Income*

Title 7 includes in paras. 9 and 12 definitions of ‘Financial Accounting Profit (or Loss)’ and ‘Other Comprehensive Income’. In particular, the former does not include any items of income or expense that are included in the latter.

It is not unknown for an item to be recorded within Financial Accounting Profit (or Loss) within one accounting period while some related item is recorded within other comprehensive income in a different accounting period. While one would hope that this should be a rare occurrence, the potential for mismatches must be recognised.

There must be an express provision that will prevent any such mismatches. Depending on the nature of the mismatched item, all related items should either be included in or excluded from Financial Accounting Profit (or Loss). As an example, any mismatch that relates in any manner to one or more Group businesses should require that all related mismatched items be included in Financial Accounting Profit (or Loss).

### *‘Policy Disallowed Expenses’*

Title 7 includes in para. 20b a threshold amount for the classification of certain fines or penalties as Policy Disallowed Expenses. It is not clear from the language whether each fine or penalty must equal or exceed €50 thousand or whether the aggregate of the fines and penalties must equal or exceed €50 thousand. We suggest that the language be clarified to make clear that all fines and penalties, no matter the individual amount, will be treated as Policy Disallowed Expenses if all fines and penalties equal or exceed €50 thousand in the aggregate.

### *‘Disclosed Segment’*

Title 7 includes in para. 27 a definition of Disclosed Segment that is based solely on what a Group has disclosed as a segment within its financial reporting.

We of course understand the desire for simplicity and certainty that has resulted in this approach. We are concerned, though, that there will be numerous instances of Groups that will meet the revenue test by a large margin but that fail the profitability test on a Group-wide basis. Where such Groups have product or service lines or operating units that separately meet the revenue and profitability tests, there are equity and policy reasons to treat that internal segment as a Disclosed Segment.

Understanding the particular desire of the Inclusive Framework for simplicity and certainty during the initial rollout of Pillar One, we agree that the definition of Disclosed Segment in the first two years should remain as it now is. However, from the third year, we strongly recommend that the rules include for all Groups that meet the revenue test but not the profitability test a requirement that they identify their product or service lines and operating units and perform revenue and profitability tests for each. Any such internal lines or units that meet both tests would be treated as a Disclosed Segment. Administrative rules could require such Groups that meet the revenue test but not the profitability test on a Group-wide basis to report on the identity and status of its product or service lines and operating units to its home country tax authority beginning from the third year that Pillar One is in effect.

We also believe that this is important since the effect of including segment disclosure in a Group’s financial statements will have Pillar One tax consequences. This will be an incentive (which is bad from a tax policy perspective) for a Group’s management to choose not to disclose segment information in its financial statements.

### *‘Eligible Prior Period’*

The large number of bracketed words in Title 7, para. 29a suggests that there is still ongoing discussion regarding which years may be included as an Eligible Prior Period. This definition is important regarding the carry-forward of losses.

The concept of pre-implementation loss carry forward is unfair, as the MNE will be allowed to share losses when it is not sharing profits. It should be deleted.

The post-implementation period of ten years is too long. Since these are highly profitable Groups, such a long period is not required. It is also difficult from an administrative standpoint. The period should be much shorter.

### *‘Group Demerger’*

Title 7, para. 35 defines Group Demerger and Demerging Group and Schedule A, para. 2.b. provides that demerged data will be used in the profitability test for prior years (Article 1.2.b.ii.). While these are appropriate rules, more is required.

There are some number of privately-owned Groups and closely held listed Groups that meet the revenue test in Article 1.2.a, but which would have the practical flexibility to restructure through demerger or other separation transactions. This could turn highly profitable segments into Groups that would fall below the €20 billion revenue threshold. There appears to be nothing that would prevent such demerger transactions, except in the circumstances of there being a Stapled Structure, a Dual-listed Arrangement, or an Internal Fragmentation.

As we understand these definitions and how they apply, an *individual* interest holder or group of individual interest holders (not constituting an Excluded Entity, an Investment Fund that is not a UPE or a Real Estate Investment Vehicle that is not a UPE) could separate a Group with revenues above the €20 billion revenue threshold into two or more such Groups with revenues below this threshold. Such an individual or individuals appear not be caught by any of these exceptions.

If this understanding of the rules is correct, the exceptions must be expanded so that an individual owner(s) of a Group may not separate the Group so as to avoid Covered Group status and achieve avoidance of Amount A.