Tax Policy Bulletin

OECD releases a Progress Report on Amount A of Pillar One

15 July 2022

In brief

The OECD released a Progress Report on Amount A of Pillar One on 11 July 2022. The OECD is seeking public comments by 19 August 2022. The OECD also published frequently asked questions (FAQs) and a fact sheet that includes a high-level overview of the rules on Amount A and a process map with steps for applying the rules.

The Progress Report contains “domestic model rules” for the different building blocks relating to the new taxing right under Amount A. These rules include proposals for the marketing and distribution safe harbour (MDSH) and elimination of double tax. They also include updates to rules on other building blocks based on previous consultations. Notably, the rules introduce a three-year transition period for Covered Groups to use simplified revenue sourcing rules (i.e., allocation keys). The consultation document does not include the rules on the administration of Amount A, tax certainty related provisions, the identification of the liable entity(ies), or the implication of withholding taxes on deductible payments made to in-scope Groups, which it states will be released before the Inclusive Framework meeting in October.

The Progress Report includes a Cover Note approved by the Inclusive Framework (the first Pillar One consensus document since the October 2021 Statement). The Cover Note states that the Inclusive Framework agreed to revise the schedule for completion of the work on Amount A as follows:

Revised Schedule for Completion on Amount A	
19 August 2022	Stakeholder feedback is due on the Amount A Progress Report.
October 2022	The Inclusive Framework will review stakeholder input and seek to stabilise the rules at its meeting.
First half 2023	The work on the detailed provisions of the multilateral convention (MLC) and its Explanatory Statement is expected to be completed so that a signing ceremony of the MLC can be held in the first half of 2023 with the objective of enabling it to enter into force in 2024 once a critical mass of jurisdictions as defined by the MLC have ratified it.

The Cover Note also states that the MLC will enter into force only upon ratification by a "critical mass" of countries, which will include the residence jurisdictions of the ultimate parent entities of a substantial majority of the in-scope companies whose profits will be subject to the Amount A taxing right (i.e., the US), as well as the key additional jurisdictions that will be allocated the obligation to eliminate double taxation otherwise arising as a result of the Amount A tax. In reality, of course, that is a condition which may be hard to meet, raising questions about the future of Pillar One, as well as questions about what might instead be introduced by countries – more Digital Services Taxes (DSTs) or other unilateral measures?

In addition to the operative provisions of Amount A, the MLC will also contain provisions requiring the withdrawal of all existing digital service taxes and relevant similar measures with respect to all companies, as well as a commitment not to enter into such measures in the future.

The Progress Report was included as an annex to the OECD Secretary-General tax report to G20 finance ministers for their 15-16 July meeting in Bali, Indonesia. The G20 report highlights the revised and "more realistic" timetable approved by the Inclusive Framework and notes that "the new deadline calls for the work to be completed by the first half of 2023, which will become a hard deadline."

While it appears that many of the building blocks have a clear design from a technical perspective, it is particularly important to note that these draft rules still represent only the work of the OECD Secretariat. The Inclusive Framework has not approved the draft rules yet. They may, therefore, be subject to change, unrelated to the consultation process. This alert provides a short overview of the report and some initial observations.

In detail

Overview

The Progress Report contains a consolidated version of updated draft rules on previously consulted building blocks, drawing from stakeholder comments. It also, for the first time, sets out proposed rules for the elimination of double taxation under Amount A and the MDSH.

The Progress Report is divided in two parts: a brief overview of the operative provisions of Amount A (Section 1), which also clarifies several open issues; and a consolidated version of the substantive rules on Amount A (Section 2). The draft rules are organised in seven Titles and ten Schedules. The Schedules are intended to supplement and provide guidance on the application of the rules contained in the Titles. Much of the document is made up of brand new definitions.

The fact sheet provides a high-level description of the following steps to determine and allocate Amount A:

- Step 1: Determine whether the MNE is in scope of Amount A.
- Step 2: Nexus & Revenue Sourcing – determine which market jurisdictions are eligible to tax a portion of the MNE's residual profit under Amount A.
- Step 3: Tax Base Determination – determine the relevant measure of profit of the Group.
- Step 4: Allocate Amount A to eligible market jurisdictions.
- Step 5: Eliminate Double Taxation.

The OECD had previously released seven public consultation documents on Amount A. Separate responses were requested in relation to each consultation document. The first release covered the revenue sourcing and nexus rules, the second release covered the rules for tax base determinations, the third release covered the general scope rules, the fourth release covered the exclusion for extractive industries, the fifth release covered the exclusion for regulated financial services, and the sixth & seventh covered tax certainty.

Substantive rules on Amount A

Scope

Main provisions

Amount A is based on a comprehensive scope that uses quantitative thresholds to determine whether a multinational enterprise (MNE) is subject to the rules on Amount A. Under the scope thresholds, MNEs with revenues greater than EUR 20 billion and with profitability greater than 10% will be in scope of Amount A.

The averaging mechanisms outlined in the previous scope consultation document have been slightly modified. In particular, the revenue test now 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, the average test and prior period test apply.

Observation: This means a Group will not be scoped out of Amount A over an extended period under the averaging mechanism in the case of an exceptional loss, but an exceptional loss may still be taken into account and carried forward under the tax base rules.

Segmentation

Provisions for application of Amount A to Disclosed Segments have been added to the draft rules. These rules will apply in exceptional circumstances where an MNE with more than EUR 20 billion of revenues does not meet the 10% profitability scope requirement, but a Disclosed Segment of that MNE meets both the EUR 20 billion revenue and the 10% profitability thresholds. In these circumstances, the Amount A rules will apply to such a Disclosed Segment as if it was an independent business from the rest of the MNE, and part of the Disclosed Segment's profits will be reallocated to the market country where the products and services of the segment are provided to the consumer.

Observation: The draft rules define a Disclosed Segment as any segment reported in the consolidated financial statements of the Ultimate Parent Entity of a Group under an Acceptable Financial Accounting Standard, which includes (but is not limited to) IFRS and US GAAP. Segment reporting outcomes may differ depending upon the relevant applicable accounting standard.

Exclusion of revenues and profits of a qualifying extractives group

The draft rules modify the application of the Amount A taxing right rules to “Qualifying Extractives Groups” that derive revenues from the exploration, development or extraction of qualifying products including minerals and hydrocarbons. Broadly, a Qualifying Extractives Group will not be subject to Amount A unless its non-Extractives Revenues for the period are greater than EUR 20 billion and its “non-Extractives Pre-Tax Profit Margin” is greater than 10%.

Non-Extractives Revenue will include revenues relating to activities or value realised after specific “Extractive Activities” have occurred. These Extractive Activities include the initial extraction of the mineral and hydrocarbon, “Primary Processing” to concentrate, isolate or refine those products, as well as transport and storage associated with those activities. The rules specifically identify the production of certain products (including LNG, metal concentrates and aluminum) as being within the scope of Extractive Activities.

The calculation of non-Extractives Revenue and non-Extractives Pre-Tax Profit Margin will be based on the disclosures in the group’s Consolidated Financial Statements, with adjustments made for “Extractive Segments” or “Extractive Entities”. Broadly, this applies a predominance test which excludes disclosed segments or underlying entities where 75% or more of the revenues are related to Extractive Activities.

The draft rules introduce a six-year initial transition phase during which Qualifying Extractives Groups can demonstrate they do not meet the non-Extractives profitability test or the non-Extractives Segment profitability test (as applicable) by applying prescribed simplified calculations.

Observation: The draft rules reflect a number of changes to the previous public consultation document released on 14 April 2022. Under the previous consultation document, in applying the EUR 20 billion in-scope threshold test, groups could only exclude third party revenue generated up to the “Extractive Activities” delineation point. This resulted in the value of extractive activities being included to the extent the first third party sale occurred after the delineation point. Under the draft rules, the value of such products should be excluded from the threshold test by applying arm’s length principles to value the product at the Extractive Activities delineation point. Other relevant changes include more options for demonstrating that the “in-scope” threshold is not met, more flexibility for groups in choosing whether to apply the segment or entity approach, and removal of maximum in-scope revenue thresholds in applying the predominance tests.

Exclusion of revenues and profits from regulated financial services

The draft rules set out the basis on which revenues and profits from regulated financial services will be excluded from the Amount A calculation. Important to the industry, both asset management and reinsurance remain excluded from the application of Amount A. Section 20(16) of Schedule C lists the other types of regulated financial services that qualify for the exclusion, which include depositary institutions; credit institutions; investment institutions; insurance institutions; asset managers; mixed financial institutions; and regulated financial service (RFI) service entities.

Where a consolidated group carries out regulated financial services (RFS) and other (non-RFS) activities, it will be necessary to consider both parts of the group separately. The RFS activities will not be in scope of Amount A and the non-RFS activities will only be in scope where the revenue and profitability of these activities alone would meet the revenue and profitability scope thresholds. Simplified tests have been introduced which allow a group to demonstrate its non-RFS activities have not breached the scope thresholds by either:

- Deducting the revenues earned by regulated financial institutions per the consolidated financial statements from the overall group revenue, or
- Aggregating the revenues of only non-RFS entities reported in their financial statements.

Observation: If a group cannot demonstrate that it is not in scope of Amount A by using either of the two simplified tests, then more detailed calculations would be required. One further change introduced in the draft rules is that the definition of RFS now includes a credit institution, instead of a mortgage institution, which was referred to in previous publications.

Tax base determination

Book-to-tax adjustments

The group profit on which amount A is then calculated is called the “allocation tax base” and is determined based on the net financial accounting income of the MNE based on consolidated financial accounts prepared in accordance with IFRS, US GAAP or an equivalent financial accounting standard. In addition to the book-to-tax adjustments outlined in the previous tax base determination consultation document, the new draft rules include four additional proposed adjustments to the allocation tax base. These include:

- Asset Fair Value or Impairment Adjustments;
- Acquired Equity Basis Adjustments;
- Asset Gain (or Loss) Spreading Adjustments; and
- [Treatment of profit attributable to non-controlling interests] – The brackets mean there is no consensus on whether or how such profit should be included or excluded in the tax base.

Observation: Certain of these additional proposed adjustments have similarities to concepts included in the Pillar Two Model Rules and Commentary. For example, adjustments for Asset Fair Value or Impairment Adjustments generally require that fair value or impairment outcomes included in the relevant financial accounting standards are adjusted to reflect only realised gains and losses. Moreover, Acquired Entity Basis Adjustments generally require a Covered Group to adjust the results of an acquired entity to reflect outcomes prior to the impacts of any applicable business combination accounting considerations (e.g., acquisition accounting adjustments to fair market value for acquired intangibles). However, the Pillar One and Pillar Two tax bases still diverge in important places, with the potential for additional work (and confusion) for businesses.

Loss carry-forward

The draft rules provide for a loss carry-forward regime based on an earn-out mechanism designed to ensure, subject to certain time limitations, that no Amount A profit is reallocated until the historic losses of the MNE have been absorbed. The draft rules provide that losses can be carried-forward up to 10 years, including losses incurred up to 3-years before implementation of Amount A (i.e., for pre-implementation losses). The limitation for pre-implementation losses is a transitional rule.

The draft rules include specific conditions for MNEs to apply the loss-carry forward rules to historic losses incurred by another business that has since become a part of that MNE as a result of a business combination or a division. These new rules for transferred losses are elective (i.e., MNEs have the option to apply them if relevant).

Nexus & Revenue sourcing rules

Nexus test

Once an MNE has determined how much revenue it generates in each of its market countries, Amount A profit will be reallocated only to the market countries where the MNE meets a quantitative special purpose nexus test. This test is satisfied when an MNE generates more than EUR 1 million in revenues in a market country (as determined under the revenue sourcing rules). A lower nexus threshold of EUR 250 000 applies where a country's GDP is lower than EUR 40 billion (e.g., currently Cyprus, Estonia, Latvia, Malta, Senegal, Zambia).

Revenue sourcing rules

To determine whether a Covered Group satisfies the nexus test for Amount A in a jurisdiction, the Group will have to apply the revenue sourcing rules. Article 4 and Schedule E of the draft rules include the provisions for identifying the jurisdiction in which revenue arises. Drawing from stakeholder support for further simplicity and administrability, the rules drop the prior proposal that required Covered Groups to source revenue on a transaction-by-transaction basis.

The draft rules also introduce more flexibility by permitting businesses to use a broader range of information to source revenues for most types of revenue categories. This is done, in part, by permitting the use of an “Alternative Reliable Indicator.” Where applicable, this allows a Covered Group to use its own proxies so long as they produce results that are consistent with the revenue sourcing rule for the category of revenues at issue. In addition, the rules propose a more simplified approach to sourcing revenue from business-to-business services. Here, the rules allow a Covered Group to use the billing address of its smaller customers as a reliable indicator. The rules also include more targeted proxies and allocation keys, which approximate the market country (such as allocation keys based on statistical information on aggregated headcount data or macro-economic proxies).

Finally, the draft rules provide a new three-year transitional phase during which MNEs can apply a more formulaic approach to revenue sourcing (i.e., presumptive use of specific allocation keys).

Observation: While the new rules provide added flexibility, they still require (except where an allocation key is applicable), that revenues be sourced in a manner that accounts for differences among jurisdictions in the goods, content, property, products and services sold, licensed or otherwise alienated and provided by the Covered Group, and their quantities and prices. For transport services, the draft rules (without explanation) require the use of prescribed allocation keys in all cases. The concept of a transition period was mentioned in the previous consultation on the tax certainty framework for Amount A – which also mentioned a transitional “soft-landing” period where a Group's calculation would be accepted as filed if the Group made reasonable efforts to reflect a correct application of the revenue sourcing rules.

Allocation of profit

Marketing and Distribution Profits Safe Harbour (MDSH)

The MDSH is primarily designed to address issues related to "double counting." This may occur, for example, if a market country has the ability to tax the same item of residual profit of a MNE twice: once through a physical presence taxable under existing profit allocation rules (typically transfer pricing), and again through an Amount A allocation. To prevent this, in circumstances where a market country already has taxing rights over a MNE's residual profit, an additional step is included in the calculation of Amount A to reduce the profit reallocated to that country by an estimate of the amount of residual profit already taxed there. Thus, the MDSH adjustment serves to reduce – and possibly eliminate — the Amount A allocation to an eligible market jurisdiction under applicable circumstances.

The MDSH relies on certain concepts and measures based on the jurisdictional and quantitative approach used in connection with the elimination of double taxation (see below). This includes a jurisdictional measure of pre-tax profits referred to as "elimination profits" and measures of profitability — return on depreciation and payroll ("RoDP") — where the profit is expressed as a percentage of depreciation and payroll ("D&P"). The formula for the MDSH quantifies a measure of the residual profits already subject to tax in the jurisdiction multiplied by an "offset percentage" (the exact value of which is not yet specified). In turn, the measure of jurisdictional residual profits is calculated as the difference between the elimination profit in the jurisdiction less the greater of two values that represent "routine profits" — profit equal to 40 percent of the D&P in the jurisdiction or profit equal to the "elimination threshold" RoDP multiplied by the jurisdictional D&P. The elimination threshold RoDP equals the ratio of 10 percent of revenues for the Controlled Group divided by the D&P for the Controlled Group. Finally, the MDSH limits the amount of the adjustment to no more than the (pre-MDSH) Amount A allocation to ensure that the adjustment does not reduce the Amount A allocation to any eligible market jurisdiction below zero.

An additional aspect addressed in the description of the MDSH is the interplay with the mechanics and rules for the elimination of double taxation. In particular, the Progress Report specifies that to the extent the MDSH adjustment limits the Amount A allocation to a given market jurisdiction, some multiple (specific value also unspecified) 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.

Observation: At a basic level, the logic behind the MDSH 'simply' goes that 'a jurisdiction's entitlement to Amount A should be abated or exhausted to the extent that it already earns profit in excess of the elimination threshold. This threshold equates to the 10 percent used in the main Amount A formula (or a 40 percent RoDP if this is higher). The essence of substance is, for the purpose of the MDSH formula, deemed to be assets and payroll. This has led to the observation that some in-country marketing and distribution whose profits are determined using a return on sales (ROS) as a profit level indicator might be already earning a high return on depreciation and payroll and may not receive additional income via Amount A (or only a capped amount) because of the MDSH. The Progress Report notes in footnote 3 that work is on-going to explore fallback metrics for the purposes of the MDSH to address concerns that a pure RoDP approach based on the contemplated thresholds could result in inappropriate outcomes for routine activities with a low payroll and asset base, for instance routine distributors.

Observation: As a more general comment, however, all of this is very complex, and far from intuitive. Furthermore, some of the percentages (and indeed measures such as RoDP) seem based more on what could be agreed between the major countries, rather than on any discernible underlying rationale. This again raises issues as to whether the MDSH, even if initially agreed, will be meaningfully stable over time.

Elimination of double taxation with respect to Amount A

Title 5 in the draft rules provide the framework to identify "relieving jurisdictions" that will have the obligation to eliminate double taxation with respect to the Amount A allocated to eligible market jurisdictions (pursuant to the rules covered under Title 2). The obligation to relieve double taxation is allocated among the relieving jurisdictions using a quantitative approach that stratifies relieving jurisdictions into tiers.

The intent of the rules to identify relieving jurisdictions and allocate the obligation of double tax relief for Amount A among those jurisdictions is to have that obligation be borne by countries where the Controlled Group earns residual profits. For the purpose of identifying those countries, another measure of profit of the MNE needs to be calculated under Amount A at the level of each relevant country. This is the purpose of the "elimination tax base" or "elimination profits." Unlike the allocation tax base, the elimination tax base is determined for a country only based on the sum of the adjusted financial accounting profit or loss of each entity located in that country. This elimination tax base uses the same accounting standards as the allocation tax base, and is generally subject to the same book-to-tax adjustments, with only some additional adjustments typically aimed at ensuring a closer alignment with existing domestic corporate income tax rules.

The relieving jurisdiction that will bear the obligation of double tax relief will be drawn from a set of "specified jurisdictions" — the smallest set of jurisdictions that together account for at least 95 percent of the Covered Group's elimination profits (plus others with elimination profits in excess of EUR 50 million). Per the draft rules, countries within the set of specified jurisdictions are then divided into tiers based on profitability — again, using the RoDP as the profitability measure — relative to the profitability of the Covered Group overall. The obligation of Amount A relief is allocated first among jurisdictions within Tier 1 and then (if needed) to lower tier jurisdictions in sequential order. Tier 1 jurisdictions are those that have a RoDP greater than 15 times the group wide RoDP. Tier 2 includes Tier 1 jurisdictions and others whose RoDP exceeds 1.5 times the group wide RoDP. Similarly, Tier 3A includes jurisdictions in Tier 1 and 2, and others whose RoDP exceeds 40 percent when this value exceeds the "elimination threshold" RoDP for the Covered Group – this value equates to 10 percent of the group's in-scope third-party sales divided by its D&P and is the measure of "routine" profits in the Amount A formula. Finally, Tier 3B comprises those jurisdictions that have a RoDP greater than the elimination threshold RoDP.

Double taxation is eliminated first by countries in Tier 1 using a "waterfall" approach. The country with the highest RoDP relieves double taxation first. The amount that is allocated to that country in this step is no greater than what would reduce its RoDP until it is equal to the RoDP of the country with the second highest RoDP. If this amount exceeds the total Amount A allocable to eligible market jurisdictions, the jurisdiction with the highest RoDP in Tier 1 is the only one that bears the obligation to relieve double tax with respect to Amount A. If that is not the case (i.e., there is Amount A that remains to be allocated), the countries with the highest and second-highest RoDP in Tier 1 then relieve double taxation on an amount of profit that would reduce their RoDP until it is equal to the RoDP of the country with the third highest RoDP. This process continues until either the obligation to relieve double taxation with respect to the Amount A profit of the MNE has been fully allocated, or the RoDP of countries in Tier 1 has been reduced to 15 times the RoDP of the Covered Group.

If double taxation is not fully relieved from Tier 1 residual profits, Tier 2 countries will be required to relieve double taxation in proportion to their "Tier 2 residual profits" — i.e., the jurisdiction's elimination profit less the amount of profits corresponding to 1.5 times the group-wide RoDP (and also any Amount A allocated under Tier 1). Tier 2 jurisdictions will be allocated a total Amount A obligation that is the lower of what is remaining after the Tier 1 allocation or the Tier 2 residual profits are exhausted. The draft rules then allocate any remaining Amount A to Tier 3A jurisdictions and, if needed, Tier 3B jurisdictions in an analogous manner.

Finally, the Progress Report states that specific rules will govern the identification of the Controlled Group entities in these countries that will be allocated the obligation of double tax relief, and rules will also address the methods by which relief will be provided.

Observation*:* The rules governing the identification of relieving jurisdictions and the allocation of double tax relief for Amount A among those jurisdictions have elements of a "waterfall" approach as well as a "pro-rata" approach. They are complex in their exposition and will likely be more complex to implement. Given the tiered approach, the likely outcome will be to concentrate the burden of double tax relief among investment hub jurisdictions that earn profits attributable to intangibles and risk.

Observation: It must also be observed that this is the most political part of the project because none of the G7 countries (especially the US) want to suffer net tax base loss. Again, however, the other jurisdictions upon which this engineered solution/burden is placed may seek to negate some of the effects, undoubtedly reducing the stability of any solution.

The takeaway

The Inclusive Framework continues to operate under the mantra "nothing is agreed until everything is agreed," which is worrisome considering the number of outstanding issues and increasing complexity of the rules. Even with the "more realistic" timetable approved by the Inclusive Framework, a lot of work remains to finalise the rules and translate them into a MLC by mid 2023 — a date that coincides with when the EU Commission is obliged under the latest draft EU minimum tax Directive to submit a report to the EU Council assessing the progress on Pillar One. The Cover Note approved by the Inclusive Framework recognises that a "critical mass" of countries will need to ratify the MLC before it goes into force. Hence, the concrete feasibility of Pillar One is intrinsically linked to whether countries, particularly the US, are able to adopt it. Should the stars align for Amount A to actually take effect, compliance will require an enormous effort for MNEs in scope.

Let's talk

For a deeper discussion of how the proposed approach to Amount A might affect your business, please contact:

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