The **BEPS**

Monitoring

Group

COMMENTS ON PILLAR 1
DRAFT MODEL RULES FOR TAX BASE DETERMINATIONS

These comments by the BEPS Monitoring Group (BMG) analyse the draft model rules for tax base determinations released by the OECD Secretariat on 18 February 2022 for public consultation, in the continuing work to address the tax challenges of the digitalised economy by the Task Force on the Digital Economy (TFDE) set up by the G20/OECD Inclusive Framework on BEPS. 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, Oxfam, and Tax Research UK. This submission 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 is based on our previous reports, and has been drafted by Jeffery Kadet, Tommaso Faccio and Sol Picciotto, with comments by Attiya Waris.

4 March 2022

A. General Comments

1. Background and Context

We welcome the opportunity to comment on this draft, which addresses issues that, while technical in nature, have potentially far-reaching policy implications. As stated in the Background section of the consultation document:

> Given that Amount A is a new taxing right that is determined based on the profits of a group (rather than on a separate entity basis), it is necessary to use consolidated group financial accounts as the starting point for computing the Amount A tax base. This approach also has the advantage that the Amount A tax base is less affected by controlled transactions.

This is quite an understatement.

The agreement by the Inclusive Framework in July 2021, as we have previously commented, constituted a historic breakthrough. It charted the way towards a new paradigm in which real business activities and taxable profits of multinational enterprises (MNEs) could be more closely aligned, so as to greatly reduce both tax competition between countries and MNE profit-shifting motivation. This entails new rules that could finally ensure taxation of multinational corporate groups in accordance with the economic reality that they operate as unitary enterprises. The current discussion draft will provide an important building block, by

establishing an agreed approach towards adjusting the consolidated accounts that MNE corporate groups already produce for financial accounting to make them suitable for tax reporting purposes.

Such a major shift will undoubtedly take time. It is understandable that the current proposals for Pillar One are intended to have a limited scope, applying only to around one hundred of the largest and most profitable MNEs and solely for purposes of calculating the allocation of tax rights to market jurisdictions. It is nevertheless important that they should be designed to enable the eventual more comprehensive global adoption of this new approach.

2. Technical Complexity

In view of the significance of the issues involved, it is clearly crucial that there should be adequate public debate of the design of these new rules. This is especially difficult because the intention is to ensure adoption of these rules by a large number of countries with little or no further opportunity for modification. Hence, it is particularly important that these public consultations should be conducted in a way that facilitates wide participation before the rules are finalised.

However, we are being asked to comment on detailed technical rules, with only the brief Background section to explain their rationale and intended effects. This states in general terms that the adjustments to financial accounts 'will be kept to a minimum in order to limit complexity, and align where possible with adjustments under Pillar Two'. While there is broad alignment on some aspects between the rules for the two Pillars, for example in the specification of Acceptable Accounting Standards in Pillar Two and Qualifying Financial Accounting Standards in this draft, in other respects the drafting differs. However, without fuller explanations it is hard to discern if the differences are material and intentional, or not.

These difficulties are exacerbated by the drafting style adopted in these rules, which relies to a large extent on the definition of terms. Article 5.1 itself is deceptively simple, specifying that the Adjusted Profit Before Tax is 'the Financial Accounting Profit (or Loss) of the Covered Group', subject to the adjustments specified in Article 5.2. However, the definition of 'Financial Accounting Profit (or Loss)' states that this excludes 'those items reported as other comprehensive income'. This is a key adjustment, as 'other comprehensive income' (OCI) can include unrealised income, which is usually excluded for tax purposes. The manner in which the adjustments are made for OCI should be carefully considered, and we comment further on this in section B.

While the choice of financial accounting standards as the starting point is understandable, it must be recalled that they are formulated to provide information to investors and not tax authorities. This difference must be firmly kept in mind as this process to define the taxable base for Amount A proceeds. In particular, financial accounting rules allow inclusion of some types of unrealised gains or losses, which may not be appropriate for tax purposes. To ensure ease of administration and avoid complexity, we agree that adjustments should be kept to a minimum. Nevertheless, where accounting rules allow an MNE's management considerable scope for judgment and discretion regarding the inclusion of unrealised amounts, it may be important to exclude such amounts for tax purposes. We discuss this further in item B.4. below.

B. SPECIFIC COMMENTS

1. Blanket Exclusion of Other Comprehensive Income

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. For example, an upward revaluation of property (including intellectual property) at an estimation of its 'fair value' may be included in other comprehensive income, while a downward revaluation would be recorded through the profit and loss account. This is because the other comprehensive income presentation can include unrealised future gains which may never materialise, whilst losses are actual and usually recorded directly in the profit and loss account under the prudence principle.

While one would hope that this should be a rare occurrence, the potential for mismatches must be recognised. Either through inclusion in the Model Rules or within the Commentary, there must be an express provision that will prevent 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). We note the treatment in the GloBE Model Rules released on 20 December 2021 of Included Revaluation Method Gain or Loss. Some similar mechanism could be considered.

As an example, consistent with our discussion below concerning the treatment of equity interests, 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).

2. Treatment of Equity Interests

As presently written, the Model Rules would eliminate all Equity Gain (or Loss) from Financial Accounting Profit (or Loss), which is the tax base for Amount A. In the example provided in footnote 12, gain or loss from a controlling interest could be included.

We believe that whether an Ownership Interest is controlling or not is an inappropriate approach to inclusion or exclusion from Financial Accounting Profit (or Loss). Rather, we believe that the best long-term measure of a Group's income or loss that should be the tax base for Amount A is a *comprehensive* measure that the Group's businesses create over time. Such a measure includes both the results from day-to-day operations and the increases or decreases in value of Ownership Interests that constitute either controlled interests or interests that relate to the business of the Group.

Thus, no matter whether a minority Ownership Interest qualifies for equity method treatment due to ownership percentage or influence, increases or decreases in value of an Ownership Interest should be included if the reason behind holding the Ownership Interest relates to one or more of the Group's businesses. For example, if a Group has acquired, say, a 2% interest in an important supplier or customer, changes in value of that Ownership Interest included in either Financial Accounting Profit (or Loss) or other comprehensive income should be included in the tax base for Amount A. On the other hand, a 2% portfolio investment in some listed company, the business of which has no relationship to the Group's business, would be excluded from Financial Accounting Profit (or Loss) under Article 5, paragraph 2.

3. Treatment of a Division of a Covered Group

Title 9 includes a definition for 'Eligible Division'. Whether a specific transaction conducted by a Covered Group qualifies as an Eligible Division or not, there will be situations where one or more of the resulting individual entities or Groups created or continuing to exist

following the transaction will have global turnover of less than €20 billion and profitability of 10% or less.

It is clear that in many cases, there will be considerable motivation to break up existing Covered Groups or to restructure portions of such groups so as to cause parts or all of their operations to no longer be covered by Pillar One.

To prevent such actions, there must be a clear rule that any corporate transactions conducted by a Covered Group that result in one or more successor entities or Groups that would not be Covered Groups on their own would continue to be treated as Covered Groups.

We recognise that this aspect is not within the scope of this Public Consultation Document. Clearly, though, this suggested treatment of transactions that would reduce business operations covered by Amount A must be included in other forthcoming Model Rules. We suggest that there should be no de minimis rule regarding this.

4. Reserves for Uncertain Liabilities

We are concerned about the effect on the calculation of the taxable base for Amount A of reserves accrued for uncertain liabilities, which are allowable under financial accounting rules. Such reserves decrease the tax base, and are inconsistent with the tax principle of accounting only for actual expenses or liabilities. Most concerning is the high degree of management influence and discretion over such reserves, which is totally inconsistent with Pillar One goals and principles. As a common example of such a reserve, where an MNE is the subject of a lawsuit, it will commonly accrue some amount to reflect its estimation of future obligations. Although such an accrual directly affects Financial Accounting Net Income or Loss, it is typically added-back in the taxable income calculation. The accrual of such a reserve would reduce the Amount A tax base in Article 5.1. We suggest that reserves for uncertain liabilities and any similar accruals be added-back so that the Financial Accounting Profit (or Loss) of the Covered Group is not reduced by the accrual of such uncertain future liabilities.