

OECD launches Public Consultation on Pillar One draft Model Rules on Tax Base Determinations

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In brief

On 18 February 2022, the OECD released [draft Model Rules](#) with respect to the Tax Base Determinations under Amount A of Pillar One. Comments to the draft Model rules are due by 4 March 2022. This alert provides a short overview of the draft Model Rules and some initial observations. This is the second in a series of up to thirteen sets of rules that the OECD is expected to release over the coming months, with very short comment periods, as part of a “rolling consultation.” The first release covered the revenues sourcing and nexus rules, for which we prepared [this short overview](#). It is particularly important to note that the Inclusive Framework has not agreed to these draft rules – rather, for the moment, they represent the work of the OECD Secretariat. They may, therefore, be subject to change, unrelated to the consultation process. Importantly, IF members will not be required to adopt the GloBE rules. The rules will have the status of a common approach and not of a minimum standard.

In detail

Background

The purpose of the tax base determination rules is to establish the profit (or loss) of in-scope MNEs (Covered Groups) that will be used for the Amount A calculations to reallocate a portion of their profits to market jurisdictions. The rules determine that profit (or loss) will be calculated based on the consolidated group audited financial accounts, while making a limited number of book-to-tax adjustments (in general terms, aligning where possible with adjustments under Pillar Two). The rules also include provisions for loss carryforwards. Details on this provision are forthcoming. The rules do not include the tax base rules necessary for Covered Groups that are subject to segmentation for Amount A purposes. The background notes that segmentation rules will be released at a later date.

Determination of Profit Before Tax

The Amount A tax base will be quantified using an Adjusted Profit Before Tax measure, derived from the consolidated financial accounts of Covered Groups, rather than on a separate entity basis. The draft Model Rules

define Adjusted Profit Before Tax as the Financial Accounting Profit (or Loss) of the Covered Group after making specified book-to-tax adjustments and restatement adjustments set out in the Model Rules and deducting any Net Losses calculated in accordance with the Model Rules.

Financial accounting standards

Computation of the Amount A tax base will start from the bottom line figure of the P&L statement (i.e., the total for profit or loss). The Financial Accounting Profit (or Loss) is defined as the profit or loss set out in the Consolidated Financial Statements of the Ultimate Parent Entity (UPE) taking into account all income and expenses of the Covered Group except for those items reported as other comprehensive income.

The definition of a Financial Accounting Profit (or Loss) refers to Consolidated Financial Statements, which are defined as the audited financial statements prepared by the UPE under a Qualifying Financial Accounting Standard (QFAS) in which the assets, liabilities, income, expenses and cash flows of the UPE and other entities are presented as those of a single economic entity. A QFAS means IFRS and Equivalent Financial Accounting Standards (which is a reference to the GAAP from an extensive list of countries shown below).

- Australia
- Japan
- Russia
- Brazil
- Mexico
- Singapore
- Canada
- New Zealand
- Switzerland
- Member States of the European Union
- China
- United States
- Members States of the European Economic Area
- India
- United Kingdom
- Hong Kong
- Korea

Observation: Footnote 8 provides that the definition of Equivalent Financial Accounting Standards was drafted to ensure consistency with the equivalent definition applied in the context of Pillar Two. It also states that GAAP of other countries may subsequently be considered for inclusion in this definition - which will be particularly important if the scope threshold is reduced in the future.

Observation: The approach requires all Covered Groups to prepare tax base calculations under a QFAS on the basis that most Covered Groups will already be using a QFAS. Footnote 9 notes that if a Covered Group's non-QFAS GAAP were permitted with a material competitive distortion check (which was contemplated in the October 2020 Pillar One Blueprint), the Covered Group would be required to effectively calculate a QFAS-compliant tax base to determine whether a material competitive distortion exists. Therefore, the requirement to use a QFAS is unlikely to impose a further compliance burden on Covered Groups, the document asserts. Input from stakeholders is requested on this point.

Adjustments

Book-to-tax adjustments

Article 2(a) of the draft Model Rules outlines the required book-to-tax adjustments in the computation of the Financial Accounting Profit (or Loss). It provides that the following items of income and deducted expenses must be reversed:

- Tax Expense (or Tax Income) - excluded on the basis that income tax expenses are usually not deductible for corporate income tax purposes in Inclusive Framework jurisdictions.

- Dividends - excluded on the basis that dividends are excluded, in whole or in part, from the corporate income tax base in many Inclusive Framework jurisdictions, or in other instances the recipient benefits from tax relief (such as indirect credit for taxes paid).
- Equity Gain (or Loss) - excluded to ensure that the tax base of a Covered Group does not include specified gains or losses deriving from gains or losses generated by another entity.
- Policy Disallowed Expenses (e.g., bribes, kickbacks, fines, penalties) - excluded as they relate to behaviours that governments regard as undesirable but are treated as expenses under financial accounting rules.

One item included in the definition of Equity Gain (or Loss) is the disposition of an Ownership Interest. The consultation document notes that the treatment of gains and losses associated with the disposal of equity interests is still under discussion in the Inclusive Framework. Under the current draft Model Rules, gains and losses associated with disposal of asset interests are included in the Tax Base, whereas gains and losses associated with disposal of equity interests are not. Footnote 12 of the consultation document notes that amendments to these rules may be required to remove this difference in treatment in some instances, for example by no longer excluding from the tax base gains and losses associated with disposal of equity interests where the equity interest disposed of is a controlling interest. Input from stakeholders is requested on the scope of the adjustments for equity gains and losses, particularly on whether gains and losses from controlling interests should be excluded from the tax base.

Observation: The public consultation document suggests that, for ease of administration and compliance, the adjustments to calculate the Adjusted Profit Before Tax for Amount A will be kept to a minimum in order to limit complexity and align where possible with adjustments under Pillar Two. While the Pillar One tax base, the Adjusted Profit Before Tax, is intended to resemble the Pillar Two GloBE tax base, the adjustments under both Pillars' base calculations will differ. There are clearly fewer adjustments outlined in these draft rules than there are for calculating GloBE income (e.g., no adjustments for pension, stock compensation, foreign exchange gain and loss). The Pillar One tax base will also differ from individual country corporate income tax (CIT) bases. Note that the draft rules do not address whether or how to account for minority interests in computing the Amount A tax base, nor do the rules address issues around computing the tax base for dual-headed MNE groups that are listed on different exchanges.

Restatement adjustments

Article 2(b) of the draft Model Rules outlines the treatment of restatement adjustments in the computation of the Financial Accounting Profit (or Loss). Restatements of accounting income for prior year(s) would be reflected in the tax base for the period in which the restatement is identified and recognised. The restatements reflected in the tax base are subject to limitations (as set out in the definition of "Eligible Restatement Adjustments"). The current draft proposes an applicable cap on the Eligible Restatement Adjustment for the Period. The level of the cap will be subject to further analysis to balance competing objectives of simplicity and avoidance of excessive single-year impacts. Input from stakeholders is requested on this subject.

Calculating and deducting losses from prior year(s)

To limit any reallocation under Amount A to economic profit, tax base determination is also subject to loss carry forward rules. These rules require that unrelieved losses of a Covered Group incurred in a prior period (hereafter, "Net Losses") are carried forward and offset against any subsequent profit of that Group, following an "earn-out" mechanism. Specific rules apply in a number of instances, such as for (a) pre-implementation losses (i.e., Net

Losses incurred prior to the introduction of Amount A), and (b) losses transferred following certain types of defined business reorganisations.

Net Losses represent the total amount of cumulative “Financial Accounting Losses” exceeding the cumulative amount of “Financial Accounting Profits” over a specified period (referred to as the “Eligible Prior Period(s)”). Notably, the draft Model Rules do not specify the duration of this period with only a placeholder indicating this to be between 5 and 15 years.

The draft Model Rules note that the introduction of time limitations to the utilisation of Net Losses is a question that is still under discussion within the Inclusive Framework.

Observation: With respect to the Amount A carryforward regime, the [October 2020 Pillar One Blueprint](#) raised the issue of whether it should apply exclusively to economic losses or be extended to cover “profit shortfalls” (where the profit of a group or segment falls below the profitability threshold). Notably, the draft Model Rules do not include a profit shortfall approach.

The Net Losses that are deductible from the tax base include “Transferred Losses.” These are Net Losses inherited as a result of mergers or divestitures. Transferred Losses appear to be subject to certain eligibility restrictions that have the flavour of anti-abuse measures. These restrictions include the requirement that specific “Business Continuity Conditions” be met. The intent of this requirement appears to be to prevent a Covered Group from using Transferred Losses (e.g., as acquired via a merger) generated in one type of business to offset the tax base from a different type of business.

Model Rules subject to change

The background accompanying the draft Model Rules highlights that these rules are released as a “Secretariat working document” and cautions that they do not reflect the final views of the Inclusive Framework members (i.e., are non-consensus/“without prejudice”). The rules represent the work undertaken to date and illustrate the framework for tax base determinations. As such, further changes may be made. On this point, the background section identifies the potential need for changes once the scope exclusions for Regulated Financial Services have been agreed to ensure that the tax base determination rules appropriately address the specificities of certain non-regulated financial services.

Observation: While the technical work on Amount A progresses, it is clear that political agreement on the rules is far from being reached. It is particularly noteworthy, despite the late stage in the project’s official timeline for completion, that the rules are offered with cautionary “without prejudice” language. Several essential aspects of the rules have either been left open (e.g., the period over which net losses may be carried forward and included in the tax base computation) or are stated to be addressed in other documents (e.g., the question of segmentation). Extensive footnotes throughout the document state that the practical application of rules and definitions will be covered in commentaries.

The takeaway

There clearly are still many unresolved issues and policy decisions for the Amount A tax base determinations that need to be addressed. Stakeholder input is specifically requested on almost all aspects of these rules. Further, these rules will need to be revisited once other aspects of Amount A become clear, e.g., segmentation requirements and the extent of the scope exclusions for regulated financial services and extractives.

These draft Model Rules effectively introduce another tax base calculation system that will need to be administered in the future, requiring Covered Groups to calculate: (i) financial accounting profit for group/and or entity level

reporting; (ii) CIT base in determining domestic tax liability; (iii) Pillar Two GloBE income; and (iv) Pillar One Adjusted Profit Before Tax base, whereby all computations interact but none are replicated exactly. Further clarification will be needed on these interactions, and in particular, how the Pillar One and Pillar Two bases differ.

The complexity of the Pillar One and Pillar Two rules (including their interaction) becomes clearer and clearer. It will require enormous effort to implement, administer and comply with these rules, which calls into question whether the stated goal of making the rules operational by 1 January 2023 can be achieved.

Let's talk

For a deeper discussion of how the draft Model Rules might affect your business, please contact:

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