KPMG

Memo

To Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

From KPMG International

Date March 4, 2022

Ref Comments on the Public Consultation Document for Pillar One – Amount A: Draft Model Rules for Tax Base Determinations

Professionals in the member firms of KPMG International[1] ("KPMG") welcome the opportunity to comment on the OECD's public consultation document entitled "Pillar One – Amount A: Draft Model Rules for Tax Base Determinations," released on 18 February 2022 (the "Consultation Document").

The Consultation Document contains the Draft Model Rules to calculate the profit (or loss) of an in-scope group that will be used to measure the profit subject to partial reallocation under Amount A.

KPMG's comments on the Consultation Document are presented below. In view of the two-week turnaround, our comments are limited to broad themes, as well as a few detailed aspects where input was specifically requested. Importantly, the Consultation Document carves-out several issues that closely relate to the tax base determination, including, for example, the averaging mechanism, segmentation rules, sectoral exclusions, and certain key definitions, including the meaning of a "Covered Group". Once the details of these related issues emerge, we may, therefore, have additional comments regarding potential interactions with the tax base.

As a final introductory comment, we encourage the Task Force on the Digital Economy (the "Task Force") to carefully review all the adjustments agreed as part of the Pillar Two GloBE rules and consider arriving at a single tax base determination, to the greatest extent possible, that can be consistently applied across both Pillars. In our comments below we call out several specific areas in which aligning the Amount A tax base with the Pillar Two GloBE Rules tax base seems particularly important.

We hope the Task Force will find our comments constructive as it works to finalize its work on the Amount A tax base.

---

[1] KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 154 countries and territories and have 200,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

Accepting only Qualifying Financial Accounting Standards should be revisited if the revenue scoping threshold drops to €10 billion, as envisioned

The Consultation Document is drafted on the basis that all in-scope groups would be required to prepare tax base calculations under a limited number of qualifying financial accounting standards, as opposed to the alternative approach of permitting all accounting standards paired with a "competitive distortion check". The former approach was put forward on the basis that:

- Most in-scope groups already prepare their accounts using one of the qualifying accounting standards, and
- Applying the "competitive distortion check" would unwind the benefit of the alternative approach as it would effectively require determining the Amount A tax base under a qualifying accounting standard to perform such a check.

We generally agree with the proposed approach to use a prescriptive list of acceptable financial accounting standards, as well as the accounting standards that are on that list, which is aligned with the Pillar Two GloBE rules. However, it is notable that the first argument above may need to be revisited, particularly if the revenue scoping threshold drops from €20 billion to €10 billion, as many in-scope groups may not be subject to a qualifying accounting standard by virtue of the jurisdiction of their ultimate parent entity. As a result, it seems necessary to revisit the proposed approach at the same time the revenue scoping threshold is revisited. At that time, an assessment should be performed to determine the proportion of in-scope groups not applying one of the qualifying standards, and, at the very least, a transitional rule could be considered.

The to-be-developed Commentaries for the book-to-tax adjustments should be the subject of a future public consultation

The Consultation Document contemplates several "book-to-tax adjustments" that would be reversed (i.e., excluded) from the group's unadjusted financial accounting profit (or loss), including:

- Tax Expense (or Tax Income);
- Dividends;
- Equity Gain (or Loss); and
- Policy Disallowed Expenses.

There is no detail in the Consultation Document for how these book-to-tax adjustments would practically apply. The Consultation Document acknowledges this gap and notes that "Commentaries will elaborate on the practical application of the exclusion". Once these Commentaries are prepared, they should be the subject of a future consultation to ensure that the actual detailed rules are both clear and administrable for in-scope businesses to apply.

Another book-to-tax adjustment should be added to exclude fair value accounting gains/impairments related to assets and liabilities

While the Consultation Document excludes changes in fair value of an equity ownership interest, it does not have a similar rule with respect to fair value accounting gains/impairments related to assets and liabilities. Such gains/impairments are non-economic in nature and therefore should be reversed out of the Amount A tax base. Doing so would be consistent with the Pillar Two GloBE rules (see Article 3.2.5) which provides businesses with an election to exclude these items.

Minority interests should be explicitly excluded

The starting point for the Amount A tax base determination is financial accounting profit (or loss), which is defined as the profit or loss set out in the consolidated financial statements of the ultimate parent entity taking into account all income and expenses of the group except for those items reported as other comprehensive income.

While it seems to generally follow from the foregoing definition, the final Model Rules and Commentaries should be explicit that income related to minority interest is excluded from the group's Amount A tax base. Excluding minority interests ensures that the in-scope group is subject to Amount A on only its share of the group's economic income. This would also be consistent with the Pillar Two GloBE rules which delivers this principle through an "allocable share" limitation (see Article 2.1.1, for example).

All aspects of the Amount A tax base should be included in the tax certainty process and any disputes should be dealt with in a mandatory and binding manner

While the to-be-developed Commentary will presumably set out detailed guidance for how the various contemplated adjustments are to be practically applied, jurisdictions will inevitably take varying interpretations, with the result being potential double taxation for businesses. It is, therefore, essential that all aspects of the Amount A tax base determination – including all book-to-tax adjustments, the treatment of restatements, and the treatment of losses, including transferred losses – be included in the upfront tax certainty process and any disputes be dealt with in a mandatory and binding manner.

A materiality threshold should be considered, particularly for Policy Disallowed Expenses

As currently drafted, all the proposed book-to-tax adjustments apply without regard to materiality.

Consideration should be given to adding materiality thresholds for at least some of the items, particularly Policy Disallowed Expenses. Doing so would help avoid the needless complexity and administrative burden associated with businesses needing to identify and adjust for immaterial fines and penalties, for example. In fact, the Inclusive Framework has already taken this approach in the Pillar Two GloBE rules, which generally limits Policy Disallowed Expenses to expenses for fines and penalties that exceed €50,000 (see the definition of Policy Disallowed Expenses in Article 10.1). A similar approach seems logical for purposes of determining the Amount A tax base, but with a higher materiality threshold recognizing that Amount A applies using consolidated-level accounts whereas the Pillar Two GloBE rules applies using constituent entity-level accounts.

The Eligible Restatement Adjustment "cap" should be eliminated to avoid businesses needing to track carry-forward attributes

Under the Consultation Document, restatements are dealt with during the period in which they arise, rather than going back to the year the restatement relates and doing re-computations for prior years. But a "cap" limits the adjustment that can be considered in the current period to 0.5% of revenue, with the excess balance carried forward.

We recommend eliminating (or at least increasing) the cap to avoid in-scope groups needing to track a carry-forward attribute which entails both complexity and administrative burden.

Time limitations imposed on the loss carry-forward mechanism should be lengthened

The Consultation Document seeks to limit any reallocation under Amount A to economic profit by incorporating a loss carry-forward mechanism. These rules allow unrelieved losses of an in-scope group incurred in a prior period to be carried-forward and offset against any subsequent profit of that group, following an 'earn-out' mechanism, over a defined period, which varies for post-Amount A implementation losses and pre-Amount A implementation losses.

This mechanism is welcome but the imposition of the relatively short time limitations, particularly in the case of pre-Amount A implementation losses (which is contemplated to be no more than between 2 and 8 years prior to the implementation of Amount A) risks undermining the policy intent of the loss carry-forward mechanism. As such, the time limitations should be lengthened.

As with the book-to-tax adjustments, the Consultation Document notes that "Commentaries will clarify the application of this draft provision". Given the importance of this provision, the to-be-developed Commentary should be the subject to a future public consultation.

Transferred Losses in an Eligible Business Combination or an Eligible Division

The loss carry-forward mechanism described above also extends to losses transferred following certain types of defined business reorganizations (referred to as Transferred Losses).

We agree with the general approach to include Transferred Losses in the overall loss carry-forward mechanism provided they relate to certain defined business reorganizations, including eligible business combinations – involving either the transfer of a stand-alone entity, or the transfer of all or substantially all of the assets and liabilities of a group, without regard to the specific legal form of the operation –, or eligible divisions.

However, it is not clear why the contemplated "Business Continuity Conditions" are necessary. Such a condition was not previously included in the Pillar One Blueprint and there is no stated rationale included in the Consultation Document. To the extent the Task Force is concerned about structured transactions designed to utilize losses, that would seem like a more general concern best dealt with as part of regular domestic tax rules, not the design of Amount A. Moreover, it is not clear how "same or similar" would be practically applied and administrated in a way that didn't give rise to regular disputes. And related to that, it is unclear how the 24-month post-business combination test reconciles with the upfront tax certainty process. Finally, it would be rare for a group to acquire another group with cumulative losses and not continue its business operations in some way, and thus the potential for abuse is very limited and, in our view, does not justify the complexity and administrative burden that a subjective business continuity test would entail. For all these reasons, we recommended that the "Business Continuity Conditions" be eliminated.

Furthermore, consistent with our comments in the section immediately above, the time limitations imposed on transferred losses should be lengthened.

Exclusion for the disposition of an ownership interest

It is noted in Footnote 12 that the Task Force is contemplating no longer excluding from the Amount A tax base gains and losses associated with the disposal of equity interests where the equity interest disposed of is a controlling interest.

This approach should not be adopted. In many Inclusive Framework jurisdictions, gains arising from the disposition of controlling equity interests are wholly or partially exempt from tax or subject to taxation at reduced rates. In other words, if the Pillar One tax base were to include these gains, it would be broader than the tax base that is used by many Inclusive Framework members. It would also be inconsistent with the Pillar Two GloBE rules, which excludes such gains (see Article 3.2.1.(c)).

The exclusion for Regulated Financial Services should be broad to avoid the inherent complexity of determining the Amount A tax base for financial services businesses

The Consultation Document notes that "further changes may also be needed once the scope of exclusions for Regulated Financial Services have been agreed, to ensure that the tax base determinations rules appropriately address the specificities of certain non-regulated financial services"*.*

Instead of developing complicated rules to address such specificities, the scope of the exclusion for Regulated Financial Services should be broad enough to exclude the vast majority of financial services businesses in the first place, and as a minimum should include all forms of banking and insurance and reinsurance business subject to prudential regulation and those subject to regulatory limitations on what services can be provided on a cross-border basis.

This would be consistent with the Pillar One Blueprint which pointed to the complexity of measuring profit as one of the key reasons for why the financial services sector should be excluded (in addition to other factors, including, the high degree of regulation). For example, in the context of the insurance sector the Pillar One Blueprint noted:

> *"There are also concerns that the measurement of profits in the insurance sector is not comparable to the approach outside the financial sector. Insurers measure income and costs differently than other industries so traditional profit measurements might inaccurately result in excess profits that do not in reality exist."*

Accounting standards can also vary significantly between accounting frameworks, especially following the introduction of IFRS 17 for insurance business on 1 January 2023, and therefore it is difficult to ensure the same tax treatment is applied to otherwise identical insurers who report on different accounting frameworks.

Similar issues may arise in relation to the Extractives sector.

Enclosures:
Attached letter from KPMG Tax Services Limited in Hong Kong

KPMG Contacts	Firm	E-mail
Manal Corwin	KPMG in the US	mcorwin@kpmg.com
Marcus Heyland	KPMG in the US	mheyland@kpmg.com
Grant Wardell-Johnson	KPMG in the UK	Grant.WardellJohnson@kpmg.co.uk

KPMG LLP
1801 K Street NW
Suite 12000
Washington, DC 20006

Private & confidential
Tax Treaties, Transfer Pricing and Financial Transactions Division OECD/CTPA

By email: tdfe@oecd.org

Our ref JMT / IDM
Contact John Timpany
+852 2140 8790
Ivor Morris
+852 2847 5092

4 March 2022

Consultation: Pillar One – Amount A: Draft Model Rules for Tax Base Determinations

We welcome the opportunity to comment on the OECD's public consultation document entitled "Pillar One – Amount A: Draft Model Rules for Tax Base Determinations" issued on 18 February. Under the proposals set out in the document, Amount A will be calculated based on the profit or loss as set out in the consolidated financial statements, subject to a limited number of specified exclusions and deductions. We note that revaluation movements on immoveable property are not set out as an adjustment or exclusion and that unrealised fair value movements on investment properties would therefore form part of the Amount A total.

The inclusion of these amounts poses particular problems for Hong Kong, China, where real estate values are among the highest in the world and which can result in significant revaluation movements being recognised in the accounts. Many of the largest businesses operating in Hong Kong, China are conglomerates owning significant amounts of immoveable property within the jurisdiction as well as retail, manufacturing and other businesses both within the territory and overseas. These investment properties have often been held on a very long term basis and revaluation gains are unlikely to be realised for many years, if at all. We expect that this issue would be of concern for many jurisdictions.

It is generally accepted, not least in the OECD's Model Tax Convention, that real estate is a special case as it is so closely (and literally) connected to the territory where it is sited. Consequently, rental income and gains on the disposal of investment properties are expressly allocated to the territory where they are located, regardless of the considerations that would generally apply to other types of business. This presumably partly reflects the fact that real estate and the profits arising from it, are by their nature extremely difficult to shift across borders. Were the profits to arise from rental income or sales of real estate, the revenue would be allocated to the location of the real estate in accordance with the allocation key. However, as a revaluation gain is merely an accounting entry without any third-party customer, it is classed as non-customer revenue and is automatically allocated in proportion to other revenues, resulting in unrealised profits on investment properties being allocated to other jurisdictions.

We note that, on a similar basis, profits from the exploitation of natural resources, have been carved out of the scope of Amount A, presumably on the basis that the taxing right ought to rest in the location of the natural resources. We cannot see a reason why a similar logic should not apply to real estate.

We note that the original blueprints issued in 2020 had not proposed to include real estate income within the scope of Amount A. Its inclusion at this stage is therefore something of a surprise and has been done without industry consultation. We consider, given the fundamental change to the location of taxing rights that could arise, wider consultation should be considered on this point.

We also note that, regardless of whether profits from investment properties should be forming part of Amount A, the current proposed approach includes unrealised gains. In businesses that hold investment properties for the long term, these gains are unlikely to be realised soon. Many jurisdictions choose not to tax such gains while they remain theoretical, and only tax them on realisation. This is recognised by the Pillar 2 proposals, which allow for unrealised revaluation gains to be excluded from the effective tax rate calculations. We note that consideration is being given to excluding equity gains from the Amount A calculation, and would suggest that a similar treatment should be adopted for other capital assets, especially in respect of unrealised gains.

The model rules are intended to address base erosion and profit shifting opportunities and tax challenges arising out of the digitalisation of the economy. It is difficult to see how conventional investment property holdings fall within this remit. Further the rules as proposed appear to result in a situation where a group that has significant valuation increases on investment properties in one jurisdiction may find the right to tax a part of those valuation adjustments assigned to another jurisdiction. This may be the case even where neither jurisdiction would ordinarily seek to tax such unrealised gains. It may also lead to the same profits being taxed twice when the investment property is eventually sold and the profits taxed in the home jurisdiction.

We would therefore suggest that consideration be given to excluding gains on investment properties, and in particular unrealised gains, from the Amount A calculation.

Yours faithfully,
For and on behalf of KPMG Tax Services Limited

John Timpany
Head of Tax