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PwC's comments in relation to the Reports on the Pillar One and Pillar Two Blueprints in light of the consultation document of 12 October 2020

PricewaterhouseCoopers International Limited, on behalf of the Network Member Firms of PwC (PwC), thanks the OECD for the opportunity to provide comments on the consultation document entitled *Reports on the Pillar One and Pillar Two Blueprints*.

We wish to convey our sincere appreciation to the Inclusive Framework and OECD Secretariat for their work on the issues around taxation in a digitalizing economy, particularly in light of the pandemic and a challenging political environment. We particularly appreciate the ongoing willingness to engage external stakeholders. We believe the willingness to engage and debate will lead to a better outcome, and we continue to stand ready to assist the Inclusive Framework.

In this spirit of cooperation, we wish to share several perspectives: (1) the importance of grounding the Pillar One and Pillar Two frameworks in rational economic principles that are broadly understood and agreed; (2) the anticipated negative effects arising from overwhelming complexity inherent in the proposed frameworks; (3) the value of "framework-proofing" agreed measures to ensure their long-term viability and administrative simplicity in practice; and (4) technical concerns with various elements of the Blueprint documents for which we offer suggestions for further improvements.

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I. Policy principles - Pillar One

The OECD has identified a list of overarching tax policy principles it believes should underpin the search for any redesign of the international tax system with regard to issues arising from the digitalizing economy – neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. Without clear economic concepts that unify the entire endeavor, however, we believe this rational list will be insufficient to yield enduring political agreement among governments or to guide interpretation and implementation once agreement is reached. Therefore, in our view it is essential that the frameworks developed be explicitly tied to economic principles, applicable from conceptual agreement and technical construction to implementation methods.

For example, one reason the current international profit allocation regime has remained in place so long is its anchoring in a rationally articulated principle: that profit should be allocated among the jurisdictions where the functions, assets, and risks are located based on the separate enterprise method. A viable alternative - unlimited fractional apportionment - was discussed almost a century ago and then firmly rejected. For decades, most governments have thus relied on an articulation of the arm's length principle and profit attribution to identify the circumstances in which corporate profits are recognized in one jurisdiction versus another. It's widespread use is the result of being an agreed, concrete economic principle which ties the allocation of profit to the economic activity in a jurisdiction. While criticized for various perceived deficiencies, it has been an animating principle that has helped preserve a measure of certainty in the international tax arena for a substantial period of time. That governments have been able to use the arm's length principle to review and risk assess millions of intercompany transactions, which have largely been found satisfactory, demonstrates how much of a cornerstone it has become in the cross-border trade in goods and services. Indeed, the legal and economic rationales behind the arm's length principle are known and shaped by multilateral consensus, providing reasonable certainty and administrative grounding. This is not an argument for the status quo, but merely illustrative of what Pillar One must become: a rooted economic principle to which governments assent, articulated by interpretive guidelines with tolerance for dynamic changes in business models and economic/trade evolution in the years to come.

The BEPS Action 1 report and subsequent interim report on the digitalizing economy offered several competing rationales for revised profit allocation rules. For example, the concept of value creation was early on a driving force in the discussion surrounding the Inclusive Framework's digital taxation project, but is no longer found referenced anywhere in the Pillar

One Unified Approach. The Pillar One Blueprint instead espouses the goal of devising new nexus and profit allocation rules to ensure that “the allocation of taxing rights is no longer exclusively circumscribed by reference to physical presence” and that the new rules are “based on net basis taxation, avoid double taxation and should be as simple as possible". But in crafting an approach to expand the taxing rights of market jurisdictions where there is active and sustained participation of a business in the economy of that jurisdiction, instead a formulary approach is being proposed – there is no articulated principle on which to anchor Pillar One.

A principled approach should facilitate agreement and prove to be more sustainable over time. The principle of value creation as laid down in the BEPS 8-10 reports of October 2015 may be used as the basis for a more principled approach. The idea behind allocating taxing rights to user jurisdictions would seem to be the belief that users of certain online services (regardless of the industry, sector, or product) create value for the relevant enterprise. If one could identify that value by reference for example to the investments made to reach those users, one may be able to prevent drifting of the tax base among production/DEMP jurisdictions and market jurisdictions.

Yet, in an effort to accommodate political agreement among the Inclusive Framework members, the Pillar One Unified Approach seems to have been decoupled from an identifiable principle. This gives us concern for the reasons explained above and because an unprincipled solution may not be very sustainable due to changing political interests and priorities. Unprincipled solutions could strengthen governments’ belief that they should safeguard their tax base by exercising their sovereign rights inconsistently with a Pillar One agreement.

Without a solution that is rooted in a principled rationale, the risk of administrative practices that lead to divergence from the final solution that would undercut the whole exercise would be significant.

It thus seems useful and necessary to once again revisit how Pillar One should be constructed as a principles-based approach, even at this stage in the work. While taking time to embed clear principles into the Pillar One framework may distract from ongoing technical work, it could actually give ongoing political negotiations a stronger purpose that may well lead to a greater sense of international understanding and commitment over the long term.

II. **Scoping with respect to Amount A**

The Amount A determination and allocation add significant complexity to the international tax system, and seem to be driven by what is politically achievable. This complexity could

potentially hamper the sustainability of an eventual consensus, not in the least because of the difference of administrative capacity between various countries. We realize that in this stage of the process drastic simplification suggestions could be perceived as counterproductive, because countries may sense that we are now in the process of further refinement of the draft rules. A principled approach may be refined, but a negotiated approach that is not grounded on principles becomes more complex as the details are designed, which can lead to further dissent. Further complexity may be detrimental to achievable implementation and tax certainty. The scoping rules and the subsequent segmentation rules and revenue sourcing rules are very detailed and complex already, and one must assume that we are only at the beginning of providing workable guidance given the many questions that still remain. The Amount A application may benefit from either a far more narrow scope of the activities subject to Amount A, or on the other side of the spectrum from a very wide scope, i.e., by including in-scope all MNEs with global revenue above an agreed threshold.

III. Towards a netting system between governments instead?

The policy goal underlying Pillar One – and likely the political goal of Amount A – is to facilitate a reallocation of tax revenues between countries by giving more taxing rights to market jurisdictions. Under the current design of Pillar One, a very complex system has been designed on the basis that tax revenue is divided by allocating profits of a taxpayer based on sales or consumer location, leading to a myriad of complex calculation and administrative issues (e.g., determining the surrendering entities, paying entities, addressing double counting issues, taking away double taxation, establishing panel mechanisms and new arbitration mechanisms, etc.).

There is widespread consensus among policymakers that Amount A is to be regarded as an overlay to the current international tax system, with a separate tax base, separate allocation rules, and separate nexus rules. Pillar One leads to an estimated reallocation of around 100 billion USD of profits. By involving taxpayers in the reallocation mechanism, we believe that tax certainty is a challenge, the risk of multiple taxation is material, and implementation costs will be disproportionate in light of the policy rationale. An important question to consider then becomes: could the same reallocation of profits be realized using the concepts developed to date, but without involving the taxpayer? In other words, if the taxpayer provided governments with limited data on their user/customer locations, could governments then reallocate tax revenues among themselves, using the concepts developed for Amount A? Countries would need to design a netting mechanism for that purpose, e.g., by using their current accounts with the IMF for the

net transfers of tax revenue[1]. A netting system between countries would put responsibility for the reallocation where it belongs (with governments).

IV. Viability testing

An additional consideration involves how to translate the extensive Pillar One Unified Approach programme of work carried out so far into a realistic model of administrable success – both for governments and in-scope MNEs. We acknowledge the sustained and mounting pressure to reach political agreement in short order to diffuse the rising tensions leading to unilateral measures; but that should not prevent the Inclusive Framework from pursuing as part of the overall negotiations a testing process to ensure final implementation of any agreement is fit-for-purpose.

The undoubted aim of the Inclusive Framework with Pillar One is to produce a rational system whereby conceptual changes to profit allocation and nexus rules, remuneration of certain marketing/distribution activities, and dispute prevention/resolution mechanisms are practically aligned with intended results. The challenge is moving from the conceptual to the practical, but this can be aided by an intervening pilot of an "agreed-in-principle" framework while still reserving on final implementation pending review of the trial results.

The shape of this framework-proofing could take the following form (merely as an example): (i) a political agreement on Pillar One would expressly reserve on finality while a testing phase is carried out; (ii) testing of the system based on the political agreement and technical elements agreed to date (i.e., before changing the treaties and domestic legislation) for a certain period involving a small number of MNEs and tax administrations who already volunteered to participate in the International Compliance Assurance Program (ICAP); (iii) a subsequent (e.g., 6-month) intensive review of the technical framework based on the profit reallocation pilot, with any resulting recommendations subject to approval by the Inclusive Framework; and (iv) any agreed changes are incorporated into a revised Pillar One political framework that is then systematically implemented by concurring Inclusive Framework members.

There is already established practice for elaborate testing of administrative risk assessment programmes, such as ICAP. While a Pillar One viability test would involve more taxpayers and tax authorities than ICAP, with a much broader technical scope, there is demonstrated ability and willingness on the part of taxpayers and authorities (with OECD Secretariat assistance) to

[1] See for an established equalisation system: Fiscal equalisation the Swiss way, Worldbank, Worldbank, Fiscal Equalisation

conduct comprehensive pilots of the type needed for a dry run of the Pillar One mechanics. Given the high stakes associated with Pillar One, it is reasonable to assume that a number of potential in-scope MNEs together with the tax administrations involved would volunteer to test out the mechanics of Pillar One on a hypothetical basis if doing so helped identify gaps, gross inefficiencies, and problematic administrative procedures that could lead to corrections of the Pillar One architecture, or even to understand if the suggested approach is feasible at all.

This suggestion is made with the intent of keeping forward momentum by not slowing down the political will to see a global consensus emerge on digitalization issues, while at the same time providing a specific process to rationally stress test the envisaged system in order to ensure that the process and outcomes align with the agreed policy objectives and can be supported by the range of technical capabilities of Inclusive Framework members.

V. Policy principles - Pillar Two

The Pillar Two Blueprint formally addresses “the remaining BEPS issues”. In fact Pillar Two is an agreement to adopt the principle of Capital Export Neutrality (CEN) for situations in which the Effective Tax Rate (ETR) does not meet a certain threshold. We of course do not dispute the sovereign right of countries to agree on an extended CEN principle, but welcome additional clarity about the principles countries wish to establish under Pillar Two. Clarity about the principles will be helpful to align Pillar Two with the efforts of the OECD Forum on Harmful Tax Practices and the EU Code of Conduct Group on Business Taxation. Clarity will also contribute, for example, to the analysis of the compatibility of the IIR/UTPR with art. 24 of the OECD Model Convention and of the compatibility with EU law, which is not addressed by the IF, but which is crucial for the ability to implement Pillar Two. We are deeply concerned about the complexity Pillar Two adds to the international tax system and about the lack of certainty with regard to the determination of the amount of top-up tax and the allocation of the top-up tax among countries under the UTPR. Indeed, the level of complexity of Pillar Two as described in the Blueprint will almost certainly prevent it from being enacted into national legislation of IF members in a consistent, coherent manner. This, in turn, will result in a dramatic increase in disputes between tax authorities and taxpayers and significant double taxation. Put simply, if Pillar 2 is not dramatically simplified, it will fail to achieve its objectives. Regarding one aspect of this, we suggest the Inclusive Framework consider expanding the scope of the panels that are established for Amount A to the determination and allocation of the top-up tax. In Annex 3, some suggestions are provided to consider potential simplifications to the international tax system outside Pillar Two.

VI. Technical Matters

Finally, we wish to share with you several technical matters regarding the published Reports on the Pillar One and Pillar Two Blueprints. Annex 1 and Annex 2 aim to respond to a number of the specific complexity questions about technical issues raised in the consultation document on Pillar One and Pillar Two, respectively. Annex 3 provides some other thoughts we believe constructively seek to move matters forward on the Blueprints. These annexes should be read in the context of the reflections on principle set out in this letter.

VII. Conclusion

We again thank you for your willingness to engage with stakeholders to ensure the long-term success of the significant changes being considered to the international tax regime.

Yours faithfully,

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Annex 1

Annex on questions posed in relation to the Pillar One Blueprint

The material discussed in this Annex is included on the basis of the request from the OECD in the consultation document to address matters of simplification. Our covering letter refers to our views on the principles that should help drive the project, both as a whole and in relation to Pillar One or Pillar Two individually. Annex 1 and Annex 2 then aim to respond to a number of the specific complexity questions about technical issues raised in the consultation document on Pillar One and Pillar Two respectively. Annex 3 provides some other thoughts we believe constructively seek to move matters forward on the Blueprints. These annexes should be read in the context of the overriding reflections on principle set out in our letter.

I. The activity test to define the scope of Amount A

- Our covering letter refers to the objectives of the project and the clarity of the measures addressing them. The scope of Amount A is a critical issue in that regard. The need for tax certainty requires a very clear understanding including, if it is to be an activity test, the meaning of the word 'activity'. There may be some benefit in considering the meaning of 'economic activity' used and interpreted widely for VAT purposes. There will be many calls for particular activities to be excluded from the scope altogether or in particular circumstances, so an approach based on clear principles rather than ambiguous segments might be more straightforward.
- Many groups will carry out multiple activities. If groups with widely diversified activities are to be in scope, consideration could be given to the extent to which it would be helpful to identify more than one main activity and location.
- Ideally, the test(s) would be based on established criteria but also have a view to the future. That would suggest not being business model specific, as there are already many variants and groups may employ a large number of different models. Business models are also evolving constantly and new business models are regularly established.
- Positive and negative lists are likely to be helpful, more so if they are shown to be illustrative of the stated principles rather than raising additional uncertainties about scope, as we have seen in some contexts.
- We address the review panel in section XI, but it should be ready to address many questions involving scope in order to aid in interpretation of the legislative design and any official guidance, as we've seen for example in relation to DSTs. The outcomes could be used regularly to review the guidance.

II. The design of a specific Amount A revenue threshold (in addition to a global revenue threshold) to exclude large MNEs that have a de minimis amount of foreign source in-scope revenue.

- Part of the rationale for introducing the foreign in-scope revenue test is, as set out in para 182, based on excluding businesses whose in-scope revenues are concentrated in a single jurisdiction. The other part is excluding MNEs that do not earn more than the de minimis foreign in-scope revenue threshold amount from in-scope activities. The determination of the threshold is largely a political question, but an absolute figure of EUR250m (as used by way of example in the

Blueprint) has some resonance if the global group overall revenue threshold were to be EUR750m.

- On that basis, one might assume the UPE could potentially be ignored and a simple way to differentiate between the home market and foreign markets might be to determine the former as the country with the largest in-scope revenues. Otherwise, if the UPE is located in country M, and that determines the home market, but the group only realises in-scope revenues in country N, and those exceed the threshold, it would mean the group is still subject to Amount A. Using Year-1 revenue data would have the advantages of administrative simplicity. Where a group is on the tipping point this may give rise to uncertainty throughout the year where they may only know if Amount A applies after closing of the accounts. At this point it may be too late or extremely burdensome to apply certain aspects of the Pillar One framework (e.g. linked to revenue sourcing & retrieving data from third party distributors or changing the ERP setup to retrieve certain data points).
- If the UPE has significant business substance and/ or assumes economically significant risks for the group, there is an increased argument that its location should be the home market. However, the UPE may just operate as the group holding company. Hence, it might seem more reasonable, but more complex, to define the group's domestic or home market as the jurisdiction (e.g., group headquarters) that sustains the significant business substance and/ or assumes economically significant risks for the group. To assess the business substance for defining the domestic or home market, you could consider a similar approach to what has been suggested with the CbC Report ETR Safe Harbour concept raised for Pillar Two as a simplification measure, i.e. to leverage the available financial information contained in the CbC Report. This information might consider, for example, total revenues; number of employees; tangible assets other than cash and cash equivalents; business activity; other factors.
- Alternatively, one might think of a mixture of criteria that combine elements of all of the above, to satisfy different demands but prevent over-manipulation. For example, with priority to be added, the determination of the home market could involve things like:
    - Where the UPE is situated, provided at least X% of in-scope revenue is generated there
    - Where substance and risks are located outside the UPE, provided at least X% of in-scope revenue is generated there
    - Where the largest in-scope revenue is generated, even if there is no existing presence,

III. The development of a nexus rule

- According to the Blueprint, the new nexus rule(s) will be based on indicators of a significant and sustained engagement with market jurisdictions. In other words, absent this engagement with a jurisdiction, none of a group's profits will be reallocated to that jurisdiction under Amount A. It might be helpful to clarify that this will be a rule supplemental to the existing PE nexus which determines that functions, assets and risks will lead to an ALP return in absence of Amount A or Amount B and a return of at least that return where there is an Amount A allocation or Amount B determination (but the need to avoid double counting).
- While the Blueprint states that the revenue threshold for ADS nexus may be less than the threshold for CFB nexus (both apparently political decisions although a principled approach would be preferable), these will need to be carefully defined/ sourced and a decision made as to whether to use absolute figures or to factor in features of spend in a certain jurisdiction such as by

incorporating macro-economic indicators such as GDP (e.g., relative amounts or categories such as low/ middle/ high income countries).

- As regards the potential inclusion of 'plus factors' for CFB, there are a number of arguments.
    - The use of plus factors is inherently more complex and is likely to result also in further complexity so there may be a concern that the burden on those with CFB could potentially outweigh the benefit.
    - The ability to participate in the market in relation to CFB will likely differ on a company by company basis. As such, principles-based criteria to determine what constitutes ability to participate in the market may always be an approximation or compromise.
    - There could be a tipping point where a given level of CFB revenues gives rise to a new taxable nexus anyway even if the plus factors are absent - sheer size could be an indicator of significant and sustained engagement in some cases but possibly not in every case. An extension of this might involve the exclusion of plus factors in exchange for a slightly higher revenue threshold.
    - A "physical presence test" could imply an extension of the force of attraction rule that all profits that the enterprise derives from that country - whether the transactions are routed and performed through the PE or not - are in scope. Indeed, take the example of a physical presence in the absence of a sales entity such as the case with a toll manufacturer. One may wonder whether it would be required to allocate income and if so what the rationale would be behind such an allocation. By the same token even an independent sales agent could trigger deemed presence. As a matter of principle, unaffected by the Blueprint, a "presence" should already receive an AL remuneration (or amount B in case of an LRD); the paying entity may not be the same (and will likely not be the same) as the taxpayer in the country.
- It may be important to consider whether the introduction of new nexus thresholds could result in unintended consequences on the existing guidance in relation to PEs through interpretation by tax administrations. Some administrations may see a weakening of the existing guidance by interaction with or overlay of alternative rules.
- An engagement could only be sustained by reference to a particular period of some length. Such a requirement would avoid covering isolated or one-off transactions and the longer the period the greater the extent to which the degree of permanency would be required.
    - One year may be relatively short in relation to many circumstances.
    - A meeting of the threshold during each of the [say 3-5] financial years directly preceding the financial year in question would provide a considerably more robust presence test and provide some relief for market entrants if that were to be considered helpful.
    - Application based on the average of the [say 3-5] financial years directly preceding the financial year in question would mitigate the impact of cyclical changes and avoid dipping into and rolling out of the system again on a nearly yearly (or regular) basis.
    - Giving taxpayers the option of using the average over the prior [say 3-5] years might have some advantages over a single year determination, including dealing with new market entrants.
    - Whether a period of 3 years or longer might be considered appropriate for any multi-year calculation is perhaps most relevant to long-standing businesses. In this regard the period could be reviewed on a regular basis and adjusted accordingly. Information may not be available for the past 3 or more years in year 1 of the rules, particularly if sourcing rules were to require sales data from third party distributors, in which case a phasing in

of the requirement might allow the taxpayer to use only one year's data in year 1, two years in year 2 and so on.

IV. The development of revenue sourcing rules

- The Blueprint provides complex sourcing rules, including a hierarchical list of the acceptable indicators for both ADS services and CFB, together with specific rules on documentation requirements for MNEs. This may significantly increase the implementation burdens of MNE groups. We refer to this, combined with complexity added by scoping and segmentation, in our covering letter.
- In particular, this applies as regards the suggestion that an MNE needs to first justify that the information of the current indicator is unavailable (if it is not within the MNE's possession, and reasonable steps have been taken to obtain the information but these have not been successful) or unreliable (if the MNE can justify that the indicator is not a true representation of the principle in the source rule) before applying the next indicator in the hierarchy.
- Rules/ requirements that are distortive of business practices could increase transaction costs and affect business decisions/ activity in a way that would have a negative impact on economic stability and growth. Attempts could be made to utilize the information generally available as part of normal business practice and use it to apply the revenue-sourcing principles with some degree of flexibility afforded to taxpayers. Taxpayers should not be asked to "change the contract" with unrelated parties in order to comply with tax reporting requirements.
- Perhaps there is something to be learnt from the US FDII regulations in certain respects and the change between the proposed and final regulations, e.g., the ability to rely on statistical sampling, and more generally estimations/approximations that can be shown to be unbiased, reliable and true to the destination-based principle (which is the outcome intended under the revenue sourcing principles), etc.
- Alternatively, one could adopt a "white list" of certain jurisdictions whose rules are generally in line with the rules of Pillar One. This could extend to alignment with those existing sourcing rules that are considered appropriate for jurisdictions that have launched DSTs.
- Indicators that are consistent with information already being collected by MNEs, such as VAT sourcing rules, would also seem to be more efficient.
- Bearing in mind existing privacy/ confidentiality rules in determining the information that can be sought/ used would potentially avoid conflicts which would make compliance difficult or illegal. One could go further and suggest that this extend to information customers might reasonably be expected/ able to provide. A cost/ benefit analysis should perhaps be the controlling factor here.

V. The framework for segmenting the Amount A tax, and how it could be further developed to deliver its objectives

- Segmentation could be used to introduce a closer link between the tax system and the economic reality of various multinational groups engaged in different activities characterised by different profit margins. Segmentation would, it is often argued, prevent more profitable business lines and markets from subsidising for Pillar One purposes low profitability business lines and markets.
- The Blueprint provides for applying a segmented approach subject to exemption for MNE groups 1) with global revenue less than EUR [X] bn, and 2) having a relatively homogenous business. Subject to the threshold amount of the abovementioned global revenue and the operational

nature of different business lines (in particular with carve-out business), a number of MNE groups may still not be exempted and thus mandated to calculate the Amount A tax based on a segmented basis. For reasons discussed below, the strict requirement of the segmentation basis relying on the disclosed operating segments included in financial statements and the complexity of allocating overhead costs suggests it may be more pragmatic to make the segmentation basis as an elective option for MNEs.

- Segmentation presents challenges in some cases and may not fit all multinational groups in the same way. Segmentation within financial accounts is determined by how the management runs and operates their business across different business lines and different geographical areas. In addition, for companies with products and services sold to both the final consumer and other businesses (e.g. washing machines sold to private households but also to hotels), business lines are not run and operated based on whether they are "consumer facing" or not. Hence, differentiating global businesses profits would require significant extra work and data. For the same reason, it is difficult to understand how segmentation can be harmonised across different multinational groups which are run and operated differently by their management.
- There is a "rebuttable presumption" in the design document which implies that the vast majority of MNEs will be able to utilize existing financial statement segment reporting, as opposed to having to create a separate "alternative segment". How this will be ultimately determined could be made clearer to avoid the risk that MNEs would need to report under alternative segment(s), which may require a separate set of segments accounts/ creation of additional administration and compliance. It is worth noting that segment reporting is not required for private companies nor for entities/ investments accounted for using the equity method (perhaps this is not an issue if it is adjusted from the tax base).
- Additional guidance may be required to supplement the rebuttable presumption for segment reporting where the basis of financial statement segmentation changes. Financial statement segment reporting is intended to present disaggregated information of a business in terms of how the group's management views the business. This will change over time based on new management, shifts in the business, etc. and decisions will be needed on the tax calculation if segments are changed and whether a recomputation may be appropriate.
- Profitability measures of activity segment reporting are not consistent among companies and likely will not alone contain the level of detail required to determine the tax base under Pillar One. Additional rules may be required when management review segments at operating income, EBIT, EBITDA, and/ or a combination of profitability measures.
    - Although the Blueprint provides a simplification option of using a revenue-based allocation for central costs between segments, it meanwhile addresses that this option would be available only where the proportion of central costs to be allocated between segments falls below a given percentage of total group or segment costs. In reality, the proportion of central (indirect) costs could vary significantly among industries. For example, a MNE group in digital economy may engage in provision of certain high-profit online ADS services, and meanwhile invests significantly in customised cloud computing business (carve-out business) with losses incurred within a certain period. In this case, a segmentation appears to be necessary for the MNE group. However, it would potentially face great challenges of applying the revenue-based allocation given that normally the ratio of central costs (e.g., bandwidth costs) over total in this industry would be much higher than traditional industries. In this regard, it is suggested to set a high threshold for

this simplified cost allocation approach or determine a set of thresholds by taking account of the different cost structures by industry.
    - Some adjustment may be considered for where the allocation of costs is not done on an arm's length basis within segments (i.e. head office costs often get left in a corporate segment).
- IAS 14 has been superseded by IFRS 8, which is similar to US GAAP. It would seem appropriate to change the reference from IAS 14 in accordance with existing GAAP used to report income.

VI. Loss carry-forward regime

- In principle, the loss carry-forward objectives set forth in paragraphs 473 and 474 might seem to be best served with a symmetric treatment - i.e., calculation and allocation of (residual) profits and losses to market jurisdictions. However, for the reasons described in paragraph 479 this may be difficult to implement in practice given the nature of the "new taxing right", the standalone concept of nexus associated with this taxing right and the time-variant set of market jurisdictions that will possess the taxing right (with respect to a given taxpayer). With that being said, that scenario does offer a useful benchmark to evaluate/ compare other alternatives that are more practically implementable.
- According to the Blueprint, the loss carry-forward regime will seek to ensure that Amount A is based on an appropriate measure of net profit. Complex discussions about 'old losses' and new market jurisdictions could be avoided if as a transitional measure a compromise were agreed on the number of years to do a national Amount A calculation to determine losses prior to the rules entering into force. Strictly, the extent to which a transitional regime is needed to allow groups to recover the costs of investment undertaken before the introduction of Amount A (i.e., distortions arising from the timing of introduction of the new taxing right), and prevent a reallocation of profit under Amount A hinges on the principle of economic profit.
    - Tax losses of earlier years being offset against current year taxable profits enables businesses to recoup losses reflecting costs of their investment, and place businesses with volatile profit in the same position as those with more stable profit. This seems like an argument for allowing all pre-regime losses rather than some estimate over a limited period, notwithstanding that it would treat pre-regime losses and pre-regime profits differently.
    - The asymmetry could be used as an argument for deducting pre-regime losses against future Amount A in-regime profits only up to a certain time limit, as it could lead to inappropriate results and is a bargaining chip to accelerate the consensus to be reached among IF members. Some have suggested the time period could be the same as the temporal requirement for the market revenue threshold for nexus rules, so as to maintain a consistency in Pillar One design and facilitate the implementation. Others argue an unlimited period more directly meets the objectives.
- Once Amount A is up and running, a carryforward regime that is structured around "profit shortfalls" instead of losses seems more consistent with the overall objectives of allocating residual profits to market jurisdictions while safeguarding the taxing rights of residence jurisdictions (paragraphs 473 and 474).
    - A regime that allows for a carryforward of profit shortfalls (including losses) and offsets current-year residual profits against prior-year profit shortfalls (instead of just losses)

lead to an economically equivalent outcome over a period of time (e.g., when a group's or segment's profitability varies around the Amount A profitability threshold over time).
    - By extending to profit shortfalls, a carry-forward regime would: 1) improve neutrality by ensuring that Amount A does not apply differently to taxpayers with volatile profits from one period to the next; 2) allow Amount A to better adapt to unpredictable economic situation; 3) be more consistent with transfer pricing methods, such as the TNMM, rely on average financial data over a number of years, and without the administrative difficulties of an averaging method; 4) improve the accuracy of the measure of residual profit subject to the Amount A formula, by ensuring that only profit in excess of the profitability threshold calculated over a longer period (and business cycle) is reallocated to market jurisdictions. In comparison with routine profitability, residual profits are much more volatile and easily impacted by both the MNE group's internal operations and external market environment. Accordingly, it is common in tax administrative practices that a relatively stable profit level is required for routine entities with tax adjustment conducted on a year-by-year basis, while multiple-years data review is normally required for assessing the reasonableness of residual profit splits. The rationale for Amount A to allocate market jurisdictions a share of profits above a threshold designed to limit interactions between Amount A and existing profit allocation rules, rather than routine profits, appears consistent with this treatment of profit shortfalls.
    - The profit shortfall system is not about averaging, but an adjustment similar to that relieving losses except that the baseline is not zero but a PBT/ revenue ratio equal to a percentage (e.g. 10%). In the same way that in general tax systems companies are required to pay tax as soon as their profits exceed zero, the amount A tax is only payable if the PBT/ revenue exceeds a certain ratio. The amount A tax will be exactly the same regardless of whether the group makes losses or earns an amount (say 9%) that is less than the PBT/revenue ratio. As such, any difference in treatment between both groups would seem artificial.
    - Disregarding profit shortfalls will have no or a limited impact on the tax burden of many taxpayers since it would primarily be of aid to companies which are around the [10%] PBT/revenue tipping point. But it may reduce the need for those tipping point companies to enter into the complexity of Pillar One when the impact and tax paid would be minimal. Not including the profit shortfall would have these types of companies hop in and out of the rules leading to minimal tax revenues but a significant compliance cost for the companies as they would be required to collect all the data and adjust their ERP system to allow for it.
    - Compared to the overall Pillar One proposal the profit shortfall system seems to be a relatively easy element to administer.
    - Further work may need to be done to determine whether stricter time limits would need to apply to profit shortfalls compared with losses, on the basis that accounting for profit shortfalls over an excessively long period would lead to inappropriate results.

VII. Double counting issues arising from interactions between Amount A and existing taxing rights on business profits in market jurisdictions

- In principle, the "netting off" approach should work to alleviate/ address double-tax and double-counting issues for both centralized and decentralized models as long as the principles of the

four-step approach (or some variant of the process) to identify payor entities is followed fully and consistently. In the case of decentralized models (e.g., where full-risk/ entrepreneurial distributors claim some residual profit/ loss under the ALP), this means that those local entities in the market jurisdictions be identified as potential payor entities as long as the profitability test is met - likely based on returns on deemed routine returns on tangible assets and payroll expenses. Each such local entity would potentially share in the burden of providing relief against Amount A subject to the requirements of the profitability test (and if applicable, the market connection priority test). To the extent that a local entity in a given market jurisdiction does not bear this burden for reasons of insufficient profitability, such an outcome is not inconsistent with an IP-owning entity in a centralized model not having to bear this burden because of the same reason (i.e., insufficient profitability). The netting-off of Amount A allocations to market jurisdiction against relief provided by one or more of the same jurisdictions based on a commonly applied process would then avoid double-tax and double-counting concerns.

- In contrast, a marketing and distribution profits safe harbour ("MDPSH") - no Amount A allocation where a group already allocates and actually earns residual profit in the market - raises a number of issues including potentially leaving double counting issues unresolved.
  - Calling this a marketing and distribution safe harbour is problematic, because it may infer that Amount A only relates to marketing and distribution profit, when in fact the residual being reallocated is not strictly subject to such a characterisation. If it is intended to refer only to a marketing and distribution allocation, it could be worth exploring whether an agreement could be reached which limited the Amount A payment in situations where a business was posting any returns in excess of a certain percentage of system profit in the end market. As with the calculation for amount A itself, this would not be based on the ALP. It might be more appropriate to simply set a threshold which does not differentiate between activities in the destination territory and instead state that if a certain portion of system profit is recognised in that territory (regardless of the function it attaches to) then Amount A should not apply.
  - A key technical challenge will be the identification of marketing and distribution related profits, if it is intended to be limited to those profits. Some areas of concern could be brand related returns both as a licensor and local IP owner, warehouse/ logistics, use of certain manufacturing facilities to perform marketing, central marketing function for other markets etc.
  - The question may also need to be addressed as to the alignment of the MDPSH and Amount B. The fixed return for MDPSH could be determined in different ways, for example by (i) making reference to the % determined for Amount B - albeit being applied for a different purpose and to a different revenue base or (ii) formulaic (i.e. fixed percentage). When looking at a formulaic % this will likely be a case of reaching consensus among the countries. If a formulaic approach would be taken, a single rate would be the most straightforward absent variations by industry/ region. The example mentioned in the blueprint (para 545) where pharmaceutical companies' distributors earn higher profits and therefore require a higher minimum margin causes an internal conflict. Insofar as the purpose of the MDPSH is to avoid double counting (i.e. where profits are in the market already), if a certain company, group of companies or industry typically leaves more profits in the market already this means that there is less of a need to allocate additional taxing rights as the objective is already reached (in part). In addition, the MDPSH for high margin industries would by definition be higher as the Amount A allocation is simply higher. As such, if the fixed return is increased as well

there is an additional impact for high margin businesses (on top of the fact that due to the rule design high margin businesses will already need to proportionally reallocate a higher share of their total system profit compared to lower margin ones).
    - As a particular illustration of potential double counting, in the example in Annex C, Box C.2, if the MDPSH approach absolves Distributor 5 of providing any relief from Amount A allocated to other market jurisdictions -- when in fact, a consistent application of the four-part process would have identified the entity as a payor entity -- the MDPSH approach would leave double-counting issues and potential unresolved.
- The issue identified in para 532, is the scenario where the residual profit owner does not pass the profitability test. We wonder whether a change to step 2 of the surrendering framework could be contemplated. Specifically, step 2 could be seen as not being required in cases where there is a netting off (i.e., where the surrendering entity owning the residual profit is based in the country where Amount A is allocated). The result would be that countries where residual results are allocated do not receive an Amount A (subject to the residual profit/ loss being linked to the revenues attracting amount A). Not doing so would mean that entities performing badly receive support payments from entities performing better. Making this change to step 2 would remove the need for the MDPSH as currently proposed. A key question here may be whether local residual profit owners should be carved out in all cases (the change to step 2) or only if they are profit making (the current proposal).
- To the extent that withholding tax is imposed on revenue which generates the non-routine profits in the local jurisdiction upon which the Amount A tax is imposed, it should be creditable against the Amount A tax if double tax is to be avoided.
- The purpose of the domestic-to-domestic business exemption and the meaning of domestic could be more clearly defined.
    - If the purpose is to avoid double counting the modification to step 2 as outlined above might be a more simple solution, It is in intended to remove these businesses from Amount A altogether and re-perform the exercise (in full, or in part e.g. only the surrendering piece) absent these businesses, that may lead to some administrative simplification. Absent the modification to step 2, it might be mandatory because of the impact on the overall profit allocation and avoidance of double counting but it could be made optional if only administrative simplification is sought since the ERP and reporting changes to allow for such tracking may outweigh the benefit gained.
    - The approach taken to identify a domestic business could be qualitative or quantitative. A quantitative test could involve one or more thresholds (e.g. costs as a % of revenue - likely with certain adjustments such as removal of third party cost disbursements). A qualitative test could look at whether the profit base of the entity is untested (i.e. it is not determined through any of the traditional TP methods nor the TNMM).
    - The implications might need to be further considered where the UPE is not situated in the jurisdiction where the main activity takes place.

VIII. Process to identify the paying entities for the purpose of eliminating double taxation

- We refer to various aspects of the four-step test for identifying payor entities in section VII above. A further overall simplification would be to focus on the outcome per the OECD TP Guidelines to identify the residual profit owners e.g. as set out in para 588. This would avoid the need for

significant guidance on criteria to define the surrendering entity ultimately seeking to replicate the outcome of an analysis under the OECD TP Guidelines.

- A simplification to the step 1 activities test may be to consider all entities earning residual profit under the principles of the TP Guidelines. This would, at the same time, avoid the need to replicate the process/ guidance around the identification of surrendering entities through existing concepts such as DEMPE and rather refer to the existing principles.
- Performing a profitability test as in step 2 could lead to unintended consequences without some other modifications. If applied at an entity level it could result in potential differences depending on the legal entity setup within a given country (e.g. having multiple activities in the same legal entity versus separate entities). This could be addressed by, similarly to Pillar Two, applying the test on a country level basis. As it is an ability to pay test, this would dictate that the credit/ exemption should also be made available to all entities within the country. It may for example be the case that the 'surrendering entity' does not meet the threshold on a standalone basis but, on a country level, the group does pass the test. It would not be recommended to apply the step 2 profitability test instead of the step 1 activities test. Doing so may lead to strange outcomes whereby for example a limited risk manufacturing plant with largely depreciated assets or a shared service centre with no/limited assets relying heavily on systems rather than employees may be identified as the surrendering entity. The complexity described in the blueprint when it comes to the application of surrendering rules to decentralised models could be reduced significantly by making the change to the step 2 profitability test as set out in section VII (i.e. remove the step 2 requirement in case of netting).
- Insofar as the objective of the BEPS action plan was to align profits and value creation, the inclusion of the step 3 market connection priority test (MCPT) seems to retain this principle for, without it (or changing to a formulaic type of approach), taxing rights may be driven more by other factors. Specifically, those entities performing well (creating value) might lose taxing rights whereas the entities performing badly gain taxing rights. However, other issues could be considered.
  - The MCPT increases complexity, especially since the proportionate allocation step acts as a backstop and reduces the impact of the MCPT anyway.
  - If the MCPT is to work so as to achieve the intended effect, it is arguable that the Amount A allocation to market jurisdictions (potentially in a geographic region) that have "market connection" to a given payor entity/ entities should be capped at the level of the excess profits in that/ those payor entity/ entities arising from that connection. In other words, if the entity with the market connection under step 3 does not meet the ability to pay test under step 2 there should be no amount A allocation as there is no surrendering entity with an economic connection.
  - Additional clarification would be welcomed on how to allocate the amount to be surrendered in cases where there are multiple entities with an economic connection. A common example would be a regional principal paying a license to a central IP owner. The question is whether the IP owner would be considered a surrendering entity in such instance. If so, there would need to be a pro rata allocation between both entities. In doing so, it should be borne in mind that there is a high risk of over-allocating a surrendering amount to the IP owner as (1) it likely does not license to a single entity, (2) it may have PBT linked to a different business than IP ownership, (3) the IP license to the surrendering entity with a connection may not cover 100% of that entity's profit).
  - If MCPT is pursued, consideration could be given to the potential simplification offered by making it optional for taxpayers.

- The reliance on Step 4 being a pro-rata allocation of the (remaining) Amount A among other payor entities (and relieving jurisdictions) would add additional complexity while diluting the intended objective of limiting Amount A allocation (and relief against that allocation) between jurisdictions that are "connected" in some economically meaningful manner with regard to a company's (or company's segment's) profits.

IX. Scope of Amount B and definition of baseline marketing and distribution activities

- It is useful to first consider the role of Amount B in the overall architecture of Pillar One. If the intention of Amount A is to reallocate a portion of an MNC's residual profit to market jurisdictions, then it is important that there is a common understanding of where the residual profit is in the first place. It might be the case that some residual profit is already allocated to the market jurisdiction. This makes Amount B more than a 'nice to have'. If Amount B were to be removed from Pillar One, then it is possible that a tax authority may be more likely to argue that a distributor in their jurisdiction requires a higher than average profit by virtue of the fact, for example, that their market is important, or because there are features which make the sales and distribution entities there special in some way, and then to also receive an Amount A payment. It seems clear that this could involve double counting.
- The breadth of the scope of Amount B as narrow or broad should be dictated by the extent to which marketing and distribution affiliates can be characterised as benchmarkable. If an activity is benchmarkable then, by definition, it does not already contain any element of residual profit in the sense of Amount A.
    - In this respect, broadening the scope is not simply a case of applying Amount B to sales agents and commissionaires in addition to limited risk distributors, rather it would apply Amount B to the many instances where taxpayers benchmark marketing and distribution functions and apply the TNMM. This is the only way that this simplification can be meaningful and benefit a wide range of taxpayers.
    - If an affiliate is not benchmarkable then it will be because they undertake functions, own assets or bear risks which would represent such a unique contribution to an MNC's overall profit that the TNMM is not deemed to be an appropriate method. In this case a method will be applied which results in the marketing and distribution affiliate participating in residual profit (or loss). Using this logic, Amount B should apply in all cases where the TNMM is applied for marketing and distribution companies.
    - A narrower scope (such as the scope in the blueprint which limits Amount B to limited-risk distributors) would result in a situation where there are two boundaries to consider in every case: (1) The narrow boundary established by the Amount B definition; and (2) The wider boundary established in all other cases where the TNMM is applied. If the inference is that the Amount B boundary is deemed to be lower than the TNMM boundary then, unless Amount B is very low, expectations around profit levels for all other TNMM cases may become unrealistically high. Again, this calls into question whether this kind of 'expectation inflation' is actually ascribing to the market the same profit that is represented by Amount A. To add to this problem, there are very few third-party companies which can be identified as 'limited risk'. This means that the benchmarking samples for the two boundaries referred to above will be very hard to differentiate. This is touched on further in the answer to section X below.

  - Overall, the narrow definition does not seem helpful, and it makes more sense to use the TNMM threshold, which already exists, as the boundary for Amount B. This is the boundary between 'routine' and residual profit which is central to the operation of Amount A.
- The positive and negative lists presented in the Blueprint seem to be useful illustrations of the principles laid out. Building on the observations above, it seems likely that many 'regular' marketing and distribution subsidiaries would meet many if not most of these criteria.
  - If the increased certainty promised by Amount B is seen to be desirable, and the quantum acceptable, then it seems likely that companies will aim to meet the positive criteria and to avoid the negative criteria.
  - Ultimately much will rest on threshold issues such as the extent of a sales and marketing company's freedom to set prices, or to undertake marketing activity on its own account. These issues exist already, essentially they represent the threshold between TNMM and profit split methods. Whilst it could therefore be argued that Amount B wouldn't move anything forward in terms of certainty, there is still a clear benefit to narrowing down the criteria to be tested, and in particular to specifying that once met, these criteria enable a business to apply a pre-agreed level of profit.
  - In this regard it would be helpful to include an overarching statement, drawing on Chapter 1 and Chapter 3 of the guidelines, in which it is recognised that the key test is whether the marketing and distribution company undertakes functions, owns assets, or bears risks which give it sufficient bargaining power to capture economic rents. If it does not, then it should be benchmarkable, recognising that benchmarking is not a precise art, and that there is not a great deal of difference between one marketing and distribution company and another in terms of economic power.
- Amount B is said to be within the ALP, which suggests that both qualitative and quantitative indicators would be appropriate. But various complications should be considered.
  - While quantitative indicators may have a potential role to play in assessing the quantum of Amount B, they are more challenging in determining whether or not entities are in scope at all. This is primarily because inclusion in the scope of Amount B should be determined based on whether or not a business participates in residual profit, and this in turn is based on a series of judgements about whether the business owns intangibles or makes other unique contributions which mean that it is not capable of being benchmarked. Quantitative criteria are potentially relevant in these considerations, but it is hard to generalise.
  - Even if a narrow Amount B threshold is adopted, the question of whether a company's risk is comparatively 'limited' is dependent on a combination of contractual and functional characteristics. It might be possible to specify that, for example, inventory levels need to be below a certain amount, or even zero, but even this consideration is, ultimately, not determinative of where risk lies. Similar arguments can be made about operational expenditure relative to turnover, which has also been mooted as a potential threshold.
  - Another way in which quantitative thresholds create difficulty is that an organisation may find that half of their sales and marketing operations meet the threshold and half don't, and that in some cases individual subsidiaries might flip between meeting the criteria and not meeting them year-on-year. The compliance complications which would be created in these situations make qualitative indicators undesirable.

- It is common that sales and marketing activities are dealt with as a segment within a multifunction entity which carries on other activities. If the sales and marketing segment meets the definitional criteria set out for Amount B, then it is arguable that Amount B should apply (the issues noted above as regards Amount B vs TNMM thresholds would still be present, but at a segmental level). However, this does give rise to issues of determination and allocation (eg revenue of activities other than basic marketing and distribution, general administration costs etc) that may appear contrary to the concept of baseline distribution and marketing functions. Related issues might need to be considered.
    - The rest of the activities within the multifunctional entity could be argued as attracting residual profit subject to Amount A. The easiest way to address this might be to use TNMM as a general threshold between residual and non-residual activities, regardless of the function which is being benchmarked. If all of the segments within a multifunctional entity apply the TNMM then no residual should arise. Implicit within this is a determination of significant risks and their consequences.
    - Amount B will not necessarily be beneficial for an MNE. It will depend on the level at which Amount B is set, and on its application where negative returns may arise (common throughout many supply chains in the current pandemic).
- Amount B could be effective in reducing disputes, but potentially more so than the relatively narrow form envisaged in the Blueprint. The prescriptive definition will mean that much effort will be expended in demonstrating why a threshold has been met (or not). A broader definition, which equates to the TNMM threshold in the TP Guidelines would be far more effective in this regard, but ultimately, this will obviously rest entirely upon its acceptance by tax authorities. Whichever definition is adopted, the effectiveness of dispute resolution will rest on the widespread acceptance of the underlying benchmarking analysis. Better guidance (and training) in relation to various aspects of distributors might facilitate this, as also noted further in section XII below.
    - It is very common for taxpayers, for a wide variety of reasons which are enumerated in Chapter 3 of the TP Guidelines, to use regional comparables samples and to make pragmatic decisions about functional comparability. It is equally common for tax authorities to routinely disregard these samples, to insist that local comparables be used, to reconfigure samples or to argue that their territory is special and to assert that a high point in the comparable range should be adopted.
    - There may be merit in taking a step back and acknowledging the amount of time and effort that is invested in undertaking and arguing about comparables samples that all say essentially the same thing. A commonly agreed sales and marketing distribution return would simplify transfer pricing compliance and could focus disputes towards more fundamental areas such as what enables a particular MNE to earn residual profit, and what moors that residual profit to a particular location or locations.
    - Based on current experience, it seems unrealistic to expect that this kind of agreement can be reached, but it is worth trying. A starting point might be to derive a common agreement as to when a sales and marketing company is eligible for TNMM and to consolidate the various comparables search strategies which different taxpayers and tax authorities use into a unified approach.
    - The result of this kind of approach would be that tax authorities would surrender a degree of freedom to make idiosyncratic assessments concerning sales and marketing functions, in return for which they are allocated an incremental, formulaic Amount A. Tax

authorities and taxpayers alike stand to benefit from increased certainty and lower compliance costs inherent in a broadly-based Amount B.

X. The appropriate profit level indicator for calculating Amount B, and how it should be calculated assuming Amount B is based on a narrow scope

- Overall it seems likely that a return on sales (ROS) will have the most likelihood of significant acceptance, if only because it has already become the default profit level indicator (PLI) in practice.
- The main limitation of this PLI is that, without modification, it does not take account of the scale of the local sales function relative to turnover of the business. A classic example of this is the automotive sector, where the cost and risk of in-territory dealer management is negligible relative to all of the other costs and risk involved in getting a vehicle to market. This is sometimes called 'low functional intensity'. If this cost disparity is not factored in, then a ROS methodology can disproportionately reward the sales and marketing function - some entities that operate as buy /sell distributors are in substance closer to commissionaires or sales agents. This kind of disparity led to the widespread use of the Berry Ratio as a PLI. The Berry Ratio aims to measure the profit that comparable distributors make relative to their often low operating expenditure, as opposed to their turnover. It has not proved to be universally popular with tax authorities, but it is often used as a sense-check, or to establish a position within a ROS range. As a practical matter, Berry Ratio results from comparables sets tend to be remarkably consistent, and even if they are not accepted as a primary PLI, there is a strong case for using them to potentially modify ROS results.
- It should further be noted that amount B as it stands could equally apply to high volume, low margin businesses. This could result in a situation whereby the company earns a consolidated RoS equal to 2% whereby it would need to remunerate its LRDs on a 3% RoS (assuming a RoS based PLI for amount B). This would mean that the company needs to allocate more profit to its LRDs compared to what it actually earns thereby leaving a negative amount to remunerate its principal activities, IP, manufacturing activities etc. In addition, also for higher margin companies there may be instances where LRDs with minimal sales activities book significant revenues due to the nature of the business. A potential solution to this may be to introduce a 2 layer test:
    - Activity test (per our comments under IX)
    - Ability to pay test. Assuming a RoS PLI would be selected, amount B could be set at X% RoS. This X% RoS could be tested against the outcome of a berry ratio test with a range between Y% and Z%. If the X% RoS would cause the entity's profit to drop below or exceed the Berry Ratio results this could be an indication that Amount B is not appropriate for this entity and regular TP principles should be applied. The berry ratio range could be determined individually through regular TP methods to ensure the sense check considers the company's specific activities.
- If a narrow-scope Amount B is to be adopted, then it is critical to distinctly differentiate the returns for limited risk companies from other, yet still benchmarkable, sales and marketing operations. Given that the limited-risk samples are likely to be composed of largely the same companies, it will be necessary to make economic adjustments to account for the difference in risk profile. The TP Guidelines make reference to capital adjustments, which are commonly applied in practice to account for different amounts of working capital in limited risk companies

relative to the comparables set. In reality these adjustments assume that an investment in inventory holds equivalent risk (and therefore deserves an equivalent return to) an investment in a low-risk financial instrument. This potentially underestimates the importance of the riskiness and potential returns for working capital and the Amount B benchmarking process should take this into consideration.

- Even though Amount A applies at a PBT level and consistency is desirable, it seems more appropriate to apply Amount B at an EBIT level. This is for purely pragmatic reasons. Most businesses coordinate the results of their managed-margin entities at the EBIT level, leaving financing considerations to be dealt with separately. There are many reasons why it makes sense to adopt this approach. The most important reason is that the way that a business is financed bears no relation to the return from its operating activities. To set a PBT target for a company without any debt would inappropriately reduce its operating margin based simply on the fact that comparables are likely to bear some element of interest.
- Similarly, if a business is managing to a PBT level, and an adjustment is required to hit the desired margin, it would not be clear whether the adjustment should be to interest or to the non-financial transactions entered into by the business. Amongst other things this could have customs duty ramifications. The only way to manage this would be to refer to the EBIT margin of the comparables. Ultimately this would create a thin-cap style rule based on the interest levels in the comparables set, which would need to be universally agreed to.
- As an overarching point, it could be noted that many MNEs undertake regional comparables samples, and it is common for the results to be sufficiently convergent to apply a global ROS in applying a TNMM policy. An approach which differentiates by industry or region will ultimately result in the need for multiple annual reference sets, and seems practically difficult.
    - As noted above, one of the criteria for qualification for TNMM should be that a marketing and distribution affiliate does not undertake functions, own assets or bear risks which would give it sufficient bargaining power to capture economic rents. If it meets these criteria then it is not significantly differentiated from the thousands of independent marketing and distribution companies round the world. Distribution channels do sometimes differ markedly by territory, but where marketing and distribution companies cannot exert bargaining power, their returns are largely consistent. Because this is the case it seems preferable to apply a universal return, perhaps graduated based on functional intensity.
    - A sensible first step might be for WP6 to undertake a global search for independent marketing and distribution companies, using mutually acceptable search criteria and then to assess the extent that the results differ materially by industry or by geography.

XI. The development of an early tax certainty process

- The calculations and determinations of both Amounts A and Amount B do not rest on a universal principle, or set of principles, agreed by tax administrations and business that forms the underlying basis of allocation of taxable profits between countries – such as the existing arm's length principle which is still universally accepted and supported by the OECD Transfer Pricing Guidelines and The UN Practical Manual on Transfer Pricing. As mentioned in our covering letter, alternatives to Amount A that are closer to the ALP may be feasible; otherwise, to provide certainty over Amounts A and Amounts B, an exhaustive set of detailed rules will need to be

created that will prescribe the calculation and scope of these new measures. These rules will need to be adopted by each participating country through introduction into their domestic law.

- The outcome of tax certainty panels etc will have to be communicated to all those MNEs that request it and to do so within anything approaching an acceptable timeframe for business and without creating significant resource costs for both the tax administrations and MNEs involved in the process. It is not entirely clear what numbers of businesses we expect to be subject to Amount A, but if the global threshold is $1billion, some 2,000 MNEs may be in scope. A quarter of these were to request early certainty for Amount A, given the complexity of the rules and inexperience in applying them to real life situations plus the risk that a market territory might not agree to an MNE's self-assessment. Even if there is agreement among tax administrations on the scope and calculation of Amount A, the procedures that are described in Chapter 9 are of such complexity and require a speed of response and co-operation from tax administrations that is just not realistic – or at least is not observed today when looking at the time taken for completing MAPs and APAs.
- While the intent behind the early certainty process is appreciated, the complexity involved will necessitate significant periods of time to resolve the issues under review. Which will clash with domestic tax processes or aspects of Amount A taxation and will require tax years to remain "open" or subject to adjustment beyond local due dates.
- Unless there is some limitation on the numbers of those who could apply for tax certainty, the resource requirements may well be overwhelming for some tax administrations, particularly if they are often the lead tax administration for the MNE, such as the United States or Switzerland, for example. Such resource requirements might be difficult to satisfy without deploying significant resources from other tax administration work, including mainstream tax and transfer pricing compliance and dispute work. Restricting the numbers however would go against the aim of the Blueprint which sees early certainty as an integral part of the solution.
- Deciding on the criteria used for determining which tax administrations should participate on a particular review panel will in practice be challenging and require careful judgments with close regard to experience, relevance, politics and geography.
- As noted in the Blueprint, there are circumstances where the UPE would not be the most suitable constituent entity to be the group's co-ordinating entity.
    - In addition to the ones mentioned there are others such as dual-listed businesses and businesses where the UPE is a private company maybe because it is still in family ownership and another entity in the group in effect carries on the UPE role in terms of reporting responsibilities etc.
    - More generally certain UPEs mainly function as the group holding companies, as noted in section I above. Those UPEs may lack the capability of being the coordinating entity to handle the whole group's Pillar One self assessment procedures and early certainty process. Where the UPE would not be an Amount A paying entity under Pillar one, there may also be a case for the group's coordinating entity to be the Group's headquarters or one of the group's paying entities.
    - The situation in relation to certain joint ventures may need further consideration and possibly a choice of options.
    - These issues have in part arisen in CbCR cases and in practice MNEs have made sensible choices on which entity will take the lead. The proposed rules in paragraph 718 do not foresee any role for the MNE in deciding which country will be the lead tax administration, which does not seem appropriate or efficient.

- There are a number of different incentives that could be used to encourage participation by MNE groups.
  - The time taken for achieving early certainty must be of short enough duration to yield tangible benefits before tax reporting obligations kick in. Potential avenues for reaching early certainty include a “fast track” or similar simplified process for MNEs that clearly stay below the relevant PBT profit threshold. Another potential option to enhance the certainty process is a post-hoc peer review of home jurisdictions to assess certainty procedures.
  - A phased approach, beginning with the largest MNEs, would reduce workload volume while still covering a large percentage of the income allocation base.
  - The suspension of any payment of Amount A to the affected tax administrations until the process to achieve early certainty has finished, either successfully or has reached a point where no further process is available, e.g. if the MNE has to withdraw its request for early certainty. In particular, if determination and review panels do not agree with a taxpayer’s proposals, interest and penalties could be restricted (provided the taxpayer has reached a level of due diligence in raising its arguments).
  - Allow early certainty to apply for more than one year, giving the MNE an assurance that if it followed the basis of calculation for Amount A that was agreed for the first year, or there were no changes in scope, this would be acceptable to all affected tax administrations for the next, say, 3 to 5 years subject to an agreed set of critical assumptions – hence similar to an APA. Alternatively, once an Amount A had been agreed through a tax certainty process for a year, subsequent years could be agreed using a ‘light touch’ procedure between the UPE (or other coordinating entity) and the lead tax administration and would be acceptable to all other affected tax administrations. This could follow, with suitable adaptations, the process set out in 9.2.3. for the initial review.
  - Further participation by an MNE might be encouraged if the review panel process (and other processes) were more collaborative and invited the MNE to play a part in the process. At the moment this is seemingly limited to providing additional information and possibly attending a conference call or a face to face meeting, although the Blueprint thinks this will not normally be the case (paragraph 754).
  - In the contemplated panel structure, an MNE is not permitted to request a review panel if the lead tax administration does not seek one, and is not permitted to request a determination panel if it disagrees with the review panel outcome. In both cases, the MNE should be afforded the right to access the panel process, otherwise they are only left with domestic remedies, which in the case of Amount A reallocations could involve a significant number of jurisdictions.
  - Even if the panel keeps to the expected timescales of 3 to 9 months (paragraph 757), an affected tax administration not part of the panel process may object to the determination of Amount A by the panel and another process of 2 months elapses (paragraph 765), followed by another 3 month period for an affected tax administration to object to any finding of a review panel that does not reach an agreement (paragraph 770) with a determination panel taking another 6 months (paragraph 775). With the addition of the time that tax administrations will need to consult with each other over basic procedures, discuss differences in view and invitations to join panels etc, it is inevitable that this process will take a considerable time to run through and two years overall might be the typical time period in all but the most simple of cases, which in reality are likely to be very few in number.

  - It would be very helpful if OECD could prepare a map of the entire process showing the times allotted to each part of the process, even if these are still very much estimates, as well as set targets for the expected length of the entire process or its key parts.
  - The Amount A review and determination panels should be conducted under confidentiality rules and ensure that information cannot be used for other purposes. To enhance transparency of this process, outcomes from a review or determination panel could be made public on an anonymised basis. Given the expected significant number of cases on Amount A issues from which will arise, transparency will help provide consistency and greater clarity.
  - It may be that in reality the only way that early certainty can be delivered is if OECD itself sets up a standing committee with an OECD secretariat and including permanent representatives drawn from an agreed list of countries to provide the balance that OECD would like to see in panels. This would enable expertise to be developed quickly that could be converted into guidance or rules that would help other MNEs to calculate their Amount A. It would also significantly reduce the time taken in assembling panels and taking soundings from non-panel tax administrations. This could be part of the FTA for example.
- An Amount A process is vital for certainty both in determining whether a MNE is in-scope and all consequent determinations (such as tax base, segmentation, and allocation). But any additional time delay needs to be as short as possible (especially if the conclusion is that the MNE is within scope and then requests early certainty as regards Amount A). In practice there may well be considerable uncertainty about the scope of Amount A cases and, following the process set out in paragraph 782, a considerable time may elapse given the possible need for the UPE (or other coordinating entity) tax administration and potentially the tax administrations in all Inclusive Framework member countries that have implemented Amount A to discuss the question of scope (with no time limit provided) with recourse to a determination panel if necessary. While a definitive list of industries in-scope for Amount A is a useful tool, at a minimum some binding review process on scope is needed.

XII. New approaches to provide greater certainty beyond Amount A

- As regards in-scope taxpayers, the offer of access to mandatory and binding resolution in respect of all TP and PE disputes arising in relation to any of their constituent entities is suggested as a quid pro quo for the compliance burden of applying the new rules for Amount A. In reality however, this may not be much of a compensation given that many of the countries that are likely to be market jurisdictions have already signed up to mandatory binding arbitration through the MLI and, if they have not, they are unlikely to accept this proposal given their concerns on arbitration undermining their sovereignty as a nation state. It is possible that some countries like the US, which has not signed the MLI, might be willing to participate in this element, especially given that a large proportion of Amount A taxpayers will be US MNEs, but this would still need US Senate approval.
- There is currently very limited experience of arbitration as a means of resolving transfer pricing disputes. Its value so far has been in its deterrence as most Competent Authorities do not wish to hand over their work to an independent panel who will judge their arguments and which they may lose. Where cases have gone to arbitration, the binding nature of the outcome has been an important element of the process. It is hard to see that without this element arbitration is

anywhere near as effective an instrument and could be seen as little more than an advisory panel. If, as with the EU Arbitration Convention, the panel's opinion were to be advisory and become binding only when the authorities cannot agree there would be a strong incentive for tax administrations to reach agreement (although it would involve additional time). It is debatable whether the addition of peer review or statistical reporting will have significant impact given the time these reports take to compile and the limited amount of data that will be available.

- In relation to Amount B, disputes concerning Amount B would also be included under the design unless somehow it were to be considered that Amount B is not strictly a transfer pricing outcome. In either case it would seem only appropriate to include Amount B in the same proposed new arrangements as for Amount A.
- Insofar as the consultation document specifically asks for other ideas on certainty, some thoughts are included below.
    - Better scrutiny of cases before they reach the Competent Authority: once a case has reached the point where MAP is available to a taxpayer, it is often too late for the Competent Authority to do anything other than argue for the adjustments that have been made. However, there is strong evidence that early consultation with the Competent Authority by field audit teams before an adjustment is finalised, prevents disputes going into MAP. This also has the effect of significantly speeding up the resolution of all MAP cases by concentrating Competent Authority time on more material areas of dispute.
    - In terms of training and guidance, OECD could consider including practical guidance and the development of specialist training on marketing and distribution cases given their prominence in all transfer pricing disputes. The current Guidelines provide considerable guidance on intellectual property but very limited guidance of a practical nature on other aspects of the value chain. Marketing and distribution entities are the 'low hanging fruit' for many tax administrations and our studies show that these disputes form a large share of all the transfer pricing disputes that we see today.
    - Further thought could be given to the rules that govern decision-making in the panels. Any resolution process that allows aggressive market jurisdictions to object or override the lead tax authority will result in additional disputes and controversies which will take years to resolve (if ever).
    - In determining the activity test to find out which group entities bear Amount A tax liability, there could be transfer pricing adjustments leading to reclassification of a group entity which would implicate the use of the ALP in Article 9; therefore it is important to understand how any new instrument to implement Amount A will interact with the OECD Model Convention (including Articles 7, 9, and 25) and how to deal with subsequent TP adjustments on the UPE.
    - Consideration may be given to whether the time has come to create an independent international dispute resolution mechanism.

Annex 2

Annex on questions posed in relation to the Pillar Two Blueprint

The material discussed in this Annex is included on the basis of the request from the OECD in the consultation document to address matters of simplification. Our covering letter refers to our views on the principles that should help drive the project, both as a whole and in relation to Pillar One or Pillar Two individually. Annex 1 and Annex 2 then aim to respond to a number of the specific complexity questions about technical issues raised in the consultation document on Pillar One and Pillar Two respectively. Annex 3 provides some other thoughts we believe constructively seek to move matters forward on the Blueprints. These annexes should be read in the context of the overriding reflections on principle set out in our letter.

I. Chapter 1: Introduction and Executive Summary

- Many questions remain to be answered about a GILTI co-existence with the Pillar Two rules. These include the establishment of a principle that could, in theory, be applied to country regimes other than the US; whether such a mechanism could fit all four elements and not just the GloBE rules (IIR and UTPR); application of both regimes to MNE groups, including those with non-US UPE but US intermediate holding companies (and where the UPE and potentially a non-US intermediate holding company apply IIR - e.g., to determine in calculating the ETR, whether to exclude the entities to which GILTI is applied).
- A further question arises as to whether in referring to GILTI it is really intended to apply an interaction also with BEAT (and if the US continues to apply BEAT whether it is a covered tax).

II. Chapter 2: Scope of the GloBE rules

- In the context of insurance business and investment funds, the GloBE rules may not operate as intended unless the proposals are interpreted in particular ways. As a preliminary point it is key to consider the definition of “investment fund” (see page 32 of the Blueprint). Due to the vertical integration of insurance and asset management businesses, there may be instances where an Insurance Group sets up investment vehicles (that are consolidated line by line and that fulfill all other conditions required to be considered investment funds for GloBE purposes) whose investors are only constituent entities of the group. For the same reasons such investment vehicles could be held by other investment vehicles in which the group’s insurance companies participate (multi-layer structures of investment funds that are constituent entities). In particular it is key to determine that, in this context, where investments in investment vehicles (that are per sè investment funds, i.e. they fulfil all other requirements of the definition of investment funds for GloBE purposes) are operated by insurance companies in order to invest resources raised by issuing insurance policies and the investment is used to back the related technical reserves, it can be concluded that the requirement that the fund is held by more than one unrelated investors is fulfilled. In particular our view is that, in the context of the insurance business, the notion of “investment fund” could be interpreted in such a way that the participation of unrelated parties is satisfied when the resources invested by insurance companies are derived from issuing insurance policies and the investment is used, in whole or in part, to back technical reserves (directly or indirectly in the interest of unrelated policy holders).

III. Chapter 3: Calculating the ETR under the GloBE Rules

- To align with the objectives, the appropriate ownership threshold, both for the exclusion of portfolio dividends and the exclusion for gains/ losses on the disposition of stock, would reflect existing participation exemptions. The sale of stock in a constituent entity (CE) to another CE in the MNE group (insofar as not covered by the reorganisation provisions) is not relevant for determining the GloBE tax base. But equivalence of treatment with that for local tax due on dividends distributed between CEs would suggest that any tax due by the seller on the capital gain should be considered as a covered tax.
- The design with respect to reorganisations may be challenging. The Blueprint appears to address certain situations where tax-free or tax-deferred reorganisations occur (e.g., transfer of assets). However, it is not clear if there was an intent to address certain reorganisations involving taxable intra-group transactions (e.g., a taxable transfer of intellectual property between jurisdictions), or if this falls under the general guidance of maintaining intra-group gains and losses. This is of particular importance where the transaction results in amortisable tax basis for the acquirer.
- Some transactions that trigger an exit tax (e.g., ATAD Art. 5) could give rise to taxation in the jurisdiction of departure and a step up of values in the jurisdiction of arrival. The local tax due in the jurisdiction of departure would have to be considered as a covered tax attributable to the jurisdiction of arrival (where the step-up of value for local tax purposes occurs). Differently the exit tax paid in the jurisdiction of departure could be wasted and a GloBE liability could arise in the jurisdiction of arrival due to the step-up of value).
- The Blueprint proposes the use of an indefinite carryforward/carryback model to reconcile temporary differences (see section IV below) rather than a deferred tax model. While the deferred tax model is not without its flaws (and would require adjustment for items such as valuation allowances), such an approach would leverage data and processes that companies already have. Importantly, deferred taxes are based upon the difference in financial statement carrying values and tax base of individual assets and liabilities and are the result of specific accounting standards and guidance unlike the memorandum account that would be required for a carryforward/carryback model. Further, while the Blueprint proposes use of an indefinite carryforward/carryback model to reconcile temporary differences, to the extent countries were to impose limitations (which may be considered possible),there is likely to be double taxation on companies unrelated to the economics of the business. The deferred tax approach could address certain complexities of the carryforward model proposed in the blueprint with a more simplified approach.
- In many cases, tax depreciation and amortization may represent the largest temporary difference between the relevant tax base and financial reporting. The Blueprint proposes two alternatives to address accelerated tax depreciation - either utilizing tax depreciation rates (in lieu of depreciation rates under relevant accounting principles) or adjusting the numerator with the deferred tax liability (DTL) for depreciation.
    - Adjusting the covered taxes for the DTL for depreciation is likely to be complex and would not be as transparent.
    - Utilizing tax depreciation rates (in lieu of financial accounting depreciation rates) for calculating financial statement income (the denominator of the ETR) could represent a reasonable approach to reconcile this significant temporary difference.

IV. Chapter 4: Carry-forwards and carve-out

- While the Blueprint proposes to make the carryforward essentially indefinite, many countries may seek to adopt a limitation under their existing tax law for carryforwards. Any such limitations would create double taxation in industries, and for companies, with long reversing temporary differences.
- In relation to pre-regime losses, MNE groups with a longer life-cycle should not be adversely affected vis-à-vis those with a shorter life-cycle. For example, if an enterprise has invested in the development of a product over 10 years, leading to losses, such losses should be considered as allowable pre-regime losses (i.e., a subjective approach rather than a pure mechanical approach). A simplification might be made to allocate group consolidated pre-regime losses to individual jurisdictions based on an allocation key in situations in which determining in-country losses were difficult.
- Financial statements already leverage a deferred tax model under US GAAP/ IFRS. Using a deferred tax approach to account for temporary differences may allow for greater ability to adjust to the new system of taxation since they will be starting with a process and/ or system they are familiar with. While the deferred tax method is not without its flaws, it more likely addresses the total impacts of temporary differences than a carryforward/carryback model.
    - For example, existing deferred tax outcomes under US GAAP could be adjusted to remove the impacts of valuation allowances against such deferred taxes on existing temporary differences (or, in the case of IFRS, adjusting for the recognition of deferred taxes for temporary differences that were otherwise determined as unrecoverable for financial reporting purposes).
    - Moreover, the impacts of uncertain tax positions with respect to deferred taxes could be adjusted, consistent with requirements in the design document with respect to current taxes per the financial statements.
    - Other adjustments (changes in statutory tax rates, foreign exchange impact on non monetary assets, deferred taxes related to OCI) or exceptions to the general income tax accounting model(s) could be addressed, as appropriate (certain non-recognition outcomes, outside basis differences and interplay of withholding taxes).
- Substance based carve-outs are to be limited according to the Blueprint to fixed percentage mark-ups of the costs of depreciation/ depletion of tangible assets and payroll but other considerations may be relevant. Decisions appear to have been taken to rule out a broader carve-out for regimes aimed at attracting investment that are compliant with the BEPS Action 5 standards although it would be interesting to know whether special consideration has been given to certain regimes, including say those that for many years have been instrumental in establishing a country's credentials in a particular industry, particularly a highly regulated industry).
    - The approach to substance carve-outs seems to favour certain industries such as labour-intensive and asset-intensive industries, over other industries such as natural resources/raw materials or the tech industry. Arguments for tech may be muted given the targeting of Pillar One but the local sourcing of materials can be seen as a substantive activity less susceptible to BEPS risks. A percentage of locally sourced raw materials could also be considered for carve-out (value added percentages are released by the OECD, or as a simplification a lesser percentage of total raw material amounts).

  - With respect to the carve-out for depreciation of land, there is no financial statement amount for land depreciation, so specific rules may be required if there is to be a deemed allowance.
  - Although the determination of the fixed percentage mark-up would ultimately be a high-level decision that decision might be considered alongside the other design parameters of the GloBE, in particular the minimum rate, guided by an economic impact assessment.
  - Given that this carve out is intended to exclude a fixed (or "routine") return for substantive activities equally from different jurisdictions from the scope of the GloBE rules, it may also be appropriate to consider industry profitability. Although, on classic economic principles, (potential) profit returns are positively correlated to the costs of payroll and tangible assets, the value created from employees and certain assets could vary significantly among different industries. For example, high tech MNEs continuously spend substantial costs on hiring and maintaining talent with an aim of enhancing competitive edge and achieving a higher profitability, while traditional labour-intensive industries are more dedicated to training up labours' production skills, improving production efficiency and gaining more profits through a larger production scale.
  - On a similar basis, cost levels are well recognised in international transfer pricing practices and the OECD TP Guidelines indicate that location saving, i.e., cost savings attributable to operating in a particular market, should be included in the comparability analysis and be further quantified and allocated to related parties where necessary. The approach of applying one fixed percentage mark-up to all the jurisdictions would favour the jurisdictions having higher cost standards by coming up with a relatively larger carve-out amount, while sacrificing the interests of developing economies.
- The Blueprint addresses certain considerations with respect to government grants (and credits) as generally addressed under IAS 20. The accounting considerations for certain refundable credits may result in such benefits being recognized in a variety of pre-tax income statement categories outside of the income tax accounting model. Many jurisdictions allow for the monetisation of such credits against payroll tax obligations otherwise due. Where MNEs conclude (under applicable GAAP) that such benefits function as a reduction to payroll expenditures, there perhaps ought to be a contemplated mechanism to address this with respect to payroll costs included in carve-out determinations.
- There may be a case also for considering specific aspects of R&D activities as broadly desirable non-tax policy objectives and how a government incentivises them not just through grants etc but more widely through the tax system. Some countries offer grants while others offer tax incentives.
  - In the absence of such incentives, governments risk companies underinvesting in research. If Pillar Two does not adjust for these tax incentives, it will diminish the effectiveness of the incentives in addressing the failure of the market to provide the optimal level of investment in research. A country may find the tax subsidy intended to go to companies that undertake more of the socially desirable activity instead is transferred to a foreign treasury.
  - Failure to take the R&D into account encourages countries to pursue instead non-tax incentives, which have the difficulties discussed above.
- The Blueprint leaves an ongoing discussion area on the carve-out effect for the calculation of the ETR and top-up taxes under the GloBE, "particularly whether an MNE group that claims the benefit of the carve-out should be required to make a corresponding and proportional adjustment to the covered taxes".

- Although making a corresponding adjustment to the covered taxes when computing the ETR appears more consistent with the rationale behind the carve-out, the question is whether a proportional adjustment would be appropriate.
- Consider an illustration in which a taxpayer conducts both substantial manufacturing and R&D activities in a jurisdiction of which the normal income tax rate is 20%. Given that the taxpayer's R&D business is encouraged locally, it is now granted a preferential income tax rate, say 10% for a certain period. If before the application of the carve-out, the taxpayer has €100 of income and €10 of taxes, and after the carve-out the taxpayer has €80 of income, then a question arises as to whether the ETR for purposes of the GloBE proposal should be €10 of taxes divided by €80 of income (12.5%, by not adjusting the covered taxes) or €8 of taxes divided by €80 of income (10%, by proportionally adjusting the covered taxes). It is apparent that proportionally adjusting the covered taxes would ignore the true tax burden (i.e., €10) of the taxpayer. Therefore, since the formulaic substance-based carve-out is to "focus GloBE on 'excess income', such as intangible-related income, which is most susceptible to BEPS risks", it would be more appropriate and pragmatic to exclude the carve-out from both GloBE income and GloBE tax base but not adjust the covered taxes.

V. Chapter 5: Simplification options

- Simplification is at the heart of this consultation and we refer in the other sections on Pillar Two to various incremental steps that would assist in this regard, including in relation to the use of deferred tax accounting and carry-forward mechanisms in section IV. As a general comment and as mentioned in our covering letter, consideration could be given to whether a phased approach could be used to limit the number of enterprises and countries in scope. This is particularly relevant and feasible where thresholds are to be included.
- The idea of a CbC Reporting ETR Safe Harbour providing a list of required adjustments that appears to gauge only the significant differences between the CbC-based ETR and GloBE ETR calculation may produce a reasonably reliable approximation of the jurisdictional ETR for the purposes of a broad safe harbour. As a high-level risk assessment tool, CbC Reports are not intended to be used for rules that require accurate measurement and are not generally consistent enough to do so appropriately. Since the goal of this simplification measure would be to reduce the complexity and administrative burden associated with complying with the GloBE rules, it would be reasonable to provide certain flexibilities for not adjusting certain items where they are not significant. This could be achieved by either setting an absolute amount threshold or a percentage threshold.
- In relation to the de minimis profit exclusion it may appear that the simplest mechanism is an absolute threshold but a figure relative to the size of the MNE group could be more administratively useful. Clarifications should be considered, perhaps based on an impact assessment, of the 'profit' figures being considered. While assessment of the impact of the BEPS measures has not yet been determined, TP and other anti-avoidance measures, including those introduced into treaties, address fragmentation in a fairly comprehensive manner.
- A single jurisdictional ETR calculation to cover several years could be considered to exclude MNE groups with in general sufficiently high reported ETRs from the GloBE rules at the taxpayer's option. A calculation chosen by a tax authority is less likely to meet the overall objectives.

- If a tax system is compliant with BEPS and international standards (e.g., compliant IP boxes, non-harmful regimes - see also additional comments in Annex 2), then it would seem to be reasonable to consider it as “low risk” and administratively excluded from application of Pillar Two. This could be achieved, for example, by reference to a list of compliant regimes or of commonly accepted criteria — either of which could be subject to peer review. We understand this could add layers of complexity if taken too far, but the positive spillover effects of, for example, research and development incentives means in this narrow case that some additional complexity is a price worth paying for societal benefit.

VI. Chapter 6: Income Inclusion and Switch-over rules

- In line with BEPS, there could be an argument for focusing on the economic position, rather legal form here. There might then be a case that top-up tax is collected by the jurisdiction that sustains the most business substance of the group where that jurisdiction applies IIR. This is also aligned with the application of the de minimis foreign in-scope revenue test of Pillar One. In the de minimis foreign in-scope revenue test, both where the group is headquartered or where the UPE is tax resident could be identified as the group’s domestic or home market. Hence, it would be more reasonable to apply the same standards in the IIR rule, i.e., include the group headquarter with substantial business function as one of the optional entities receiving the top-up taxes.

VII. Chapter 7: Undertaxed payments rule

- A simplified, white list approach to the UTPR would reduce the burden on MNEs considerably. Enormous IT investment would otherwise be required by MNEs to ensure there would be no need to apply the UTPR and most of that expenditure would have little or no impact on behaviour.
- Where UPEs have substance in ‘good’ territories (without harmful tax practices and not being no or only nominal tax) the UTPR should arguably not apply to those entity’s income since that would interfere with those territories’ rights to set their own tax policies.
- The coordination mechanism for allocating the top-up tax over the UTPR taxpayers could be made more robust. A self-assessment system in combination with certifications could be supplemented with coordination taking place via MAP or using the MAAC. Consideration would also be given to introducing a panel mechanism (like for amount A) for the determination and allocation of the top-up tax.

VIII. Chapter 8: Special rules for Associates, joint ventures and orphan entities

- The inclusion of associates joint ventures or orphan entities, that are not consolidated, would appear to impose an additional reporting burden that does not seem commensurate with any benefit that has so far been put forward.

IX. Chapter 9: Subject to tax rule

- The relationship between the STTR and the other provisions of the OECD Model Tax Convention will need to be addressed. For example, questions as to whether Article 29 (entitlement to benefits) has priority over the STTR. To the extent that the Blueprint suggests the STTR has been designed for countries with limited administrative capacities, one can imagine a situation arising

in which such countries are as a result encouraged to adopt more and wider withholding tax regimes not conducive to global investment and growth.
- Analysis set out in the Blueprint in relation to the STTR and tax treaties raises a question as to the appropriateness of making comparison with the non-deductibility of other costs under domestic laws (in line with the savings clause now set out in the OECD Model and as introduced in the MLI).
- Consideration might be given to whether the UTPR and STTR could be combined into a single test and, if further simplicity is sought, the simplified ETR test (or even a statutory rate test) be applied.

X. Chapter 10: Implementation and rule coordination

- It will be a huge challenge to transpose the Pillar Two principles in law and guidance that will be applied in a uniform way and we see an enormous benefit in a specific public consultation on the draft legislation (as was the case for BEPS Action 6).
- In relation to dispute prevention (and resolution) the law and guidance could be supplemented by additional actions.
  - The measures considered in paragraphs 709 to 715 rely heavily on either existing MAP Articles or on administrative approaches by tax authorities such as joint audits and the exchange of information. The general issues in relation to the efficient working of MAP cases are well known and do not need repeating here, but two points are particularly relevant. Firstly, most MAP expertise is concentrated in Articles 5, 7 and 9 disputes – the number of MAP cases in the corporate space outside of these Articles is typically very small relatively speaking and therefore Competent Authority expertise in this area is naturally limited. MAP teams would need to be expanded and trained accordingly to cope with an increase in new disputes.
  - OECD MTC Article 25(3) is increasingly used to get disputes concerning measures similar to IIR and GloBE into treaty discussions. While article 25(3) is helpful in this respect, it only allows for consultation and not for resolution of cases not provided for in the treaty. To get the full benefit of Article 25, these new measures would need their own treaty provision within bilateral treaties.
  - Another option that would address some of the lack of balance in paragraphs 709 to 715 towards business would be to consider or encourage the introduction of clearance mechanisms that would give business an opportunity to avoid disputes and obtain early certainty. Given the very clear differences between Pillar One proposals which concern primarily a process of reallocation of tax rights and Pillar Two proposals which are primarily minimum tax measures of a more domestic relevance, we would not recommend that any early certainty or clearance regimes for Pillar Two were combined with those suggested for Pillar One.

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Annex 3

Comments on other elements of the consultation document

The material discussed in this Annex is included on the basis of the request from the OECD in the consultation document to address matters of simplification. Our covering letter refers to our views on the principles that should help drive the project, both as a whole and in relation to Pillar One or Pillar Two individually. Annex 1 and Annex 2 then aim to respond to a number of the specific complexity questions about technical issues raised in the consultation document on Pillar One and Pillar Two respectively. Annex 3 provides some other thoughts we believe constructively seek to move matters forward on the Blueprints. These annexes should be read in the context of the overriding reflections on principle set out in our letter.

The international tax system, simplicity and sovereignty

- The described simplification options within Pillar Two raise questions as to whether full implementation could be used to make the international tax system less complex. Do countries need CFC-legislation if they have an IIR? Haven't we solved many or all DD/NI situations related to hybrids with Pillar Two?
- Economic evidence shows stable corporate tax receipts and there may be concerns that minimum levels of taxation impose an artificial restraint on jurisdictional sovereignty to set tax policies that promote economic efficiency. Countries should have the right to set tax policy to encourage genuine economic activity subject to internationally agreed norms on ring-fenced regimes and other harmful tax practices. So Pillar Two should be seen, as far as possible, to adhere to these principles. For example, there is substantial economic evidence that encouraging investment in research and development, helps both correct market failure and produce beneficial spillover effects. A narrow focus on "low or no taxes" may have detrimental consequences not only for national welfare, but also for global welfare. Where tax competition is driving investment, effective removal of such benefits via a Pillar Two adjustment may result in additional emphasis and focus on other ways in which countries can attract investment, which may be less transparent and/ or more economically distortive.

Compatibility of Pillar Two with EU law

- At the current stage of the OECD work on Pillar 2, both the IIR and the UTPR have features which could be found to constitute breaches of the EU fundamental freedoms. In particular, consideration should be given to the freedom of establishment enshrined in Article 49 TFEU since it appears that the IIR and UTPR are intended to apply to the entities of consolidated groups The implementation by EU Member States of the rules described in the IIR and the UTPR could lead to restrictions on freedom of establishment since EU resident taxpayers owning subsidiaries in another Member State could be placed at a disadvantage compared to wholly domestic groups as both the IIR and UTPR are only engaged in cross border situations. This could then be argued to dissuade such taxpayers from establishing or maintaining a subsidiary in another Member State. In this regard it should be noted that the CJEU has already found that measures somewhat similar to the IIR and UTPR may constitute restrictions on the fundamental freedoms. These cases would include Cadbury Schweppes plc. (C-196/04) with respect to the IIR and Eurowings (C-294/97) or SIAT (C-318/10) with respect to the UTPR.

- A difference in treatment between cross border and domestic situations is not automatically a breach of the fundamental freedoms. In certain instances such differences may be justified by an overriding reason of public interest. One possible justification then could be the necessity to ensure a balanced allocation of taxing rights taken together with the need of preventing tax evasion and tax avoidance. However, according to the CJEU, in order to be justified on this ground, a measure should be restricted to situations involving the creation of wholly artificial arrangements and, based on the case law as it stands, it does not seem that the substance-based carveouts provided for in the Blueprint would be considered as sufficient to be able to conclude that the scope of the rules is limited to wholly artificial arrangements. A second possible justification could be the need to ensure the coherence of the national tax system. Such coherence can be found to arise where a disadvantage is inextricably linked to an advantage. The application of the top-down approach together with the interaction between the IIR and UTPR, the IIR effectively switching off the UTPR, may lead, in some situations, to a neutralisation of a tax disadvantage (the application of the IIR) with a tax advantage (the non-application of the IIR by another Member State or of the UTPR) . However, as it is currently interpreted by the CJEU the coherence of the tax system argument is a narrow one requiring generally the advantage and disadvantage to relate to both the same tax and the same taxpayer. Applying a coherence argument to the IIR and UTPR would therefore appear to constitute an extension of the argument. Finally, there is a question as to whether the CJEU would accept a justification based on the creation of "a level playing field". Such a justification has hitherto not been recognized by the CJEU. One cannot however discount the possibility that the Court may be prepared to consider such arguments. This is perhaps particularly the case if the rules were to be introduced into the EU by way of a directive recognizing that such a directive would require the unanimous approval of the EU States.
- As regards the STTR described in the Blueprint, its application may raise concerns from an EU law perspective in two circumstances: (1) when it applies to cases within the scope of the Interest & Royalties Directive which requires that there is no withholding taxes on certain qualified payments and (2) in any case in which the application of the STTR gives rise to a higher burden than would be the position in a purely domestic scenario (having regard to matters including the possibility of deducting related expenses).

Compatibility of UTPR with tax treaties

- The Blueprint (para 10.4.3) concludes that the UTPR is a pure domestic rule that is compatible with tax treaties. A very brief analysis is provided on the compatibility with Articles 9 and 24 of the OECD MTC. The arguments with respect to Art 24 do not seem very convincing, because the UTPR will de facto only apply to cross-border transactions. Analyses of BEAT in relation to Art 24 suggest the right to deny deductions without breaching treaty obligations is due to the savings clause of Article 1, para 3 OECD MTC and para 30 of the Commentary with Article 7, para 3 OECD MTC. Not all countries have opted into the savings-clause. The analysis focuses on the situation where the UTPR is implemented via (partial) non-deductibility. An analysis of implementation via a withholding tax would also be welcome.

Impact of CbCR ETR Safe Harbour

- In relation to the CbCR ETR safe harbour, CbCR was not designed for this purpose so that especially going beyond thresholds and definitions may raise additional implications for CbCR itself. Consideration might be given to the impact of CbCR as a high level risk assessment tool and its use to help determine taxable income (para 272 et al on assigning income, p 92 regarding the payroll component of the formulaic substance based carve-out).

Excluded activities as part of a diversified business

- Comment would be welcome on how to approach Pillar Two where a business combines excluded activities with other non-excluded activities. It may be difficult to envisage this in some circumstances but, for example, international shipping activities that are excluded from Pillar Two are sometimes included with broader travel activities.

Covered taxes for Pillar Two

- The Pillar Two Blueprint provides that covered taxes, or broadly taxes based on income, should follow the classification of the parent entity. It would be useful to deal with the lack of conformity on classification of a tax as income or non-income, as a recent example in the UK (ORIP tax) demonstrates. The Blueprint also suggests leveraging financial statement classification, but implies a different treatment in some cases, such as tonnage taxes, which are typically accounted for as a non-income based tax.

Interaction of Pillar Two and reviews of harmful tax practices and no or nominal tax regimes

- Consideration will need to be given to the future identification of harmful tax practices and no or nominal tax regimes in the work undertaken by the OECD’s Forum on Harmful Tax Practices and the EU’s Code of Conduct Group (Business Tax). The impact of a Pillar Two adjustment ought to be taken into account in the identification of territories or, more appropriately, the measures required to be taken or recommended in relation to particular transactions or perhaps in relation to the territories as a whole.

Investment neutrality under Pillar Two

- The Pillar Two Blueprint considers that certain entities or arrangements that would otherwise be at the top of the group ownership chain as the UPE should be excluded from the application of the GloBE rules (such as investment and pension funds). The tax neutrality of these funds is widely accepted in tax policy and the exclusion from the GloBE rules should not result in competitive advantage or create economic distortions, which is the basis for the exclusion. Consideration might be given to allow another group entity to be designated as the UPE where interests (e.g. shares or units) in such group entity is actively traded on a recognized stock exchange. In certain situations, a private entity with no international presence outside of its home jurisdiction (or a passive international investment portfolio) may control a publicly listed entity in a MNE Group.

An obligation that required the private entity rather than the publicly-traded entity to pay the Pillar Two charge could create economic distortions. In theory, the split ownership rules may achieve a fair and equitable result but for greater certainty, an election to designate the payer (deemed UPE) for purposes only of payment of the Pillar Two tax as the publicly-listed entity should create tax neutrality compared to other publicly listed MNE Groups. The lack of such an election could place the burden of tax on a private entity that does not have the financial capacity to pay the tax or the ability to cause the public entity to increase its distributions (due to regulatory requirements) to provide it with the funds to pay the tax.

Tax base - use of financial accounting

- Although the use of financial statements may appear to be a reliable starting point in terms of simplicity and consistency, it is important to understand the purpose of financial reporting and to assess whether that purpose aligns with the objectives of making tax calculations and determinations. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. GAAP is then based upon these objectives. Tax assessments are not similarly focused and often include aspects of tax policy such as to incentivise certain behaviours (such as investment in a specific area) or to achieve other objectives (such as recognizing income on a realization basis when there is liquidity to pay tax). The purpose of financial statements may not align with the goals of tax reporting. This is why today in most jurisdictions there are a number of adjustments from financial reporting to tax reporting where financial statements are used as a starting point. While the Blueprint attempts to address certain items, it does not address a number of complexities that would arise from leveraging the financial statements. These include, but are not limited to:
    - Companies may not have financial statement information for all legal entities and permanent establishments at a granular level. Stakeholders and independent auditors are generally concerned with the accuracy of the financial statements for the consolidated company and the reporting processes and associated controls may not be designed to ensure accuracy at all legal entity or jurisdiction level(s), particularly in the context of overall financial statement materiality, etc. The Blueprint proposes some simplification measures including not pushing down adjustments in certain instances where a material difference would not exist, but the detail remains to be determined.
    - How should proportionate consolidation be treated? For example, some industries (construction, oil & gas) may include equity method investments on a line item basis. Would this be considered a component entity?
    - How should companies provide information when there is a different financial statement year and tax year for constituent entities (CEs)? Will CEs need to calculate a tax "due and paid" using the full year of the UPE?
    - For practical purposes, some enterprises in a MNE group may maintain their records in local GAAP with adjustments made in consolidation for statutory to GAAP differences. This may result in additional complexity.
    - The Blueprint allows for subsidiaries to have a GAAP financial statement base that might not align with the parent company financial statements, unless these differences cause "material competitive distortion". What is the threshold for this? Who would decide

whether or not something was a “material competitive distortion” sign and how would it practically be applied?