Memo

To	Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA
From	KPMG International
Date	August 19, 2022
Ref	Comments on the Progress Report on Amount A of Pillar One

Professionals in the member firms of KPMG International[1] ("KPMG") welcome the opportunity to comment on the Progress Report on Amount A of Pillar One, released on 11 July 2022 (the "Progress Report").

We commend the decision by the OECD/G20 Inclusive Framework on BEPS (the "Inclusive Framework") to seek input from stakeholders, and specifically the business community, on the design of Amount A. We encourage the Inclusive Framework to continue to seek input as it develops the remaining parts of Amount A, Amount B, tax certainty for issues related to Amount A, and the definition of Unilateral Measures, all of which are integral to Pillar One.

As the Cover Note recognizes, the Inclusive Framework's two-pillar reform initiative is an ambitious, once-in-a-generation effort to restabilize the international tax system and address weaknesses in the current system that create uncertainty for taxpayers and tax administrations. The shift towards a formulaic, group-based profit allocation system that Amount A is designed to deliver represents the most fundamental reform of the international tax system, since the arm's length principle or arm's length standard was first discussed by the League of Nations in the 1920s. Given its importance, it is critical that the Inclusive Framework takes the time necessary to design rules that achieve their intended objective, whilst minimizing complexity; increasing the likelihood that these rules are ultimately implemented. At a minimum, this should include further consultation with stakeholders on the complete set of model rules, prior to the finalization of Amount A.

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There are six key issues that we believe warrant further consideration by the Inclusive Framework:

- It is essential that any additional compliance costs the Amount A rules create for groups that ultimately are not in-scope are minimized to the greatest extent possible. This should be specifically addressed as part of the workstream on administration.

- The revisions to the Extractives and Regulated Financial Services (“RFS”) Exclusions represent an improvement from earlier discussion drafts, but we remain concerned that, as drafted, the exclusions will create an unlevel playing field and impose undue compliance costs on groups in these sectors. We encourage the Inclusive Framework to consider further revisions to the exclusions, with a specific focus on simplification.

- It is difficult to articulate the rationale for the exceptional segmentation rule, which is likely to impact a very small number of groups and hence appears both distortionary and discriminatory. We encourage the Inclusive Framework to consider how this rule could be revised to minimize these distortions.

- The revisions to the revenue sourcing rules, such as the explicit allowance of Alternative Reliable Indicators, the introduction of an Initial Transition Phase, and the explicit statements that “Reasonable Steps” will not require contract renegotiations, are improvements from the previous discussion draft. However, we remain concerned that the rules remain overly prescriptive and continue to assume that groups have or can access information that is not, in reality, readily available to them. The Inclusive Framework should consider providing further scope for businesses to select an approach to revenue sourcing that is most appropriate for their business model, based on information that is already available to them and tracked in their existing financial systems.

- The marketing and distribution profits safe harbor (“MDSH”) is a core part of Amount A and is critical both to avoid double counting and as part of the Inclusive Framework’s broader efforts to restabilize the international tax system. We are concerned that, as drafted, the MDSH does not deliver on these two key objectives.

- The formulaic, jurisdictional approach to allocating responsibility for eliminating double taxation is a response to the difficulties of designing an approach that matches the residual profits allocated to a market jurisdiction under Amount A, with the entity (or entities) that realize these profits under the current ALS-based profit allocation system. It is important to acknowledge that the proposed approach will lead to situations where a jurisdiction is required to relieve double taxation arising from the allocation of Amount A to a market jurisdiction, where there is no economic connection between the relieving and the market jurisdiction.

The remainder of our comments are grouped into the following sections: (1) general comments; (2) scope, including subsections on the Extractives and RFS Exclusions and exceptional segmentation rules; (3) revenue sourcing; (4) determination and allocation of taxable profits, with a particular focus on the MDSH; and (5) the elimination of double taxation.

1. General comments

The Cover Note to the Progress Reports highlights a number of critical issues that have not yet been included in the rules, including the treatment of withholding taxes, the definition of unilateral measures, the tax certainty process, administration, and Amount B. For the business community, each of these building blocks is critical for the effective operation of Amount A. If withholding taxes are not accounted for when determining whether a jurisdiction should be allocated Amount A, then Amount A will not restabilize the existing international tax system because countries will retain the option to use withholding taxes to assert taxing rights that are inconsistent with existing international rules and norms. If unilateral measures are not defined appropriately, then a similar issue will arise. Amount A is a move towards a global, formulaic allocation of taxing rights and thus requires an effective multilateral tax certainty and administrative system, without which the regime will be impossible to operate. Because Amount A applies on top of the existing system, this must include tax certainty on transfer pricing and related business profits disputes. Finally, for many groups, Amount B is the most beneficial feature of Pillar One, with the potential to significantly improve the operation of existing transfer pricing rules. It is important that the Inclusive Framework delivers on this promise, whilst simultaneously ensuring that groups with atypical distribution models are not inadvertently disadvantaged. It will ultimately only be possible to assess the merits and demerits of Pillar One once every building block has been finalized.

As the Inclusive Framework has agreed, the introduction of Amount A will require countries to withdraw and not subsequently reenact digital services taxes (“DSTs”), including those imposed on groups that will fall outside the scope of Amount A. We support the Inclusive Framework’s assessment that the challenges imposed by unilateral measures that are inconsistent with existing international rules and norms extend beyond the archetypal “digital business”. The three criteria proposed to define “relevant similar measures” – i.e., that measures “impose taxation based on market-based criteria, are ring-fenced to foreign and foreign-owned businesses, and are placed outside the income tax system (and therefore outside the scope of tax treaty obligations)” – are a starting point for this definition, though other factors such as rules targeted at non-resident sales should also be considered. We note that it will be helpful for the Multilateral Convention (“MLC”) to identify the specific existing measures that should be removed, and that the exemption for “rules addressing abuse of the existing tax standards” should be limited to measures that are designed to prevent actual abuse, not simply those that are merely labelled as preventing abuse.

We appreciate the challenges of drafting complex technical rules within the time constraints imposed on the Pillar One workstream. However, it should be noted that the current draft is difficult to follow. For example, there are multiple definition sections, which mean that the interpretation of a specific Article may require the reader to look to both Title 7: Definitions and one or more Schedules. The drafting also contains important inconsistencies, for example, Schedule E: Detailed Revenue Sourcing Rules contains “Initial Revenue Sourcing Transition Phase” as a defined term, but this term is not referenced elsewhere in the rules. We strongly encourage the Inclusive Framework to consider how the drafting of the rules could be simplified and improved, particularly as these rules are converted into an MLC.

2. Scope

As the Cover Note states, it is critical that the scope rules are “readily administrable and provide certainty as to whether a taxpayer is within scope”. For the majority of groups that will ultimately fall outside the scope of

Amount A, the scope provisions are the most critical. It is also important that the rules treat businesses operating in comparable circumstances in a comparable way and do not create distortions or an unlevel playing field.

For groups that are close to the scope threshold but ultimately fall out-of-scope, access to the tax certainty process will ensure they do not face multiple audits in multiple jurisdictions. This emphasizes the importance of the Scope Certainty Review, outlined in the Public Consultation Document: Pillar One – A Tax Certainty Framework for Amount A.[2] However, it is also important that the compliance burden on groups that are not in-scope of Amount A is minimized to the greatest extent possible. For example, there should be no general requirements for out-of-scope groups to file Amount A returns to demonstrate that they are out-of-scope. This issue should be addressed as part of the further work on administration.

The definition of Revenues contained in Title 7 does not specify whether revenues should be understood as gross or net revenue. There can be material differences between gross and net revenues due to rebates, incentives, or excise taxes. This definition should be clarified to address this point. Depending on the specific circumstances, it may be appropriate to apply the revenue threshold and calculate Amount A based on either gross or net revenue. For example, in some circumstances, rebates are effectively a reduction in price of a product or service and hence should be treated as a reduction in revenues. In others, they are more akin to a cost of promotion and hence should be treated as such, not as a reduction in revenues. Given that the appropriate revenue base varies, taxpayers should be able to choose whether to use gross or net revenue, provided they do so consistently across the Amount A calculation and across periods.

The profitability threshold relies on a definition of “Pre-Tax Profit Margin” that requires a group to adjust its Financial Accounting Profit (or Loss) based on the adjustments specified in paragraph 2 of Article 5, Title 4. To minimize compliance costs, there should be a safe harbor provision stating that groups with a pre-tax profit margin of [x%] calculated without these adjustments are out-of-scope. This will ensure that Amount A does not impose compliance costs on groups that are not, and are unlikely to ever be, in-scope. This change would also reduce the burden on tax administrations and allow them to focus resources on administration and tax certainty process for groups that are in-scope.

The averaging mechanism included in the rules is unnecessarily convoluted and it is not clear what the mechanism is seeking to achieve. Groups that do not meet the profitability test in two of the four prior periods and on average across the current and four prior periods are excluded from scope, unless they meet the threshold in the two periods prior to the current period. As there is no clear policy rationale for disapply the other averaging rules where a group meets the profitability threshold for two prior periods, we suggest removing this requirement.

Extractives Exclusion

We commend the Inclusive Framework’s work to simplify the Extractives Exclusion and to revisit some aspects of the definition of Extractives Activity and Extractives Revenue. However, we remain concerned about the

[2] OECD (2021), *Public Consultation Document: Pillar One – A Tax Certainty Framework for Amount A*.

complexity of the provisions envisaged, given that in most cases groups in the extractives industry will ultimately be excluded from the scope of Amount A.

Extractives Revenues and Non-Extractives Revenues

It should be relatively straightforward for a group to establish whether it is a Qualifying Extractives Group and hence eligible for the Extractives Exclusion. However, identifying the group's Extractives Revenues will be more challenging. The definition requires a group to identify the Extractives Revenues of each Entity in the group. This will require groups to review the financial accounts of hundreds, and potentially thousands, of entities and assess the activities performed by each individual Entity to determine whether they meet the Extractives Activity definition.

It may not always be straightforward to establish whether an Entity is resident in the Jurisdiction of Extraction, particularly for revenues generated from the sales of products that have undergone Primary Processing. The homogenous, fungible nature of products in the extractive industry, and particularly in the oil and gas sector, means it can be very difficult to trace intermediate products through supply chains. Assuming that the requirement that an Entity must be resident in the Jurisdiction of Extraction is retained, the Inclusive Framework should undertake further consultation directly with affected parties to ensure that the tests required to establish this connection are administrable.

The definition of Extractives Revenues will require a group to split the revenues of an Entity undertaking processing, where only part of that processing meets the "Primary Processing" definition. This will require it to hypothesize that the Entity is split into two, to identify the revenues that would have theoretically been earned if the "sale of a product had occurred at the point that the Primary Processing was completed". The requirement that the sale be priced according to the Arm's Length Principle will be challenging to apply in practice, given that it is clear what is being priced is a hypothetical transaction that is occurring within an Entity, not a transaction between two entities to which the Arm's Length Principle is normally applied.

There is an open question whether the definition of Primary Processing includes petrochemicals and chemicals. The inclusion of these terms in brackets seems odd. It creates the possibility that diesel, kerosene and gasoline are specifically included in the definition of Primary Processing on an angel list, even though diesel, kerosene and gasoline could be described as petrochemicals, and petrochemicals could be specifically excluded from the Primary Processing definition. There is also a question whether refining diesel, kerosene and gasoline meets the general definition of Primary Processing included in paragraph 12 of Section 20, Schedule B, or whether these processes should be on a separate list that do not meet the general definition but are still covered by the Extractives Exclusion. Again, this highlights the continued uncertainty created by the Extractives Exclusion as currently drafted.

We support the inclusion in paragraph 5 of Section 2, Schedule B, of multiple tests through which a group can establish they do not meet the non-Extractives revenue test. This is of significant benefit to the majority of groups in the extractive industry, which will be outside the scope of Amount A, because their non-Extractives revenues are below EUR 20bn.

Determination of Non-Extractives Pre-Tax Profit Margin

A number of groups in the extractive industry will be required to compute their Non-Extractives Pre-Tax Profit Margin, either to demonstrate that they fall below the 10% threshold or to calculate their Amount A tax liability. We remain concerned that the process described is complex, difficult to follow and will not always lead to appropriate outcomes. These concerns are exacerbated by the fact that groups may need to calculate their Non-Extractives Pre-Tax Profit Margin across multiple Periods, either for the purpose of determining whether they exceed the profitability threshold in the required prior periods (under paragraph 3 of Section 2, Schedule B) or when applying the loss carry-forward provisions. It should be noted that due to the cyclical nature of the extractive industry and the large risks borne by groups operating in this sector, losses in some periods are not uncommon, and hence the loss carry-forward provisions are particularly important in this sector.

Under the Extractives Exclusion, a Qualifying Extractives Group can compute its Non-Extractives Segment Adjusted Profit Before Tax using either the Disclosed Segment Approach or the Entity Approach (see Section 6, Schedule B). Under the Disclosed Segment Approach, a group would need to determine whether a segment is an Extractives Segment because its revenues are primarily covered by the exclusion, a Non-Extractive Segment because its revenues are primarily not covered by the exclusion, or a Mixed Segment because it is neither an Extractives Segment nor a Non-Extractives Segment. What this discussion fails to address is that it is unlikely that groups will have existing financial reporting systems that directly map their Entity's financial data to their segment financial data. We strongly support further consideration being given to how Disclosed Segment financial data could be used to administer the Extractives Exclusion, but we note that the decision to look to an Entity when defining Extractives Revenues makes this difficult. We also note, as the Progress Report reflects, that being able to rely on Disclosed Segment data is not a panacea, as rules are still required to exclude the Extractives Revenues (and hence profit) from both a Non-Extractives Segment and a Mixed Segment (see paragraphs 4 and 5 of Section 6, Schedule B).

The Entity Approach is simpler to follow than the Disclosed Segment Approach as it states that Non-Extractive Financial Accounting Profit (or Loss) is calculated by summing Non-Extractives Revenues of the Group and the Non-Extractives Intra-Group Revenues of the Group and deducting Non-Extractives Costs of the Group and Non-Extractives Intra-Group Costs of the Group. However, on closer inspection even this has the potential to lead to odd outcomes. For example, where less than 75% of an Entity's revenues are Extractives Revenues, then the Entity is a Non-Extractives Entity. Non-Extractives Intra-Group Revenues are "the sum of the revenues of Non-Extractives Entities that are derived from transactions with an Extractives Entity". This means that where less than 75% of an Entity's revenues are Extractive Revenues (e.g., 74% of its revenues are Extractives Revenues), the revenues it generates from selling to an Extractive Entity seem to be excluded from the Extractives Exclusion (i.e., included in Amount A), irrespective of whether these revenues meet the Extractives Revenues definition. This highlights the distortive outcomes that arise from using a revenue threshold to designate entities as either an Extractive Entity or a Non-Extractive Entity, and then to use this determination to calculate the profits of the group covered by the Extractives Exclusion.

Interaction with Exceptional Segmentation Rule

The decision that a Qualifying Extractives Group should be subject to the exceptional segmentation rule and potentially brought into scope where the group has a profit margin less than 10%, but a Disclosed Segment has standalone revenues above EUR 20bn and a profit margin above 10%, creates additional complexity. Again, it is important to highlight that groups' existing financial reporting systems are unlikely to directly map their Entity financial data to their segment financial data and there will be entities that perform activities covered by two or more segments. This will further increase the complexity of identifying Extractives Revenues for a Covered Segment, as it will first be necessary to determine which entities book the revenue of the Covered Segment.

Other Issues

The Extractives Exclusions includes a placeholder for "Section 7: Allocation of profit" and "Section 8: Elimination of double taxation with respect to Amount A", as well as Sections 16 and 17, corresponding sections where the Extractives Exclusion is applied to a Covered Segment. As the placeholders recognize, it is important that a group's Extractives Profits are not accounted for in either the MDSH or in the calculation that identifies the Relieving Jurisdictions. It is unlikely that groups will have this financial information broken out by jurisdiction and hence some form of bespoke segmentation will be required. This may not be the case where a group has computed their Non-Extractive Financial Accounting Profit (or Loss) using the Entity Approach outlined above. In either case, preparing and reviewing this information will impose an additional burden on taxpayers and on tax administrations, and the fact that no rules have been drafted to date suggests that rules in this area may be very complex. This remains an important unresolved issue on which the Inclusive Framework should consult directly with affected parties.

Consideration should also be given to whether there are situations where the approaches to determining Non-Extractive Revenue or Non-Extractive Pre-Tax Profit Margin result in over or undercounting of revenues and profit, due to the impact of intra-group transactions that are eliminated as part of consolidation.

As a point of detail, we note that the reference in this paragraph 5 of Section 2, Schedule B to "Non-Extractives Revenues as defined by Section 10(13)" appears to be intended as a reference to Section 10(12).

We support the inclusion of the Initial Extractives Transition Phase in Section 21, Schedule B. Again, as a point of detail, there is a reference to both an "Initial Transition Phase" and an "Initial Extractives Transition Phase", where using a single defined term would seem preferable.

Concluding Remarks

The decision to limit the Extractives Exclusion to defined activities, rather than simply to exclude extractives groups, means that groups in this sector will inevitably face a subjective, facts and circumstances based, line drawing exercise when they identify both their Extractives Revenues and Extractive Financial Accounting Profit (or Loss). The decision to allow groups to prove they do not meet the revenue threshold using different approaches (paragraph 5 of Section 2, Schedule B) is an important addition, because it enables individual taxpayers to choose an approach that works for them, given their specific facts and the information they have readily available. There are strong arguments that this more flexible approach should also be adopted for groups that are required to compute their Extractive Financial Accounting Profit (or Loss), and for the yet undrafted rules regarding the MDSH and mechanism to eliminate double taxation. The described Disclosed Segment Approach and the Entity Approach could be included as options a group could use to determine its

Extractive Financial Accounting Profit (or Loss), but taxpayers should have the option to use alternative approaches where these are more appropriate.

RFS Exclusion

We agree with the underlying premise of the exclusion for RFS, as cited in the original consultation document[3] and welcome the amendments to the definitions of Regulated Financial Institutions, which help to ensure the exclusion delivers on its stated objectives. We strongly encourage the Inclusive Framework to consider, as part of the work stream on administration, how to minimize the compliance burden of groups eligible for the exclusion. For example, it would be beneficial to both taxpayers and tax administrations, if the Scope Certainty Review could provide rulings that a group was out-of-scope of Amount A for a number of periods, providing there was no material change in its business.[4]

Risk of Market Distortion

We remain concerned that the Exclusion, based on the current definition of “Regulated Financial Institutions”, will introduce market distortions between businesses that provide comparable products and services. For example, the current Exclusion will likely result in payment service providers that provide services to third party financial institutions falling outside the scope of the RFS Exclusion. In contrast, the profits a Regulated Financial Institution generates from payments services that support its own operations are likely to be covered.

Identification of Group Entities

Paragraph 1 of Section 2, Schedule C, applies the exclusion to Groups in which an individual Group Entity falls within one of the defined categories of Regulated Financial Institution in Section 20 – an entity-by-entity test (including an activities test, based on the income or deposits of an Entity, in each case). The definition of Entity in paragraph 2, Title 7 includes any legal person (other than a natural person) or an “arrangement” preparing or required to prepare separate financial accounts. Defining Entity (and by derivation, Group Entity) in this way brings taxable branches, which are of particular prominence in the Financial Services industry, within the definition.

In the original consultation document, a clarification was included as follows:

> *“An Entity, for the purposes of Amount A, includes any branches, whether or not there is a permanent establishment under domestic law and the applicable tax treaty,* ***and the Entity is tested as a whole****.” [emphasis added]*[5]

Footnotes to the definition of “Depositary Institution” in that document, whilst recognizing that the test for regulation should apply at the Entity level (which here means that branches should be subject to regulation by the “home state” regulator),[6] also envisaged that licensing may need to be tested at branch rather than Entity

[3] OECD (2022), *Public Consultation Document: Pillar One – Amount A: Regulated Financial Services Exclusion*, p. 3
[4] OECD (2022), *Public Consultation Document: Pillar One – A Tax Certainty Framework for Amount* A, pp. 6-7.
[5] OECD (2022), *Public Consultation Document: Pillar One – Amount A: Regulated Financial Services Exclusion*, para 12
[6] *Ibid* para 20 n 5

level.[7] The intended meaning of “Entity” in these footnotes is limited to legal persons (and not branches). The footnotes further envisaged that these (and other) detailed testing rules would be set out in the Commentary.

The defined categories of Regulated Financial Institution in Section 20, reflecting this approach, make no specific provision for branches. In our view this is likely to lead to confusion, since:

- the definition of “Entity” in paragraph 2 of Title 7 means that a branch is not merely “included” within an Entity but is itself treated as an Entity (and by derivation, under paragraph 5 of Title 7, as a Group Entity);
- the tests under each defined Regulated Financial Institution are applied to “Group Entities”; and
- there is no indication that any particular tests should be applied only to legal persons

In our view, an explanation to the contrary in the Commentary would be insufficient to override the above construction. We would recommend that the rules themselves make clear that where a legal person or a branch thereof meets the licensing requirement, the legal person as a whole will be eligible for the exclusion. For example, we recommend clarity within the rules that regulatory capital requirements are only applied at the level of the legal person.

Definition of Regulated Financial Institution

We welcome the change to the definition of “Asset Manager” in paragraph 2(b) of Section 20, Schedule C to replace the capital adequacy requirement with the regulatory criterion. In our view this is much more likely to ensure the effectiveness of the measure. We welcome the clarification of the business activities performed under the “Credit Institution” definition as compared to the previous “Mortgage Institution” definition. We continue to recommend the inclusion of Depository Institution as acceptable categories under subparagraph (a) of the Mixed Financial Institution definition. We welcome the express inclusion of reinsurance within the definition of the business of an “Insurance Institution”. We welcome the inclusion of “Insurance Products” within the definition of covered activities and the clarification that the relevant income is to be defined by reference to gross written premiums. In order to encompass the intended market, we recommend the definition of “Insurance Products” in paragraph 12 of Schedule 20 be extended by the following amendment (in bold italics):

> “Insurance Product” means a contract under which the issuer agrees to make one or more payments to another party on death, ~~***or***~~ on other specified dates ***or events*** and that the issuer is permitted to issue under its licence to carry on an insurance or reinsurance business.

We welcome the relaxations to the ownership and earnings thresholds of the RFI Service Entity definition, though we consider that both thresholds could be lowered further. The definition of “administrative support services” is a critical part of the RFI Service Entity definition that is insufficiently explained in the Model Rules, as drafted. We would encourage the Inclusive Framework to adopt a broad interpretation of this term, recognizing the broad range of activities that support Regulated Financial Institution. In particular, we reiterate our previous comments “fintech” should not by default be excluded from the definition. The requirement that

[7] *Ibid* para 20 n 8

the relevant activities are "necessary" to support the activities of the Regulated Financial Institution is likely to be unduly restrictive, particularly in Common Law jurisdictions in which the term "necessarily" is typically construed extremely narrowly.

We remain concerned about the likely compliance burden that the requirement that to meet the Regulated Financial Institution definition more than 75% of an Entity's income must come from the listed activities or for a Depositary Institution that 20% of the liabilities of the Entity consist of Deposits. Demonstrating that the requirement has been met will require complex calculations to be prepared and updated annually by taxpayers. Tax administrations will likewise need to review these complex calculations annually to satisfy themselves that the taxpayer has met the requirement. Further, the application of percentage thresholds will introduce a "cliff-edge" effect at the margins, since a group with activities-derived revenues marginally above the threshold will qualify for the exclusion, while one with such revenues only slightly less will not qualify. These are significant impediments to the effective operation of the Regulated Financial Institution definition, and we do not believe that they are necessary to apply to limit the definition to the targeted groups.

Demonstrating Compliance

The Commentary should include guidance as to how taxpayers can demonstrate, with minimal compliance costs, that licensing and regulatory conditions have been met. For example, automatic references to public registry or other publicly available information could be considered as the default, such that only in the absence of such information would a Group need to provide additional evidence that an Entity meets the relevant definition. A maintained list of jurisdictions deemed to meet the Core Principles for Effective Banking Supervision would likewise be useful.

Initial Transition Phase

As discussed above, we agree that the Initial Transition Phase is likely to be beneficial for the Extractives Exclusion and consider that similar simplified rules should be extended to groups eligible for the RFS Exclusion.

Interaction between Exclusions

There may be some groups that are eligible for both the Extractives and RFS Exclusions. It is important that the Model Rules are drafted with this in mind and that, if required, additional guidance on the application of the exclusions for these groups is provided. For example, a Group or Disclosed Segment should only be in-scope of Amount A, if it has Revenues not covered by either exclusion that exceed EUR 20bn.

Exceptional Segmentation Rule

It remains difficult to articulate the rationale for applying Amount A to a Disclosed Segment that meets both the revenue and profitability tests, where the group as a whole does not meet these tests. The rule merely seeks to bring into scope groups that would otherwise be outside the scope of Amount A. We also note that as currently drafted the rule is likely to apply to, at most, a handful of businesses and hence could be seen as both distortionary and discriminatory.

This concern is exacerbated by the proposed inclusion of a supplementary provision in paragraph 1 of Schedule A that requires a group that has previously been brought into scope under the segmentation rule to continue to calculate Amount A based on this rule even in a subsequent period during which it would be in scope as a whole, where this leads to more profit being reallocated under Amount A. This provision is not an anti-abuse provision and is discriminatory on its face, as it could result in two otherwise identical businesses being required to calculate Amount A in different ways, simply because of the historic profitability of their segments.

The segmentation rule provides for three alternative approaches to applying the averaging rule to the profitability test. Where no Segment Change has occurred in the past five years the averaging rules are consistent with the rules for a group. Where a Segment Change has occurred in the past five years, the averaging rules are only applied for periods prior to the Segment Change or where there are Segment Restated Accounts. The definition requires that this information be reported in a group's Consolidated Financial Statements. As it is uncommon for groups to prepare Segment Restated Accounts and even where they do prepare such accounts, they would typically only be available in the year the segment reporting is changed, this restricts the ability of groups brought into scope of Amount A under the segmentation rule to apply the averaging mechanism. This rule should be made more flexible, by giving a group the option of preparing Segment Restated Accounts for prior periods, even where these are not disclosed in the group's Consolidated Financial Statements.

As the draft rules reflect, it will be difficult to translate the profit figure reported in a group's accounts for its Disclosed Segment into a profit measure comparable to Adjusted Profit Before Tax for a Period. Under most accounting standards, there is no requirement for groups to disclose a pre-tax segment profit or loss figure. Indeed, it is more typical for groups to disclose a measure of segment profit at either a gross or operating level. The rules propose a prescriptive approach to allocating Unallocated Income, Unallocated Expenses and Corporate Segment Expense between segments to determine a group's Adjusted Segment Profit Before Tax for a Period, though the Progress Report simultaneously recognizes that this may not always be appropriate and hence provides for the use of "an alternative allocation factor", subject to the conditions set out in paragraph 6 of Section 5, Schedule D. It would be preferable to simply require groups to allocate Unallocated Income, Unallocated Expenses and Corporate Segment Expense on a "just and reasonable" basis, enabling them to select an Allocation Key (or Allocation Keys) that deliver appropriate outcomes. This flexibility is consistent with accepted transfer pricing guidance on cost allocations, which recognizes the reality that different allocation methods are appropriate in different circumstances.

Further consideration should be given to the development of safe harbors for groups that do not meet the Amount A profitability threshold on a group basis, and which have Disclosed Segment with revenues above EUR 20bn and profit margins that are clearly below 10%. Without some sort of safe harbor, these groups could incur significant and ongoing compliance costs to calculate their profit margin by segment based on the Amount A rules, merely to demonstrate that they are not subject to Amount A. This should be addressed as part of further work on administration.

It is important to recognize the potential complexity associated with applying the carried forward loss provisions more broadly, but these challenges are exacerbated where Amount A is applied to a Disclosed Segment. It will be difficult to determine whether losses incurred in past periods relate to business activities included in a Disclosed Segment, particularly where there has been Segment Change or where there have been mergers or acquisitions. Further consideration should be given to how these rules can be made administrable, whilst ensuring that groups remain able to carry-forward and offset past losses when determining their Amount A tax liability.

As with both the Extractives and RFI Exclusions, the draft rules include a placeholder for Section 6: Allocation of profit and Section 7: Elimination of double taxation with respect to Amount A. As outlined above, groups could be required to prepare bespoke jurisdictional accounts to identify the profits of its Covered Segment. This will impose a burden on both taxpayers and tax administrations and remains an important unresolved issue on which the Inclusive Framework should consult directly with affected parties.

3. Revenue Sourcing

We welcome the revisions to the revenue sourcing rules compared to the public consultation document released in February 2022,[8] which address some of the concerns raised by business commentators. In particular, we welcome the move towards a more flexible approach without a prescribed hierarchy of acceptable revenue sourcing indicators, including the adoption of Alternative Reliable Indicator as another category of Reliable Indicator, and the inclusion of an Initial Transition Period, allowing groups to rely on the relevant Allocation Keys for three periods after the entry into force of the MLC. However, we remain concerned that the revenue sourcing rules effectively continue to apply on a transactional approach that will be very difficult for groups to apply in practice. We are also concerned that the rules make assumptions about the type of information available to multinational groups that are unrealistic and inaccurate. The Inclusive Framework should not assume that groups can comply with its preferred approach simply by devoting additional time or resources to obtaining more information, or that having to solicit customers for more information is not a significant or burdensome undertaking. There are many situations in which transaction-specific data identifying the precise location of a final consumer or the employees of a business customer is simply not accessible. The Model Rules and associated commentary should recognize and address this fact in a practical way.

Stepping back, the political agreement to reduce the revenue threshold for Pillar One after seven years is contingent on successful implementation of Amount A during the initial period, including with respect to the tax certainty process. Thus, jurisdictions that favor expanding the number of in-scope companies have a stake in designing simplified revenue sourcing rules that are administrable and that will not lead to needless disputes between tax administrations and taxpayers. As presently drafted, the revenue sourcing rules, including their reliance on subjective standards like “Reasonable Steps” to undertake what will in many cases be futile inquiries, will put immense pressure on the tax certainty process and increase the risk of failure under that pressure.

[8] OECD (2022), *Public Consultation Document: Pillar One – Amount A: Draft Model Rules for Nexus and Revenue Sourcing*.

Transactional Approach

We welcome the deletion of the requirement, included in paragraph 2 of Article [X], Title 4 in the previous consultation document, that "Revenues must be sourced on a transaction-by-transaction basis".[9] However, in most cases the rules, as drafted, will still require groups to source revenue on a transaction-by-transaction basis. This is, in large part, a consequence of the structure of the rules, which provide different sourcing rules and a different Reliable Indicator for different types of transaction. This means that the character of a transaction (e.g., the type of good, service, or intangible that is being provided) must be determined before the revenue arising from a transaction can be sourced. The rules also provide specific sourcing provisions for Revenues from Supplementary Transactions, which means not only must a group source revenue on a transaction-by-transaction basis, but that the group must also consider the relationship between different transactions before it determines what revenue sourcing rules to apply.

It is important to reemphasize why businesses are concerned by the proposed approach. One concern is that groups will need to review individual customer contracts to determine how revenues from a particular transaction should be sourced. For example, the rules for Revenues from Finished Goods sold to a Final Customer through an Independent Distributor appear to require a group to consider how the rules should apply to each Independent Distributor that a group sells to, and to make subjective judgements, such as whether it is "reasonable to conclude that it [the Independent Distributor] is located in the same Jurisdiction as the place of the delivery of the Finished Goods to the Final Customer" (paragraph 2(b) of Section 3, Schedule E). Many groups that will be subject to the Pillar One rules sell through thousands of independent distributors. Another concern is that with respect to Large Customers that are recipients of Other Service, each customer must be separately analyzed to determine whether it is part of a multinational group and, if so, the jurisdiction of its Ultimate Parent Entity. There are numerous other similar challenges that the transaction-by-transaction approach creates.

We understand that one of the reasons for deleting the reference to sourcing revenue "transaction-by-transaction" is to signal that tax administrations will not audit the revenues underlying every transaction that has and has not been sourced to their jurisdiction. The reason this is critical is that it is not feasible for taxpayers to retain this volume of information in a format that could be audited by a tax administration, nor is it feasible that a tax administration could audit it. Instead, as suggested in the Public Consultation Document: Pillar One – A Tax Certainty Framework for Amount A, it has been proposed that tax administrations (through an Advance Certainty Review) would review a group's proposed methodology for revenue sourcing, and where this is approved, limit further reviews to testing whether the proposed methodology is being applied correctly.[10] If this understanding is correct, it would be helpful for it to be articulated more clearly. Further, any approach agreed to as part of the Advance Certainty Review should apply prospectively only; groups should not be required to retroactively change their approach for past years. The Inclusive Framework should also continue to reflect, and seek input, on how the revenue sourcing rules could be applied in situations where a taxpayer did not seek a review through the Advance Certainty Review process.

[9] OECD (2022), *Public Consultation Document: Pillar One – Amount A: Draft Model Rules for Nexus and Revenue Sourcing*.
[10] OECD (2021), *Public Consultation Document: Pillar One – A Tax Certainty Framework for Amount A*.

Categories of Revenues

The first step for groups applying the revenue sourcing rules will be to determine the category specific transactions fall into. This is not always clear. For example, it is unclear whether the provision of cloud computing services falls within the definition of Digital Content, Components, Other Services, or Intangible Property, and in some (though not all) cases, this could affect where revenue is sourced. The Inclusive Framework should consider how this issue could be addressed through clarifications to the revenue sourcing rules or administrative guidance. One option would be to allow groups to follow the rules for categorizing transactions under the relevant domestic law of the Ultimate Parent Entity.

The rules include specific Revenue Sourcing Rules for Real Property (Section 8), Government Grants (Section 9) and Non-customer Revenues (Section 10, all of Schedule I). This is confusing, as in many scenarios, these items will not be accounted for as revenue. The Inclusive Framework should discuss this issue with accounting specialists from relevant jurisdictions and consider removing these categories if there are no situations where these items are treated as revenues. More broadly, these types of transactions do not raise the policy concerns that inspired the work on Pillar One, i.e., transactions where a group could have a significant market presence in a jurisdiction without being subject to tax in the jurisdiction. Accordingly, to the extent these items are accounted for as revenue the Inclusive Framework should consider limiting the revenue sourcing rules to revenue from customers.

Furthermore, many in-scope groups run, in effect, relatively small businesses that are in an entirely different industry from the group's main lines of business. These secondary lines of businesses may be "start-ups", legacies of acquisitions, or complementary to the main businesses. The costs of implementing business processes and other systems to source the revenue from these secondary businesses would be disproportionate to the amount of revenue and profit involved. Significant burden could be avoided by not requiring groups to adopt sourcing methodologies and build systems to source small amounts of revenue from these secondary businesses. For example, secondary businesses could be defined as those that represent less than 5% of a group's total revenue. Revenue from secondary businesses could be sourced in proportion to the revenue from the most analogous revenue stream for which the sourcing rules apply or in proportion to all other revenue for which the sourcing rules apply.

Another Reliable Indicator and Alternative Reliable Indicator

Both Another Reliable Indicator and an Alternative Reliable Indicator must "produce results that are consistent with the revenue sourcing rule for the category of Revenues at issue" (see paragraphs 4(a) and 5(a) of Section 2, Schedule E). It is not clear what is meant by this requirement, nor how a group would establish that this requirement is met. This should be clarified. It should also be made clear that a group is not required to establish that Another Reliable Indicator or an Alternative Reliable Indicator produce outcomes equivalent to an Enumerated Reliable Indicator in order to rely on one of these other indicators. It should be sufficient that these indicators are reasonably expected to produce results in line with the applicable revenue sourcing rule.

Revenues from Finished Goods Sold to a Final Customer through an Independent Distributor

There remains significant uncertainty and ambiguity in the rules for Revenues from Finished Goods sold to a Final Customer through an Independent Distributor. One area of ambiguity is the definition of Location of an Independent Distributor, "as where that business has its physical premises from where it conducts the activities associated with the Revenues in question" (paragraph 16 of Section 12, Schedule I). An Independent Distributor may have multiple facilities in multiple jurisdictions, all of which meet this definition. It should be clarified that in the case of independent distributors, "Location" only refers to the physical location where the finished goods are first delivered.

It is possible to envisage some scenarios where using a Regional Allocation Key may be reasonable – for example, when a group sells to an Independent Distributor with distribution rights for two or more countries, with a single ship-to address. There may be other similar scenarios where using a Regional Allocation Key is not reasonable, for example, where a group sells to an Independent Distributor with distribution rights for two countries but has separate contracts for goods shipped to each country (where transportation costs mean shipping goods between the two countries is not economically viable). These distinctions are subtle and identifying them transaction-by-transaction will impose significant compliance costs on business. For these reasons, it is important that groups have flexibility over whether to rely on the Regional Allocation Key or Another Reliable Indicator and should not be required to establish that there is no Reliable Indicator on a transaction-by-transaction basis before using the Regional Allocation Key. Importantly, given the associated (and ongoing) compliance costs, there should be no general requirement that groups review their contracts with Independent Distributors to determine whether they contain geographic restrictions when applying the Regional Allocation Key.

The remainder of the rules in Section 3 of Schedule I are difficult to follow. Our understanding is that a group would be required to determine, for each Independent Distributor that it engages with, whether it can accurately source the associated revenue. If it can accurately source more than 95% of the revenue for a given Independent Distributor, then it can rely on the Low Income Jurisdiction Allocation Key to source the remainder, unless the group can demonstrate the revenue did not arise in Low Income Jurisdictions, in which case the Global Allocation Key is used. If a group cannot accurately source 95% of the revenue, then 5% of the revenue is sourced using the Low Income Jurisdiction Allocation Key and the remainder using the provisions included in paragraph 5, unless paragraph 6 applies. Under paragraph 5, a portion of revenue would be treated as arising on a pro rata basis in the Jurisdiction that is the Location of each Independent Distributor. In this scenario, the group is also required to take Reasonable Steps to reduce the revenue it cannot accurately source below 5%.

This process creates uncertainty and odd outcomes. For example, how does a group demonstrate that its Tail-End Revenues did not arise in Low Income Jurisdictions? What constitutes Reasonable Steps (as discussed further below)? What is a reasonable basis to conclude that Finished Goods sold through Independent Distributors are primarily delivered to Final Customers outside the Jurisdiction of the Location of its Independent Distributor? If revenue is allocated "on a pro rata basis" to the Jurisdictions of the Independent Distributors, is the allocation made based on revenue, the number of distributors in each Jurisdiction, or some other basis? What happens when an Independent Distributor operates from multiple Locations? It is also worth noting that the rationale for the Low Income Jurisdiction Allocation Key is that small, developing jurisdictions may be underrepresented by other indicators. However, the Low Income Jurisdiction definition, as "a Jurisdiction that is defined for the Period by the World Bank as a Low-Income Economy or as a Lower-Middle Income Economy" (paragraph 17 of Section 12, Schedule E) includes jurisdictions, such as India and Indonesia, that are not small jurisdictions. This could be addressed by imposing a GDP cap on the jurisdictions that would be included in the key.

The multiple rules and conditions that are now included in the sourcing rules for Revenues from Finished Goods sold to a Final Customer through an Independent Distributor make the rules difficult to follow. While it is important to give groups the option to use Allocation Keys, simplifying these multiple rules and conditions and allowing a taxpayer to select an appropriate sourcing method that aligns with the stated policy objective (i.e. sourcing Revenues from Finished Goods to the place of the delivery to the Final Customer) would mean the outcomes the rules deliver are more likely to be accurate and easier to operate because they would be less reliant on formulas and Allocation Keys that do not account for differences between companies and business models and could be based on information that is already relevant to groups.

Revenues from Components

The definition of Components is ambiguous and has the potential to create disputes about whether or not a specific product is a Component or Finished Good. For example, paragraph 4(c) of Section 12, Schedule E states that Components should be "designed to be incorporated directly or indirectly into a Finished Good". This implies that a determination of whether a product is a Component depends on the subjective intent of the product's manufacturer, which may not be the same person as the seller of the product. Similarly, paragraph 4(e) states that "the Final Customer of that Finished Good will ultimately have possession or use of that Component as an enduring input into that Finished Good…". This raises the difficult factual question of whether a Component is an enduring input. For example, it seems likely that iron ore will ultimately be transformed into something that will be an "enduring input" of a finished good, but it is unclear whether other materials, such as chemicals commonly consumed during a manufacturing process, would meet that definition. It is important that this ambiguity in the Components definition is addressed through clarification to the Model Rules, and through accompanying commentary (where examples would be particularly helpful).

In addition, sellers of Components are even less likely to have actual knowledge of the location of the Final Consumer than sellers of Finished Goods sold to a Final Customer through an Independent Distributor given that they generally will be further removed from the final sale. Accordingly, our final suggestion regarding revenues from sales of Finished Goods through an Independent Distributors – to allow the use of Allocation Keys, but also give taxpayers flexibility to select an appropriate sourcing method that aligns with the stated policy objective – also applies with respect to revenues from sales of Components.

Revenues from Online Advertising Services

Under the Progress Report, revenue from online advertising is sourced based on the location of the viewer using a Reliable Indicator. No Allocation Key is specifically provided. Even though online advertisers collect transaction-specific data, sourcing revenue based on the location or residence of users is not straightforward given the variety of transactions and the volume of data, some of which is not currently relevant for business purposes. Some groups process billions of advertising transactions a day. Sourcing revenue on a transaction-by-transaction basis is not workable for some businesses. Furthermore, the detailed data that some companies currently have about the location of users may not be available in the future due to changes in corporate policies or regulation.

The use of internal proxies for sourcing revenue to the location of users should be permitted where such proxies can be expected to approximate the same result as a transaction-by-transaction approach. In many cases such a proxy could leverage information the company currently uses internally for financial statement purposes. This would give companies flexibility to build a framework for sourcing revenue that will work in the long run. For example, one approach for sourcing revenue would be to use the locations of all users, weighted by a measure to accounted for the relative value of users in different jurisdictions. This measure of relative value could reflect both the volume of advertisements targeted at users in each jurisdiction as well as the varying prices charged to advertisers to target users in different jurisdictions. This would be a much more workable and durable solution than requiring a transaction-by-transaction analysis.
Additionally, for some online advertising models, groups may not be able to track revenue from online advertising based on the location of view without substantial modifications to their existing systems. For example, some revenue from online advertising is generated based on the number of actual clicks on an advertisement or purchases made, in which case tracking all of the views of an advertisement may not serve a business purpose. Accordingly, groups should be allowed the flexibility to develop an Allocation Key that aligns with their business models while following the general principle that revenue from online advertising should be sourced based on the location of the users.

Revenues from Other Services

The sourcing rules for Revenue from Other Services will cover the majority of business-to-business (B2B) services. The rules and accompanying guidance should further clarify that paragraphs 4 to 6 of Section 6(F), Schedule I ("Other Services sold through Resellers"), only apply to true back-to-back service transactions, not more broadly to other B2B services where the customer uses the service to provide different services to their own customers.

We welcome the inclusion of paragraph 2(a) of Section 6(F), allowing a Smaller Customer's billing address to be used as a Reliable Indicator. However, we remain concerned that the rules in respect of a Large Customer remain too onerous and could require a group to request information from the Large Customer on where its services are used. It should be clarified that this will not be required.

One area of ambiguity is how the rules apply when a Large Customer is itself a member of a multinational group. The Large Customer definition refers to a "person". In the context of a multinational group, this implies that the rules would apply separately to each Entity within that group (as a separate legal person), rather than the group. However, this interpretation seems inconsistent with the proposal that Large Customer's revenues are sourced based on an Aggregate Headcount Allocation Key for the Ultimate Parent Entity. This issue should be clarified. It may also be difficult for a group to determine the Ultimate Parent Entity of a customer or whether an entity is part of a multinational group, particularly where the entity has multiple shareholders, is disposed of by its parent, or does not have a name that indicates affiliation with its parent. These difficulties could be alleviated by allowing groups to treat customers as Smaller Customers if none of the information collected from the customer in the ordinary course of providing the service indicates that the customer is part of an identifiable multinational group.

Another area of ambiguity is how to identify the 200 customers from which the group derives the most revenue from Other Services. For example, are resellers included in this group? If the group provides services to multiple members of a multinational group, are the members aggregated (as noted above, determining whether an entity is part of a multinational group may be challenging, and aggregating customers will potentially increase the number of customers that are treated as Large Customers)? It also appears that the identification of the 200 customers generating the most revenue would occur after the close of the Period, as it is based on revenue received during the Period. This would create significant uncertainty during the Period. The final Model Rules should provide that the determination of the largest 200 customers is determined based on data that can be collected before the relevant Period so that groups know which customers will be Large Customers for a Period at the beginning of that Period. For example, the determination could be based on revenue from the two Periods preceding the Period at issue, which would also have the benefit of reducing the circumstances in which a group's Large Customers change from year-to-year. The Inclusive Framework should also consider allowing groups to identify Large Customers based on total revenue derived from all transactions, as groups may not track revenue from Other Services as a separate category from other revenue.

We also have concerns regarding the Aggregate Headcount Allocation Key as the Allocation Key for Revenues from Other Services not sourced through a Reliable Indicator. It is unreasonable for a group's customers to be required to share this information with a Covered Group. If the Inclusive Framework expects groups to apply the Aggregate Headcount Allocation Key, it will need to provide a mechanism for this information to be shared with relevant taxpayers, whilst protecting the confidentiality of the relevant Large Customer.

Reasonable Steps

For some categories of transaction, such as Revenues from Components or Other Services, the rules allow groups to rely on a specific Allocation Key where they have taken Reasonable Steps to demonstrate that an Enumerated Reliable Indicator is not available. The definition of "Reasonable Steps" helpfully provides that that it does not include changing contractual arrangements; this is a welcome update, and it is critical that the Model Rules continue to provide that groups will not be required to change their contracts. Such a requirement would be extremely disruptive to businesses.

The rules provide limited guidance about what is required to demonstrate Reasonable Steps. Reasonable Steps should never require a group to gather information that they do not collect already or to request information from its customers or other third parties. The rules should focus on groups reviewing the data in their financial systems and making a reasonable effort to determine what data could potentially be used as an Indicator. It will be important that this is clarified, either through revisions to the Model Rules or in the workstream on administration.

More fundamentally, it is highly unlikely that for some Categories of Revenues groups will ever have the information required to use an Enumerated Reliable Indicator. For example, a group that sells Components to another business customer will rarely know where the Finished Goods (including its Components) are sold to a Final Customer, particularly, in supply chains where the Component is many steps removed from the Final Customer. The revenue sourcing rules should not include as Enumerated Reliable Indicators, indicators that it is clear taxpayers will never have access to and should not require a group to demonstrate that it has taken Reasonable Steps to demonstrate it cannot access this information. For these Categories of Revenues, the Model Rules should provide taxpayers with flexibility to determine an appropriate Alternative Reliable Indicator or simply rely on the relevant Allocation Key.

Allocation Keys

Though in many cases it may be difficult for groups to identify a Reliable Indicator to source revenue from certain transactions, it must be recognized that the proposed Allocation Keys also have significant limitations. For example, it would be highly unusual for a multinational to have an international footprint that aligned with that country's share of global consumption expenditure. More typically, U.S. multinationals would have a larger footprint in the U.S., Japanese multinationals in Japan, European multinationals in Europe, etc. Simply defaulting to Allocation Keys means that these important differences will not be accounted for, and hence, as paragraph 2 of Article 4, Title 3 recognizes, will not account for differences in the quantities or prices of goods and services supplied to different jurisdictions.

Even with the Allocation Keys themselves, the inconsistent use of data sources could be distortive. For example, the Global Allocation Key could result in consumption data from the United Nations in USD being used to source revenue from some jurisdictions, consumption data from the World Bank in EUR for others, and domestically determined Gross National Income or Gross Domestic Product for others.

It is important that the option of using Allocation Keys is retained as a backstop, but it is also important that groups have the option to rely on Alternative Reliable Indicator, which is likely to deliver revenue sourcing outcomes that are more appropriate for an individual group.

Internal Control Framework

Paragraph 9 of Section 2, Schedule E requires a Covered Group to have an Internal Control Framework to evidence the application of the revenue sourcing rules. This is a necessary requirement for the application of the revenue sourcing rules, but should be specifically limited to the revenue sourcing rules and should not, for example be extended to other building blocks of Amount A or beyond Amount A. Further, the requirement that this Internal Control Framework should be reviewed by the board of directors (as required in paragraph 28 of Section 12, Schedule E), should be removed given that the board of directors are unlikely to be well placed to conduct such a review. As long the Internal Control Framework accurately reflects the group's process, there is no apparent reason to specify how it is approved within the group.

Initial Transition Phase

As outlined above, we welcome the inclusion of the Initial Transition Phase. It is currently proposed that the Initial Transition Phase is limited to three Periods beginning on or after the date on which the MLC enters into force.

To ease the compliance burden faced by taxpayers, who in some instances will need to build or restructure IT systems to extract the necessary information in a usable format, we suggest extending the transition period to seven Periods, corresponding with the timing of when the Inclusive Framework will review the implementation of Pillar One and consider whether to reduce the revenue threshold to expand its scope to additional groups. At a minimum, the period should be extended to at least the first six Periods beginning on or after the MLC enters into force, consistent with the proposed transition period for extractives. It may take time for groups to adapt their systems and processes to analyze even existing data, and groups should not have to make changes to their systems and processes until they have completed the Advance Certainty Review. Further, as noted above, any approach agreed to as part of the Advance Certainty Review should apply prospectively only; groups should not be required to retroactively change their approach for past years.

In addition, the Initial Transition Phase should be extended to groups when they first come into scope of Amount A, in order to give them the time required to collect the information the general revenue sourcing rules rely upon. Otherwise, groups that are close to the scope threshold will need to pre-emptively install systems to source revenue, just in case they meet the threshold. That would be an excessive compliance burden, especially if they are not eligible to participate in the Advance Certainty Review until they are in scope.

During the Initial Transition Phase, groups should also be permitted to rely on other indicators that would not be an Enumerated Indicator or Another Reliable Indicator but that the group reasonably expects would be accepted as an Alternative Reliable Indicator during the Advance Certainty Review. These Alternative Reliable Indicators often will be better suited to identifying market jurisdictions than Allocation Keys, and their use during the Initial Transition Phase will enable a more robust review of their outcomes during the Advance Certainty Review. For similar reasons, during the Initial Transition Phase groups should also be permitted to use Allocation Keys other than those specified for the particular transaction type, as long as it is reasonable to expect that the Allocation Key will produce results in line with the general sourcing rule.

Finally, it is not clear from the draft whether the Initial Transition Phase covers all categories of revenue or only the categories specifically mentioned. The Initial Transition Phase should cover all categories of revenue and this point should be clarified in the Model Rules.

Concluding Remarks

The revenue sourcing rules continue to pose a potentially significant compliance challenge for businesses. The revisions to the prior draft represent a step forward, but if the revenue sourcing rules adopted a less prescriptive, more principle-based approach, they would likely achieve outcomes that are both more accurate and easier for businesses to comply with.

4. Determination and Allocation of Taxable Profits

Determination of the Adjusted Profit Before Tax of a Group

From an administrative standpoint, it is important that, to the greatest extent possible, any adjustments to the Financial Accounting Profit (or Loss) are limited and / or aligned to the Global Base Erosion (“GloBE”) rules. This will limit the additional compliance and administrative costs that taxpayers will incur in preparing and tax administrations will incur in reviewing the computation of a group’s Adjusted Profit Before Tax.

As outlined above, this is particularly important, given that in theory all groups with revenue above EUR 20bn could be required to prepare these adjusted accounts, even though many will ultimately not be in-scope of Amount A. It will also make it easier for groups that need to compute their Adjusted Profit Before Tax for prior periods, either for the purposes of the averaging or loss-carry forward rules.

There is an inconsistency in the treatment of Equity Gain or Loss, which are excluded from the Amount A tax base, and Asset Gain (or Loss), which are spread over the Period and four subsequent Periods. This creates two level playing field concerns. First, share and asset deals are treated differently. This means a group making an Equity Loss is disadvantaged vis-à-vis a group making an Asset Loss, and a group making an Equity Gain is advantaged vis-à-vis a group making an Asset Gain. Second, and perhaps more importantly, groups that develop and sell assets (e.g., technology) face a higher tax burden than groups that develop assets and use them in the course of their own business. This is because groups that sell assets will have much lower revenues (and hence a higher profit margin) than groups that use assets in the ordinary course of their own business. This distortion is partly addressed by spreading an Asset Gain (or Loss) over five years but would be more appropriately addressed by excluding an Asset Gain (or Loss) from the Amount A tax base.

Footnote 1 notes that work is on-going on the treatment of profits that are attributable to non-controlling interests. It seems clear that these profits should not be accounted for in the calculation of Amount A. Including these profits would require a complicated adjustment to be made to both a group's Revenues and Adjusted Profit Before Tax, as if there was no adjustment to Revenues then a group's profit margin would be materially overstated because the underlying revenues from the non-controlling interest would not be taken into account when computing a group's profit margin (but the profits would be). Moreover, such an adjustment would be at odds with the general approach adopted by Amount A, of relying on the Financial Accounting Profit (or Loss) of a Covered Group.

Schedule G requires that, where a Covered Group acquires another Entity, the accounting carrying value of assets and liabilities of the acquired Entity immediately before the acquisition will be used to determine the Adjusted Profit Before Tax of the Covered Group. This provision does not require a comparable adjustment for changes to the accounting carrying value of assets and liabilities acquired by a Covered Group from another Entity (Entity S) that in turn were previously acquired from another Entity (Entity T). This is a reasonable approach, as in this scenario the Covered Group may not know the accounting carrying value of assets and liabilities of Entity T, however, this does create inconsistency in how assets and liabilities acquired by a Covered Group are treated.

It is important that carried forward losses can be transferred across groups post-acquisition and accounted for in the calculation of Amount A. For both technology and pharmaceutical businesses, it would not be uncommon for a large group (in-scope of Amount A) to acquire small businesses with substantial past losses. Taking these losses into account in the calculation of Amount A will preserve the benefits of carried forward losses provided by the broader corporate income tax system. As drafted, the business continuity conditions (paragraph 2 of Section 1, Schedule H) require a business to establish that a group is continuing with the same business following an Eligible Business Combination or Eligible Division. The compliance burden imposed on businesses to establish that these conditions are met should be minimized, and this should be addressed in the ongoing work on administration.

MDSH

The MDSH was designed to address the issue of double counting, where allocating Amount A to a market jurisdiction is duplicative of a taxing right already exercised by that jurisdiction; it was also intended to help restabilize the international tax system by reducing the incentives for tax administrations to make transfer pricing adjustments that go beyond an arm's length return. For these reasons, the MDSH has, and retains, strong support from the business community. We are concerned that, as currently designed, the MDSH will not deliver on its stated objectives.

First, the MDSH does not account for withholding taxes levied by market jurisdictions on outbound payments. This means that it does not adequately address the issue of double counting, as market jurisdictions would be able to tax a group's residual profits twice, once through withholding tax and again through Amount A. It also reduces the stabilizing effects of Amount A, as market jurisdictions could still expand their use of withholding taxes to extend their taxing rights beyond that supported by Amount A. There are strong arguments for taking withholding taxes into account in the MDSH or including an equivalent mechanism that would allow groups to offset their existing withholding tax liabilities in a jurisdiction against a new Amount A tax liability.

Second, the return or profit level indicator ("PLI") used to identify profits that are available to offset against Amount A, the Portion of Elimination Profit ("PEP"), is too high. Setting this return as the higher of the Elimination Threshold Return on Depreciation and Payroll or 40% is a significant overstatement of a routine return. In some instances, this overstatement may be counteracted by the fact that market jurisdictions have limited depreciation and payroll expenses, but in more asset intensive industries, setting the PEP at this level blunts the impact of the MDSH. This means that the MDSH will not appropriately cap the allocation of Amount A to market jurisdictions. Footnote 3 acknowledges the limitation of the proposed approach in situations where entities, such as routine distributors, have low payroll and asset bases. However, it suggests that to address this challenge an additional threshold could be added to set a higher PEP for these jurisdictions. A preferable approach would be to reconsider the way PEP is calculated to ensure it delivers a reasonable outcome, irrespective of the activities performed in a jurisdiction.

Third, there is the suggestion that only a portion of the PEP should be offset against Amount A, through the Y% variable. Setting Y% at less than 100% reduces the impact of the MDSH. The PEP component of the MDSH is an attempt to approximate the residual profits realized in a market jurisdiction. Having identified these residual profits, it is difficult to rationalize why Amount A should only be offset against a percentage of these profits. Again, if Y% were set at less than 100%, it will reduce the extent to which the MDSH addresses double counting and stabilizes the international tax system.

Fourth, it is difficult to rationalize the inclusion of a de minimis profit threshold in the MDSH, as suggested in footnote 2. Groups can and do realize residual profits in small market jurisdictions, and in this scenario, it is appropriate that the MDSH applies to cap the allocation of Amount A. If a de minimis profit threshold is included in the MDSH it will be important it is set at a genuine de minimis level, below the EUR 50m threshold suggested for the mechanism to eliminate double taxation.

Finally, it has been suggested that by excluding the profits accounted for in the MDSH from the mechanism to eliminate double taxation, the MDSH is an alternative way to deliver a domestic or autonomous business exemption. We do not think that the MDSH can deliver this outcome. The Report on the Pillar One Blueprint suggested that domestic or autonomous businesses (i.e., parts of a multinational group that are separate from the rest of the group) should be excluded from Amount A through a domestic business exemption.[11] A domestic or autonomous business exemption would ensure that the profits (or losses) a group generates from operations in a specific jurisdiction that are separate from the rest of the group are not accounted for in Amount A. This may increase or decrease the profits reallocated to other jurisdictions under Amount A, depending on whether the domestic or autonomous business has a profit margin above or below the group average. Simply excluding profits accounted for in the MDSH (or even a multiple of these profits) is not an alternative to a domestic or autonomous business exemption, because it does not adjust the profits reallocated to other jurisdictions as the proposed exemption would. There is even a risk that reducing the profits taken account in the elimination mechanism could result in a business facing double taxation if its residual profits are solely or primarily attributed to a domestic or autonomous business. Given this, we note that there remains an argument for a separate domestic or autonomous business exemption.

The MDSH remains a key feature of Amount A, but is also challenging to design, with obvious trade-offs between simplicity and accuracy. We encourage the Inclusive Framework to continue to explore alternative design options for the MDSH to ensure that it delivers on its stated objectives. For example, one approach could be to incorporate a cap on the percentage of system profit (i.e., the total profits a group derives from sales in a given jurisdiction) that is allocated to a market jurisdiction through Amount A. This type of cap would recognize that where a jurisdiction has taxing rights over a portion of a group's system profits, e.g., 25%, allocating Amount A on top of these existing profits would result in an overallocation of profits to the market, inconsistent with the broader agreement on Amount A reached by the Inclusive Framework.

5. Elimination of Double Taxation

The mechanism to eliminate double taxation is a core part of the design of Amount A and is particularly important for businesses, for whom the introduction of Amount A would otherwise lead to double taxation. The elimination mechanism has been subject to extensive discussion at the Inclusive Framework; however, there are a number of issues that it is important to highlight.

Legal Convention and Tax Certainty

It is important to acknowledge that the formulaic, jurisdictional approach to eliminate double taxation arising from Amount A will lead to some outcomes that are difficult to rationalize from an economic perspective. For example, it is relatively common for an MNE to divide its global operations into two or more regions, with principal entities entitled to the residual profits derived from their respective region. Under the proposed approach, the principal entity for one region could be liable for Amount A allocated to jurisdictions in the other region, even where it has no entitlement to the underlying profits realized in that region. Similarly, there could be situations where a MNE earns a particularly high return in a specific jurisdiction, where its products or services are particularly popular or command a price premium. The proposed approach could result in this

[11] OECD (2020), *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS*, p. 122

jurisdiction relieving double taxation for Amount A allocated to other jurisdictions, even though the profits realized in that jurisdiction have no connection to sales in other jurisdictions.

There is a risk that these odd outcomes destabilize the Amount A system because tax administrations are ultimately unwilling to accept them. This reemphasizes the importance of a legal convention guaranteeing the consistent application of Amount A across all Inclusive Framework members and a robust tax certainty process.

It should also be noted that the mechanism to eliminate double taxation adopts a group-based approach, where the Amount A profits taxable in all market jurisdictions and features of all potential relieving jurisdictions, will affect that amount of double taxation a given jurisdiction will be required to relieve. The current drafting of the Model Rules, which, for example, refer to "Amount A Profit" as "the total of the amounts allocated for that Period to each Jurisdiction under a provision corresponding to Article 6" (paragraph 2 of Article 9, Title 5) relies heavily on the domestic laws of jurisdictions being equivalent. It may be easier, and will provide greater certainty, if the mechanism to eliminate double taxation is clearly defined in the MLC.

Elimination Profit (or Loss): Backstop Provision

In order to eliminate double taxation, it is critical that the identified relieving jurisdictions have sufficient taxing rights over a group's profits such that they can fully eliminate double taxation. The decision to determine Elimination Profit (or Loss) using financial, not tax, accounts and by some of the other adjustments proposed in Schedule I gives rise to the risk that an identified relieving jurisdiction may not be able to fully eliminate double taxation. In this regard, the rules relating to the Transfer of Assets and Liabilities (Section 6) and Elimination Losses (Section 7) pose challenges.

In broad terms, the approach proposed in Schedules I and J seems reasonable, however, there remains a risk that a relieving jurisdiction is required to relieve double taxation on profits that exceed its existing taxing rights. For example, the inclusion of some gains on the transfer of assets in a jurisdiction's Elimination Profit (under paragraph 1 of Section 6, Schedule I, Section 6) has the potential to be highly distortive, as it in effects brings profits from future periods into the current period without any corresponding increase in a jurisdiction's depreciation and payroll expenses. Similarly, requiring an acquiring Group Entity to determine its Elimination Profit using the carrying value of assets and liabilities recorded by the disposing Group Entity, may result in the Elimination Profit of the acquiring Group Entity being inconsistent with its tax accounts, where these accounts recognize the assets and liabilities at a different rate.

The decision to account for carried-forward losses in determining a jurisdiction's Elimination Profit is critical for ensuring relieving jurisdictions actually have taxing rights over a group's profits against which double taxation can be eliminated. There are numerous examples of businesses that make losses for extended periods before becoming profitable, and hence which, having become profitable, may realize significant accounting profits in a jurisdiction without facing any incremental tax charge. To ensure this scenario does not give rise to double taxation, the carry-forward period should be no shorter than the period for which domestic tax rules allow loss carry-forward and should account for losses incurred before the introduction of the Amount A regime. It is important to note that as pre-regime losses are largely ignored when calculating a group's Amount A tax liability, the mismatch in carry-forward periods for Amount A and domestic law could result in a relieving jurisdiction being identified that has little or no taxing rights over a group in the relevant period for which it is required to relieve double taxation.

Consideration should be given to a backstop rule where a relieving jurisdiction does not have sufficient taxing rights to relieve double taxation. A number of options could be considered, including: (i) allocating responsibility for relieving double taxation for the relevant portion of profits between the other identified relieving jurisdiction; (ii) re-running the elimination calculation excluding any jurisdictions with no current taxing rights over a group's profits; (iii) providing groups with a tax credit that can be carry-forward, or preferably carried back, and offset against future (or past) tax liabilities; or (iv) reducing the profits allocated to market jurisdictions under Amount A.

It should also be noted that the requirement to calculate Elimination Profit (or Loss) over a multi-year period will impose additional compliance costs on taxpayers, particularly when groups come into scope of Amount A for the first time. This issue should be considered as part of the further work on administration.

Elimination Profit (or Loss): Other Adjustments

There are a number of other proposed adjustments to Elimination Profit (or Loss) that warrant further consideration.

First, transfer pricing adjustments can and do lead to material changes in the profits realized in different jurisdictions. Though the scale and frequency of transfer pricing adjustments should be reduced by a robust tax certainty process for issues related to Amount A, it is naïve to presume this will entirely address the issue of after-the-fact transfer pricing adjustments. It is unclear how transfer pricing adjustments are accounted for in the Model Rules, particularly given that where adjustments are made this suggests an inconsistency with the requirement of paragraph 3 of Section 2, Schedule I. Assuming that adjustments are reflected in an Entity's financial accounts, it seems likely that these adjustments would be treated as Prior Period Errors. This would mean where there is a material transfer pricing adjustment, a group would not be required to go back to a prior period and recompute which jurisdictions should have eliminated double taxation but would account for the adjustment in the current period. This poses a number of questions: what happens if a group has subsequently dropped out of scope of Amount A (or only recently come into scope); what happens if a group has restructured reducing the depreciation and payroll expenses in a jurisdiction in which income is now being recognized; or does the potential recognition of multiple years of income in a single year create distortions? It is unclear whether there would be any adjustment to Elimination Profit (or Loss) to reflect transfer pricing adjustments that are only included in tax accounts.

The fact that Amount A applies on top of a system where the final allocation of profits between jurisdictions may not be settled for many years is inherently challenging. We are not convinced that adjusting for Prior Periods Errors in the current year strikes the right balance between complexity and administrability. Consideration could be given to alternatives, such as providing an election to the taxpayer to rerun the process to identifying the relieving jurisdiction at fixed points in time (e.g., five, seven, and 10 years after the end of a period) where there has been a material transfer pricing adjustment.

Second, given that Non-Portfolio Dividends and Non-Portfolio Equity Gain or Loss are excluded from the Amount A tax base, there is a strong conceptual argument that these should have no effect on whether a jurisdiction relieves double taxation. For this reason, we are concerned by the proposal in footnote 13 that these dividends and equity gains or losses could be accounted for when determining a Group Entity's Elimination Profit (or Loss). We note though aligned with the GloBE rules, this adjustment means that Portfolio Dividends and Portfolio Equity Gain or Loss will be accounted for when determining whether a jurisdiction should relieve double taxation, but not when calculating the Amount A tax base. This conceptual mismatch creates the risk that a jurisdiction could be required to relieve double taxation because of Non-Portfolio Dividends and Non-Portfolio Equity Gain or Loss that are not accounted for in the calculation of a group's Amount A tax liability.

Third, paragraph 2 of Section 2, Schedule I requires an adjustment to be made for Stock-Based Compensation Expense. It would be helpful to clarify that this adjustment will allow groups to use the stock-based compensation deductions that they claim for tax purposes, which is not clear from the rules as drafted. It would also be helpful to clarify whether a comparable adjustment will be required when determining a jurisdiction's payroll expenses, for the purpose of calculating its return on depreciation and payroll ("RODP").

Diverted Profits Tax

There is a strong argument to account for tax measures, such as diverted profits taxes, in determining a jurisdiction's Elimination Profit (or Loss), as proposed in footnote 12. That said, it is important that incorporating diverted profits taxes into the determination of Elimination Profit is not seen as an alternative to requiring countries to remove or not adopt such measures in future, where these are considered relevant unilateral measures for the purpose of Amount A. This is because in contrast to removing or not implementing such measures, taking these measures into account in the elimination mechanism will only benefit in-scope groups, and even for in-scope groups may have little or no impact.

Return on Deprecation and Payroll

The mechanism to eliminate double taxation is built around an allocation methodology that apportions responsibility for relieving double taxation between jurisdictions based on their RODP, with jurisdictions with higher RODP more likely to relieve double taxation. For groups that primarily rely on intangibles to drive profits this approach has the potential to deliver odd outcomes. For example, a jurisdiction where a group has historically conducted research and development (R&D) and hence owns intangibles, but which has few assets or employees in the current period would have a much higher RODP than a comparable jurisdiction where a group is continuing to undertake R&D. There are pros and cons to using different profit level indicators to measure profitability, but the above example illustrates that RODP is not a perfect solution and that there are a variety of reasons that a group may have a high RODP in a particular jurisdiction.

It is important to clarify that the depreciation and payroll expenses accounted for when determining RODP are those booked in an Entity's financial accounts. This is not clear from the rules as drafted, but we assume is the intention of the rules.

Integration with Existing Tax and Legal Systems

The mechanism to eliminate double taxation is focused on identifying which jurisdictions will relieve the double taxation arising from Amount A but says little about how this mechanism will be integrated within existing national tax and legal systems.

There are a number of important questions: which entity or entities in the group will be liable for the tax arising from Amount A; how will the rights of minority shareholders be protected, or appropriately reflected in the way relief is provided; when a jurisdiction does not have a consolidated tax regime, which entity or entities will be eligible for relief from double taxation; and where a country adopts the credit method to relieve double taxation, will it be assumed that the double taxation they are relieving is drawn proportionally from all market jurisdictions allocated Amount A, or will there be a methodology to connect relieving jurisdiction(s) to specific market jurisdictions? These are important political and technical questions and have implications beyond tax policy. Given the potential corporate law implications, the Inclusive Framework should consider seeking guidance on these issues from relevant corporate law specialists.

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