KPMG

Consultation on Pillar One - Draft model rules for tax base determinations

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The Organisation for Economic Cooperation and Development (OECD) has released draft model rules for public consultation, covering tax base determinations for Amount A of Pillar One. In October 2021, the OECD announced that 137 member jurisdictions of the Inclusive Framework (IF) has agreed in principle that 25% of an in-scope multinational enterprise's (MNE) profits above a threshold margin of 10% would be subject to reallocation to market jurisdictions (Amount A).

The latest tranche of the draft model rules set out how to calculate the Amount A tax base (Adjusted Profit Before Tax) for this purpose. This follows the earlier release in February of the proposed nexus and revenue sourcing rules, which will determine which jurisdictions receive a share of Amount A on which to levy tax, and how large that share is. The OECD highlighted that none of the proposed rules have been agreed upon and are subject to modification. Once agreement is reached at an IF level, the model rules will be written into a multilateral convention which would amend the nominated bilateral tax agreements between signatory jurisdictions. The OECD will also provide a template for how jurisdictions would give effect to the multilateral convention through their domestic legislation.

KMPG perspective: Very few Asia Pacific (ASPAC) MNEs are expected to exceed this 20 billion-euro/10% profit margin threshold. However, many ASPAC regional subsidiaries of in-scope MNEs will likely have a significant role to play in fulfilling data collection requirements.

Adjusted Profit Before Tax

This is the financial accounting profit (or loss) of the MNE, calculated using the consolidated accounts of the ultimate parent entity and modified by making certain "book-to-tax" adjustments, allowing for the impact of certain restatements, and deducting any allowable net losses. These adjustments are not as extensive as those that apply under the model Pillar Two GloBE rules.

Broadly speaking, the following adjustments are to be reversed from the financial accounting profit calculation:

- Income tax expense (which may be negative)
- Dividend income
- Gain or loss arising from the disposal of an equity interest in another entity, or from a change in the fair value of such
- Profits or losses arising under the equity method of accounting, unless from a joint venture
- A fine, penalty or any illegal payment

Dividend income is excluded because it often does not form part of the tax base in IF member jurisdictions or suffers tax at a relatively low rate. There is no proposed adjustment for gains or losses from the sale of assets that are not equity interests in other entities. The IF is inviting comments on whether this differentiation is appropriate.

Profits or losses of an equity-accounted investment are disregarded as they occur outside of the MNE group itself, other than profit or losses from joint ventures where there is joint control.

The tax base determination and use of formulaic allocations could mean a reallocation of taxing rights, from a high-margin business line with a clear nexus to a particular jurisdiction, to another jurisdiction in which it operates a commercially unrelated low-margin business line. There is the possibility that rules on segmentation will be included in future to deal with more extreme cases.

Restatements

A restatement of prior year financial accounts that would have affected the Adjusted Profit Before Tax for that prior year are picked up in the year that the MNE recognises the restatement. However, the adjustment s limited to 0.5% of MNE revenues in the adjustment year and any excess is carried forward. The IF is inviting comments on whether this approach strikes the right balance between simplicity and the avoidance of large single-year impacts.

Net losses

The draft model rules anticipate significant ongoing negotiation between IF members in relation to the carry-forward of losses. Currently, the IF is considering a limitation on the number of years for which an MNE can carry forward a loss for the purpose of calculating Adjusted Profit Before Tax. The tentative timeframe bracketed in the draft model rules is five to 15 years.

There is also a placeholder for the carry-forward of losses incurred prior to the commencement of Amount A. This tentatively envisages that a loss incurred between two and eight years prior to commencement of Amount A would be eligible for inclusion in the calculation, subject to the general carry-forward time limits.

The draft model rules provide for how to deal with losses in the context of certain mergers and demergers.

There is provision for losses of a standalone entity, or of a group that is wholly acquired, to transfer to the acquiring MNE. Interestingly, it seems that, in the case of an acquisition of only part of a group, the losses would remain with the vendor group. The IF is interested in receiving comments on the scope of transactions for which a carry-forward should be allowed.

Broadly, the draft model rules envisage that an MNE may carry forward a pre-transaction loss into the post-transaction group provided that the latter, throughout the 24 months following the transaction, carries on the same or similar business(es), as the predecessor group had done throughout the 12 months preceding the transaction.

What next?

The OECD will be accepting written submissions on these elements of the draft model rules till 4 March 2022. Following the consultation periods, we expect that the OECD will release detailed commentary on the tranches of draft model rules that it has released so far over the next few months. There are more tranches to come, and some of these will tackle thorny issues such as the scope of exclusions from Pillar One.

If you would like to discuss the application of these model rules or BEPS2.0 in general, please contact your local KPMG representative. You may also reach out to Dean Rolfe, Head of International Tax, Asia Pacific.

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