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Progress Report on Amount A of Pillar One

Response by the Chartered Institute of Taxation

1 Executive Summary

1.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity, and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 19,000 members, and extensive volunteer network, in providing our response.

1.2 In October 2021, the OECD/G20 Inclusive Framework on BEPS (Inclusive Framework) reached an agreement on a two-pillar solution to reform the international tax framework in response to the challenges of digitalisation. We welcomed this historic agreement which aims to bring the international corporate tax framework up to date with the challenges of the digitalising economy, as well as to introduce more transparency and fairness in the global tax environment. We have long advocated a multilateral solution to these issues as we have been increasingly facing an international tax landscape of unilateral measures (and retaliatory actions) being taken independently by countries, which lead to less alignment of tax bases globally, resulting in potential double taxation and a significant compliance burden for businesses and, consequently, restricting economic growth and innovation. Thus, the two-pillar solution and its key objective of stabilising the international corporate tax framework is welcome.

1.3 We recognise the significant progress on the technical design of Amount A of Pillar One and note the revised schedule for the ongoing work. Whilst recognising the political drive behind the two pillars, we support the additional time being taken in the design of these innovative rules that are intended to last for decades.

1.4 We welcome the draft model rules in the Progress Report that introduce mechanisms to simplify the position for multinational enterprises (MNEs), listening to stakeholder feedback on previous consultations. We suggest that the ongoing work should continue to focus on the practicalities of the model rules and continue to ensure that these are as practicable and straightforward as possible, while delivering the policy aims.

1.5 Effective relief from double taxation is crucial in order to deliver the policy aim of Pillar One, being the allocation of profits of an MNE to jurisdictions in which goods or services are supplied or consumers are located (market jurisdictions), but it is not intended to give rise to an overall increase in taxation for the MNE. Rather the rules are intended to operate as a reallocation of profits from one jurisdiction to another. Therefore, alongside the new taxing right for market jurisdictions, it is important that the rules provide relief

for the equivalent amount that, under the existing profit allocation rules, are taxed elsewhere in order to prevent double taxation that would penalise and discourage cross-border activity. We note the ongoing work in this area.

2 About us

2.1 The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the relevant authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

2.2 The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

2.3 The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.

2.4 Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

3 General comments

3.1 We welcome the *Progress Report on Amount A of Pillar One* published by the OECD Secretariat on 11 July as a significant step in delivering the two pillars. We recognise the significant progress on the work on Amount A of Pillar One, following the consultations on the building blocks relating to the new taxing right under Amount A that have taken place during Spring 2022. We welcome this opportunity to comment on the draft domestic model rules for the various building blocks for Amount A presented in the Progress Report. However, in light of the relatively short consultation period and the fact that we are aware that many other stakeholders (including the Big 4 accounting firms and the MNEs that will be within the scope of the rules) are engaged with the OECD and the consultation process, and will be feeding in points of detail, we have limited our comments to more high level points around underlying principles and ensuring, so far as possible, that the model rules meet with our objectives for the tax system.

3.2 These objectives are that a tax system should comprise rules which translate policy intentions into law accurately and effectively, without unintended consequences. The tax system should aim to provide simplicity (so far as possible) and clarity, so businesses can understand how much tax they should be paying and why, and also to provide certainty so that businesses can plan ahead with confidence. It is also important that there is responsive and competent tax administration, with a minimum of bureaucracy.

3.3 We welcome the revised schedule for the completion of the work on Pillar One generally, and Amount A in particular. We recognise the political interest in achieving implementation of these rules as soon as possible and, therefore, the importance of having agreed dates by which it is intended various aspects of the work will be completed. However, we also agree, that it is important to allow enough time for the design of these innovative new rules to ensure that they will work as intended, without undue burdens on taxpayers and

business generally as well as tax administrations, so that they can be sustained over time. A significant amount of work is still required to finalise the model rules and then to develop and complete the Multilateral Convention (MLC), that will establish the legal obligations of the parties to implement Amount A.

3.4 Our experience in the UK is that when new, complex legislation is introduced, it is very difficult to get the rules right at the first attempt. More often than not anomalies and practical difficulties only come to light when the rules are in force and businesses, and the relevant tax authorities, are seeking to apply them to real, complicated business models. This has been the UK's experience in relation to rules that have been introduced in the UK as a result of the BEPS project, such as the Corporate Interest Restriction and the Hybrid and other Mismatch Rules, as well as domestically driven new tax rules, such as Diverted Profits Tax. To deal with this inevitability, we suggest that the MLC includes a mechanism that triggers a review in a few years' time, and a mechanism by which the MLC and, consequently, the domestic rules implementing Pillar One can be amended if necessary.

3.5 In addition, the ongoing work should continue to focus on the practicalities of the model rules. It must be recognised that the scope and detail of these proposals is vastly complicated and will create an enormous administrative burden for tax administrations and MNEs alike. The aim of the ongoing work should be to continue to minimise these burdens to the greatest extent possible and ensure that the solutions result in a set of new rules which is proportionate to the intended objectives, which we recognise must include building an increased trust in the international tax system itself.

3.6 In this respect we welcome the draft model rules in the Progress Report that introduce mechanisms to simplify rules for MNEs, notably the three-year transition period permitting the use of simplified revenue sourcing rules (allocation keys) in Title 3.

3.7 With regard to the additional commentary and guidance that is envisaged, we suggest that this should be as detailed as possible and contain multiple examples in order to assist MNEs and tax authorities in applying the rules.

3.8 At the moment the rules will impact relatively few MNEs. Therefore, the administrative burden is falling on the broadest shoulders, the businesses most able to deal with it. But the balance between the administrative burden and the perceived benefit of the rules would change if the scope were expanded and smaller MNEs were brought within the rules in the future. For example, there is a requirement (in Schedule A, paragraph 4) for the preparation of Consolidated Financial Statements, including for four historic accounting periods prior to the most recently closed accounting period in the situation where an MNE comes within the rules, but is not otherwise required to prepare Consolidated Financial Statements. This extension back in time of such a requirement would be a huge and, in our view, disproportionate burden on a smaller MNE. This should be borne in mind and flexibility introduced, or the administrative burden reduced, where possible.

3.9 Effective relief from double taxation is critical in delivering the policy aim of Pillar One, being the appropriate reallocation of profits to market jurisdictions. There are two separate issues with regard to double taxation: double taxation in the residence jurisdiction (to be resolved by exemption or credit) and double taxation in the market jurisdiction (avoiding double counting). As we discuss further below, the proposed rules for the double counting aspect of this are now dealt with by the marketing and distribution profits safe harbour (MDSH), which is found in Article 6 of the draft model rules. In addition, Title 5 sets out proposed rules for the elimination of double taxation with respect to Amount A, dealing with the potential double taxation in the residence jurisdiction. It is noted that further work is required on several aspects of these rules.

3.10 Following on from consultations published in May 2022, we note that draft model rules relating to the administration of Amount A will be released before the Inclusive Framework meeting in October this year. It

would be useful to know as early as possible when this will be to maximise the opportunity to give these draft model rules due consideration and provide comments.

3.11 We welcome the confirmation that the MLC will contain provisions requiring the withdrawal of all existing digital services taxes (DSTs) and relevant similar measures, and that there will be a commitment not to introduce these in the future. We also welcome that the MLC will include a definitive list of the existing measures that are to be withdrawn; this will provide clarity.

4 Title 1. Scope

4.1 Under the proposed rules, MNEs with revenues greater than EUR 20 billion and with profitability greater than 10% will be in scope of Amount A. The rules contain an averaging mechanism, which is intended to prevent MNEs dropping in and out of scope. The revenue test and profitability test within the averaging mechanism apply separately. The revenue test applies to the current period only and the profitability test applies to the current period and, where a Group has never been in scope or where it has been out of scope for two consecutive periods, two other tests (the average test and prior period test) are also used.

4.2 Whilst these are probably simpler tests than those previously suggested, they could give rise to some anomalous outcomes. In particular, an MNE will not be taken out of Amount A over an extended period if it suffers an exceptional loss, but an exceptional loss may still be taken into account, and carried forward, under the tax base rules.

4.3 The Progress Report includes the exclusions for Extractive Activities and Regulated Financial Services. The draft model rules demonstrate the welcome efforts to address the concerns raised during the consultations earlier this year on both of these exclusions. However, with regard to the Regulated Financial Services exclusion, we understand that the definitions set out in Section 20 of Schedule C, which are intended to encompass insurance and reinsurance, may not fully do so, because they do not include all the types of insurance policies which insurers and reinsurers are licensed to write.

4.4 We have previously suggested that some smaller businesses which would be below the normal thresholds for the rule to apply may wish to opt into the Pillar One rules to avail themselves of the perceived benefits around increased administrability, greater tax certainty and mandatory binding dispute resolution procedures. If they are competing with larger businesses in the same area, they may be at a disadvantage because they are typically in a high tax jurisdiction and cannot organise themselves as to where their profits arise. In this situation, the introduction of the Pillar One rules without allowing such an option could potentially create a two-tier system which is not necessarily desirable.

5 Title 2. Charge to tax

5.1 We do not have any comments on the draft model rules for the Charge to tax.

6 Title 3. Nexus and revenue sourcing rules

6.1 We welcome the changes to the model rules that provide further simplicity and administrability (for example, no longer requiring MNEs to source revenue on a transaction-by-transaction basis). We also welcome the new transition phase (of three periods) during which groups are not required to apply the specific sourcing rules

and can instead use a more formulaic approach (by using relevant allocation keys) to all or any part of their revenues.

6.2 However, while these new draft provisions should provide greater flexibility, the rules will still be complex, and some anomalies may still arise. For example, for transport services, prescribed allocation keys must be used in all cases; the reason for this is not given, but an explanation of the rationale for this would be welcome.

6.3 The consultation document on *Pillar One – A Tax Certainty Framework for Amount A* mentions that the Inclusive Framework is considering a transitional process, 'soft-landing', for a limited period, during which an MNE's calculation would be accepted if the MNE has made reasonable efforts as to its approach to revenue sourcing. This approach would be welcome and we would encourage its inclusion in the final rules.

7 Title 4. Determination and allocation of taxable profit

7.1 The group profit on which Amount A is calculated is called the 'allocation tax base'. This is arrived at by starting with the financial accounting profit or loss in the consolidated financial statements, and then making a limited number of book-to-tax adjustments. These adjustments include Asset Fair Value or Impairment Adjustments and Acquired Equity Basis Adjustments, which are similar to concepts included in the Pillar Two Model Rules and Commentary. However, they are also different in several respects, resulting in a different tax base for Pillar One from Pillar Two. We would prefer to see the two sets of rules aligned as closely as possible to reduce the extent to which MNEs have to keep two further additional sets of figures and to mitigate potential confusion for businesses.

7.2 The total amount of profit that can be reallocated under Amount A is 25% of a business's residual profit above a 10% profit margin. This amount is then allocated to the individual countries with which the business has an Amount A nexus, in proportion to the ratio of the revenues arising in each country over the total revenues of the group. The share of Amount A allocated to a specific country can be reduced by the MDSH. The MDSH is intended to address the issues of double taxation arising from 'double counting'.

7.3 The MDSH adopts a formulaic approach using depreciation (representing assets) and payroll as a proxy to determine the 'profitability' of the group that is already taxed in the relevant jurisdiction. We understand that a mechanical approach has been adopted due to concerns that permitting MNEs to arrive at a realistic estimate of this profitability on a more bespoke basis could open up the possibility of manipulation of financial statements etc. However, the result is highly complicated and far from intuitive. It is not clear that some of the percentages and measures being used in the formulas are realistic in all circumstances, which may mean that the results flowing from the MDSH could fluctuate over time.

7.4 It is also noted in the Progress Report that work continues in relation to the interaction between the MDSH and the rules for elimination of double taxation under Title 5. In particular, the draft rules in the Progress Report specify that to the extent the MDSH adjustment limits the Amount A allocation to a market jurisdiction, some multiple of the adjustment would be subtracted from the jurisdiction's elimination profits when determining that jurisdiction's obligation as a 'relieving jurisdiction' to provide relief against double taxation with respect to Amount A. (The multiple of the adjustment to be subtracted is as yet unspecified - see article 6(6).) It is not clear why a multiple would be required, and whether this is intended to be a multiple of more or less than one (although the more natural interpretation of 'multiple' would be that this would be more than one). If the multiple is less than one, the smaller share of 'the adjustment' that is then deducted would be inconsistent with identifying the residual profit as anything above a certain return on payroll and depreciation. However, if as is more likely being considered, there is a multiple of more than one, this would mean that the

MDSH adjustment that limits the Amount A allocation to a given market jurisdiction will be different to the adjustment deducted from the elimination profit that is used to determine that jurisdiction's obligation as a 'relieving jurisdiction', which would unbalance the equations and result in double taxation.

7.5 Further simplification of these rules, including the de minimis test that is under consideration, would be welcome.

8 Title 5. Elimination of double taxation with respect to Amount A

8.1 The obligation to eliminate double taxation in respect of any Amount A liability is to be allocated among countries that earn residual profits ('relieving jurisdictions'). The draft model rules for this also use a formulaic approach, creating tiers of countries based on profitability in each country relative to the overall profitability of the group. The rules then also use a 'waterfall' mechanism to cascade the obligation to provide the relief down the tiers.

8.2 Further work is being undertaken around the rules identifying specific entities in each relieving jurisdiction that will be entitled to relief from double taxation.

8.3 In addition, the Progress Report notes that work continues on the methods for elimination. As we have said previously, we prefer the exemption over credit method regarding double tax relief in the relieving jurisdiction. The credit method will not always give full relief, depending on the particular regime in the relieving jurisdiction. The exemption mechanism more consistently provides double tax relief in respect of relieving jurisdiction double taxation.

8.4 We note from the Progress Report that there are divergent rules regarding withholding taxes. In our view there is an interaction between withholding taxes in market jurisdictions and the taxes under Amount A. It seems clear that withholding tax related double counting, that is to say market jurisdiction double taxation, will arise in connection with Amount A. It is important that these interactions are addressed. One way of achieving this would be for the withholding tax suffered in a market jurisdiction to be creditable against any Amount A liability for that jurisdiction.

8.5 Overall, these rules are complicated and will be burdensome to implement. The further work that is being done should consider how to reduce the administrative burden. In addition, the mechanisms will have to consider the interaction with the Pillar Two rules.

9 Acknowledgement of submission

9.1 We would be grateful if you could acknowledge safe receipt of this submission and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

The Chartered Institute of Taxation
17 August 2022