Ernst & Young, LLP
1101 New York Avenue, NW
Washington, DC 20005-4213

Tel: +202-327-6000
ey.com

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Organisation for Economic Co-operation and Development
Centre for Tax Policy and Administration
Committee on Fiscal Affairs

Sent via email: cfa@oecd.org

Subject: Comments on OECD/G20 Inclusive Framework Public Consultation Document – *Reports on the Pillar One and Pillar Two Blueprints*

Ladies and Gentlemen:

We appreciate the opportunity to submit these comments on behalf of EY on the OECD/G20 Inclusive Framework's public consultation document *Reports on the Pillar One and Pillar Two Blueprints*. In this submission we address Pillar One and Pillar Two in separate sections. In each section, we first provide some overall comments on the pillar and then provide specific comments on the Blueprint details and the questions laid out in the consultation document.

I. Comments on Pillar One Blueprint

A. Overall comments on Pillar One

The Pillar One Blueprint reflects the substantial amount of technical work that has been done in fleshing out the Unified Approach. It also identifies areas where further technical work is being done. Filling in all the details of the proposed approach is essential to ensuring that any consensus on the major change to the international tax architecture that is contemplated under Pillar One is grounded in a common understanding and fully informed commitment by all countries. Before turning to comments on the technical components of the Blueprint, we want to begin with some big picture considerations regarding the overall approach reflected in the Blueprint that we believe are essential to sustainability and stability.

1. Importance of a principled framework

As an overarching concern, we would like to highlight what seems to be an unresolved internal struggle in the Pillar One Blueprint among various competing objectives, which include generation of tax revenue; concepts of ‘fairness’ in the form of ideas such as segmentation, digital differentiation, jurisdictional differentiation, and progressivity; avoidance of double counting; simplicity; and administrability. In addition, the approaches reflected in the Blueprint do not seem to be aligned with these competing objectives as the proposed rules would impose significant burdens on businesses that would not seem to give rise to the concerns that underlie the various objectives. Moreover, we note that all the numeric parameters relating to thresholds, profit allocation percentages, and reallocation percentages are not yet defined, awaiting political determination. We do not see in the Blueprint the necessary unifying principles by which all of these interconnected determinations can be made.

We believe that Pillar One requires a coherent underlying principled framework that could forge the basis for a stable working system. In some cases, the lack of a clear grounding in the Blueprint makes it difficult to address the specific questions raised. For example, the ‘double counting’ referenced in the Blueprint is relative to exactly what norm? As another example, is the policy rationale behind Amount A driven by the lack of residual/entrepreneurial returns in local jurisdictions or by the lack of ‘appropriate’ profits, and if the latter, how is ‘appropriate’ to be determined? While we recognize that there are a series of political decisions that still need to be made, we are concerned that calls made on discrete issues in a vacuum without an underlying driving principle would likely prove to be unsustainable.

2. Balancing burden and benefit

Achieving consistent and sustained global implementation and application of the approach reflected in the Pillar One Blueprint is dependent on the approach reflecting a reasonable balance between the burdens of the new rules for taxpayers and tax administrations and the benefits that are associated with the reallocation of taxing rights that would result from the new rules.

The OECD Secretariat’s economic impact assessment report released at the same time as the Blueprint shows only a very modest overall net tax revenue gain anticipated from global adoption of the approach reflected in the Pillar One Blueprint. Moreover, it is likely that the estimated annual overall revenue gain of 0.2-0.5% of global corporate tax revenues is overstated for several reasons. In particular, as the OECD Secretariat’s report caveats, the data used for the impact assessment dates back to 2016 and 2017, which pre-dates important developments around the world with respect to the implementation of the various recommendations that came out of the OECD’s Base Erosion and Profit Shifting (BEPS) project and were reflected in the final reports issued in October 2015. It can be expected that the changes in domestic tax law that have been made in so many countries around the world more recently would have the effect of reducing the magnitude of any overall tax rate increase associated with the reallocation of taxing rights that would result from the new rules. Moreover, because the approach is still under development, simplifying assumptions had to be made for purposes of the economic analysis. For example, the potential for double counting in the reallocations to market jurisdictions is recognized in the Blueprint, with a safe harbor mechanism being proposed as a means for reducing this double counting. As that safe harbor approach is further developed, the reduction in inappropriate double counting necessarily would reduce any potential reallocations under the new rules.

As difficult it is to precisely quantify the potential gain in terms of additional revenues overall, the potential burden of the new rules in terms of compliance and administration is even harder to quantify. However, it is clear that the costs associated with the new rules would be substantial. Companies would have to make major systems changes in order to collect and produce the data that would be required to apply the new rules. New systems and processes would be needed to create the new tax reporting that would be required under the new rules. Participation in the essential dispute prevention and dispute resolution processes that would be necessary under the rules would require significant resources. The new rules would also impose substantial new burdens on tax administrations in all the same areas. Moreover, the costs for both taxpayers and tax administrations would not be limited to a transition period as application and administration of the new rules would require significant additional resources on an ongoing basis.

In the interest of achieving a balance of benefits and burdens that is reasonable and sustainable, we urge the Inclusive Framework to focus on reducing complexity and easing the burdens as the ongoing work continues. We believe that this should be a core consideration as design decisions are made. In this regard, we would note that many of the questions identified in the consultation document relate to the possibility of abuse and how to eliminate any such potential. We encourage the Inclusive Framework to avoid excessive focus on such hypothetical possibilities in order to avoid increasing complexity and burden without clear benefit. Indeed, we would note the near impossibility of designing a new system or rules that will be "bullet-proof" from the outset. A better approach would be to plan a thorough review after several years of experience with the new rules to determine what refinements should be made to address any problem areas that may have arisen.

Finally, we urge the Inclusive Framework to return to the fundamental objectives of Pillar One in order to ensure that the rules being developed are fully aligned with those objectives.

3. Addressing unilateral measures

One of the core objectives of Pillar One is to prevent the spread of uncoordinated unilateral measures that will lead to overlapping taxation and create a barrier to cross-border economic activity. The adoption of digital services taxes and other measures that are uncoordinated attempts to address the same concerns that Pillar One addresses in a coordinated way is proliferating, which makes it all the more important that clear agreement both to roll back any such unilateral measures and not to adopt any such measures in the future be a central element of the commitment to Pillar One.

The agreement with respect to unilateral measures necessarily must include all forms of digital services tax. It must also include all other types of unilateral measures that deviate from traditional transfer pricing or permanent establishment principles. The agreement cannot be limited to measures that are in place when the commitment to Pillar One is made. It must extend into the future and serve as a bar to future action on such a measure. In addition, the scope limitations that are built into Amount A must be viewed as irrelevant to the reach of the commitments regarding unilateral measures. In other words, the fact that a particular activity may be carved out of the new Amount A rules cannot limit in any way the protection against application of any unilateral measure to such activity.

We urge the Inclusive Framework to develop a comprehensive list of unilateral measures that are inconsistent with a Pillar One commitment. In addition, we urge the Inclusive Framework to develop a clear set of guidelines on the features that would cause a tax rule to be considered an inconsistent unilateral measure so that measures enacted in the future can be tested against those features to determine whether they are prohibited measures that should not be advanced or that must be eliminated. Finally, this is an area where ongoing monitoring by the Inclusive Framework will be essential in order to promptly address any future action by a country on a unilateral measure.

4. Interaction of Pillar One and Pillar Two

As part of the work on both Pillar One and Pillar Two, it is essential that there be clear coordination of the rules being developed under each pillar so that the new rules do not combine in a way that results in inappropriate taxation. In our view, the new rules under Pillar One undoubtedly should apply before any application of new rules under Pillar Two, but that should be made clear. Moreover, the Inclusive Framework should establish clear guidance on how any subsequent adjustments of the results under Pillar One should be flowed through to trigger a reconsideration of the application of the new rules under Pillar Two. Without such a reconsideration, a subsequent adjustment under Pillar One could mean that the tax imposed under Pillar Two would result in excessive taxation. Finally, a commitment under Pillar One must include an agreement to follow these ordering and reconsideration rules with respect to Pillar Two.

5. Implementation process

The new rules contemplated under the Pillar One Blueprint would require that countries make significant changes to their domestic legislation and their bilateral treaties. In addition, the Pillar One Blueprint contemplates extensive multilateral processes for dispute prevention and dispute resolution to which countries must agree. Thus, it must be recognized that consensus under Pillar One would only be the start of the substantial work that will need to be done on implementation. It is important that the Inclusive Framework be involved in overseeing and monitoring all aspects of implementation.

We urge the Inclusive Framework to establish a clear process for overseeing the necessary steps for implementation. Given the importance of effective dispute prevention and resolution mechanisms, it is essential that these processes be agreed and fully operational at the time the new rules become effective. It also is essential that the Inclusive Framework clearly spell out what is meant by the objective of full consensus and commitment.

The work of the Inclusive Framework should continue beyond implementation in order to ensure that the new rules are being applied appropriately in practice so that the intended results are achieved. This should include a peer review process, with a workable procedure for stakeholder input so that taxpayers can provide information on how the new rules are being applied in practice without fear of reprisal and with the expectation that any practices that are not consistent with the commitment to the consensus agreement will be called out and addressed promptly and effectively. Finally, a schedule should be laid out for periodic review of the operation of the new rules together with a process for making any adjustments to the rules that are found to be needed during such review.

6. Deliberative process

Finally, as noted in the opening, while the Pillar One Blueprint reflects the significant technical work that has been done in the past year, there clearly still remains substantial additional technical work to be done. Moreover, as decisions are made on the major areas where there are political differences, those decisions will trigger the need for additional technical work. This work must be completed in order to have a clear set of rules that countries will be able to incorporate into their domestic law and apply in practice in a way that yields consistent results. We also note the importance of continuing the public consultation process as the technical work advances in order to get feedback from businesses on operational and compliance implications of the rules being developed.

Real consensus requires that there be a fully informed meeting of the minds in order to provide the stability and certainty that is important to taxpayers and tax administrations. Without such a meeting of the minds, countries could take inconsistent approaches while each believing mistakenly that its approach reflects the global consensus. This would be a very dangerous result.

It is essential that unrealistic deadlines not be allowed to interfere with the continuation of the collaborative process for completing the technical work that is necessary to achieve true consensus.

B. Comments on Pillar One Blueprint details and questions in consultation document

1. Scope

In the Pillar One Blueprint, the discussion of scope with respect to Amount A notes the considerable technical work that has been done in defining Automated Digital Services and Consumer Facing Businesses. The Blueprint discusses the need to accommodate new business models with the goal of ensuring a level playing field over time. We concur in the importance of providing principles and definitions with respect to scope that can be applied by tax administrations and taxpayers on a consistent basis to business models that do not yet exist today. Indeed, this is essential in the context of ADS given the ongoing fast-moving and transformational development in the industry. We encourage the Inclusive Framework to make this objective of clear and forward-looking definitions a key focus as the work on scope continues.

Activity test – Automated Digital Services

With respect to Automated Digital Services (ADS), the Pillar One Blueprint identifies parameters for ADS (citing the features of 'automated' and 'digital') and provides a definition that primarily consists of a positive list and a negative list. However, the line between the activities on the positive list and those on the negative list is blurry, which makes it difficult to evaluate the treatment of an activity that is not on either list by analogizing to the listed activities. Moreover, we are concerned that the continual and accelerating evolution in the industry will quickly render it impossible to use the two lists to make any credible analogy for a new digital business model. We encourage the Inclusive Framework to ensure that the scope of ADS is clearly defined, with positive and negative lists that are fully aligned with operative principles that delineate the boundaries of scope.

We also are concerned that there is a substantial risk that the scope of Amount A laid out in the Blueprint eventually would operate to sweep in all internet commerce, which in our view would extend beyond the intended reach of Pillar One. For example, there seems very little substantive technical or legal distinction between the online digital and consumer business models that are on the positive list and the models that are on the negative list and thus out of scope. Looking forward, as automation and scale increase across the global digital economy, the approach reflected in the Blueprint seems likely to mean that the activities currently on the negative list would move toward the positive list as they evolve and advance. This is especially true in the global markets for tangible goods ordered and delivered through automated means, as those consumer markets increasingly become a gateway for creating new markets for related consumer goods and services (including digital services).

We urge the Inclusive Framework to carefully consider the extent to which the ADS scope definition in the Blueprint results in a substantial expansion beyond the original intentions and objectives of Pillar One. As the technical work on Pillar One continues, it would make sense for the Inclusive Framework to evaluate the forward-looking implications of the ADS definition and reassess whether the defined scope is appropriately targeted to the areas where concerns regarding the operation of the long-standing tax architecture have been identified.

Activity test - Consumer Facing Businesses

Prescription pharmaceutical products -The Pillar One Blueprint includes a pro and con discussion of whether prescription pharmaceutical products should be in scope or out of scope of Pillar One. We believe this determination should be made based on the policy objectives of Pillar One, which in our view fully support the exclusion of prescription pharmaceuticals from the definition of Consumer Facing Businesses (CFB).

Starting with the CFB definition laid out in the Blueprint, prescription pharmaceuticals cannot be considered to be ‘commonly sold to consumers,’ because it is a medical professional who makes the decision regarding the use of a particular prescription pharmaceutical by a patient and thus determines whether that patient becomes a consumer of the pharmaceutical or not. Pharmaceutical products are properly classified as an essential component of the varied resources that are available to medical professionals in treating their patients. Indeed, prescription pharmaceuticals often are potential substitutes for surgical procedures, which are properly carved out of Pillar One.

The primary – and from a Hippocratic ethical standpoint, the only – consideration in whether a specific pharmaceutical product is prescribed for a patient is its inherent characteristics. Do the chemical or biological properties of the pharmaceutical effectively and safely alleviate or heal the patient’s condition, and if so, does the pharmaceutical do so in a manner that is superior to alternative treatments? This is an empirical determination, independent of marketing. And it is this determination that controls whether or not the patient becomes a consumer of the pharmaceutical.

In most jurisdictions, direct advertising of pharmaceutical products to consumers is not permitted. Even where such advertising is permitted, its reach is limited by the physician’s ultimate authority to determine whether the patient can use product or not. Therefore, we do not believe that the existence of such marketing is relevant to the CFB determination. Moreover, the marketing of pharmaceuticals to medical professionals is properly classified as assisting those professionals in providing medical services to patients, comparable to marketing associated with surgical tools and medical diagnostic equipment.

We do not think that the points raised in the Blueprint as supporting the treatment of prescription pharmaceuticals as in scope outweigh these important policy considerations. For example, the point is made that the distinction between over-the-counter and prescription status is not consistent across jurisdictions. This does not present a real administrative difficulty, as the delineation is typically very clear. Moreover, we further note that this delineation is based on considerations that are completely independent of tax. In those relatively few instances where the delineation may be less clear (such as a pharmaceutical having both over-the-counter and prescription applications within a single jurisdiction), we are confident that an objective rule can be developed to address this as is noted in the Blueprint. In our view, these manageable administrative considerations should not take precedence over the underlying policy considerations.

The Blueprint also makes a point that many prescription pharmaceutical products are very profitable. This would be an alarming justification for putting prescription pharmaceuticals – or any other product for that matter – in scope. Moreover, in the case of pharmaceutical products, this comment overlooks the hundreds of billions of dollars that are spent on research and development activities, the vast majority of which do not lead to successful products.

Accordingly, we believe that the policy considerations strongly support prescription pharmaceutical products being out of scope of Pillar One.

Medical devices – In our view, the stated policy objectives of Pillar One and the definition of CFB also supports the similar exclusion of medical devices that are implanted, installed or prescribed by a medical professional. These medical devices are not 'commonly sold to consumers.' Rather, medical professionals make the decision regarding the use of a particular medical device for a patient. Such medical devices are part of the resources available to medical professionals to serve patients and may be an alternative to other approaches to treatment such as non-device implementing surgery. Finally, the use of such medical devices is dependent on their inherent characteristics and whether those characteristics represent the best available treatment. Therefore, we believe that these medical devices, like prescription pharmaceuticals, should be out of scope of Pillar One.

Licensing and franchising – Under the Blueprint, licensing and franchising activity that relates to what are ultimately CFB goods or services is itself treated as in-scope. This is reflected in the Blueprint's definition of CFB, which includes any business that licenses or otherwise exploits intangible property that is connected to the supply of goods or services that are otherwise of a type commonly sold to consumers. In this regard, it should be noted that no specific details are provided on the potential computation of amount A for these businesses. Rather, the Blueprint indicates only that further work is underway on matters such as how to apply the nexus test, what revenues should be regarded as in scope, the interaction with withholding taxes, and so forth.

In our view, for purposes of computing Amount A, there should be a substantial difference between licensing or franchising businesses and the "traditional" consumer facing businesses that directly supply the goods and services to consumers. In particular, the level of a business's participation in the economy of the local jurisdiction through a licensing or franchising arrangement is significantly lower than what is involved in directly selling the goods and services. Indeed, in the case of a licensing or franchising arrangement, it is the licensee or franchisee operating in the specific market jurisdiction that has significant and sustained interaction with customers and users. We recognize that this difference may be considered to be partially reflected in the different categories of in scope revenues (i.e., revenues from sales of goods and services in the case of the licensee or franchisee versus licensing or franchising fees in the case of the licensor or franchisor). However, we believe that it would be appropriate for the allocation percentage with respect to Amount A for a business that is involved in a market jurisdiction through a franchising and/or licensing arrangement to be lower than the percentage that is applicable in case of a direct sale of goods and services in the market.

Moreover, as described in the Blueprint, licensing and franchising activity can be carried out in a range of different ways that involve different degrees of connection by the franchisor or licensor to the market jurisdiction. We believe that adjustments to the proposed approach are needed to reflect the particular circumstances of these arrangements.

- *Licenses for a fixed fee.* As recognized in the Blueprint, in a fixed fee license arrangement, the licensor is not entitled to share in the revenues earned by the licensee and instead is entitled to a fixed fee regardless of how successful the licensee is in commercializing the licensed material. The licensor will typically have limited rights to control how the licensee operates in respect of the licensed material. Therefore, the licensor will have very limited or no connection to the market jurisdiction in these arrangements. Accordingly, the allocation percentage of Amount A also should be very limited. In the interest of simplification, we believe it would be appropriate to exclude such a licensor from Amount A. In this regard, anti-avoidance rules could be used to address any concerns about the potential for artificial changes in a license arrangement from variable to fixed fee.
- *Related-party arrangements.* We are concerned about the potential for the proposed treatment of license and franchise arrangements to lead to double-counting with respect to Amount A in certain situations. Under the Blueprint, an intermediary that operates as a licensee or franchisee would be in scope of Amount when it is a directly consumer-facing business. In addition, the licensor or franchisor would also be considered to be in scope under the rules related to licensing and franchising activity. We believe it should be made clear that if both parties to a license or franchise arrangement are in scope for Amount A, the computation of the respective Amounts A does not involve any kind of double counting.
- *Third-party arrangements.* Under the Blueprint, in related-party situations, consideration will be given to the amount of residual profits already allocated to market jurisdiction through the marketing and distribution safe harbor and the process for eliminating double taxation. However, this will not be the case in situations involving license or franchise agreements between unrelated parties. Given that in license and franchise agreements the parties in the market often perform significant entrepreneurial activities, both using the intangibles they are entitled to use under the license and franchise agreement and also building their own market-related intangibles and taking commercial risks in the process, it is likely that the profits of the licensee and franchisee already include relevant residual profits. Whether a license or franchise will make residual profits depends on how the risks associated with the activity materialize and how they are mitigated. However, the treatment of any residual profits that are already reported in the market must be addressed in the third-party license or franchise situation to avoid double-counting and to avoid any distortion of business models from the application of different rules to similar related-party arrangements.

Finally, to the extent the licensor or franchisor is subject to Amount A, we believe that any withholding tax imposed in the market jurisdiction on the license or franchise fee should be a direct credit that reduces the tax that otherwise would be due with respect to Amount A. Moreover, the licensor or franchisor should be

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considered to be the surrendering entity for this portion of Amount A so that the withholding tax will be aligned with the tax that would otherwise be due on Amount A.

Exclusions

In our view, the industry sector exclusions that are provided in the Pillar One Blueprint are important to ensuring that an appropriate balance ultimately can be achieved with respect to Amount A through the ongoing work on scope. We encourage the Inclusive Framework make sure that the reach of the industry sector exclusions is clear and to prioritize simplicity in delineating how far the exclusion applies to each sector in order to minimize the need to separate different elements of activity within an otherwise excluded sector.

Thresholds

Global revenue test – The Pillar One Blueprint identifies the current EUR 750 million threshold for Country-by-Country Reporting (CbCR) as the most appropriate threshold for the global revenue test for determining the MNE groups that are in scope of Amount A. We concur on this point. In the context of CbCR, the EUR 750 million was established because it strikes an appropriate balance between compliance burden and informational benefit. The inherent concentration of business activity means that a small minority of the largest MNE groups account for the vast majority of global business activity. Based on the work that was done in connection with the establishment of CbCR, a gross revenue threshold of EUR 750 million was expected to exclude approximately 85 to 90 percent of MNE groups while at the same time including MNE groups that generate approximately 90 percent of corporate revenues. A review of current public data confirms that this concentration of business activity persists. We believe that the balance achieved with a EUR 750 million threshold is appropriate for determining MNE groups in scope of Amount A, just as it continues to be appropriate for determining MNE groups in scope of the CbCR requirements.

The Blueprint raises the possibility of using a phase in approach for the global revenue threshold, with the threshold being set at a substantially higher number at first and then being phased down to the EUR 750 million level over a period of years. This would further limit the number of MNE groups that are subject to Amount A in the earlier years, reducing the burden on tax administrations and allowing them to gain experience working with Amount A. We believe that a several year phase-in from a higher global revenue threshold down to the EUR 750 million threshold would be a good approach.

De minimis foreign revenue test – The Blueprint also describes a de minimis foreign in-scope revenue test that would operate to exclude an MNE group that has less than EUR 250 million of in-scope revenue outside its domestic or home market. The Blueprint suggests that application of this test will first require an MNE group to identify its domestic or home market using a standardized definition such as where the group is headquartered or where the ultimate parent entity (UPE) is tax resident.

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We are concerned that use of a standardized definition could have distorting effects. This is illustrated as follows. An MNE group is headquartered in country A and its UPE is tax resident there. Its in-scope revenue in country A is EUR 200 million and its in-scope revenue in country B is EUR 700 million. If the standardized definition treats country A as the domestic or home market, the exception would not apply. This would disadvantage the MNE group as compared to a peer that has the same revenue distribution pattern but is headquartered in country B with its UPE tax resident there. This potential distortion could be avoided by allowing an MNE group to identify its home market for purposes of the application of the de minimis foreign in-scope revenue test. In this regard, consideration could be given to including a reasonable consistency requirement to limit changes in home market identification absent a substantial change in relevant circumstances.

2. Revenue sourcing

The Pillar One Blueprint outlines a web of revenue sourcing rules that are relevant for the application of the de minimis foreign in-scope revenue test, the determination of nexus, and the computations related to Amount A. For each category of activity, the Blueprint provides both a sourcing principle and a hierarchical list of indicators to be used to apply the principle to source the income from that activity.

We believe that the rules laid out in the Blueprint are unnecessarily burdensome, in particular in the case of sales through an independent distributor by an MNE group that is considered to fall within the CFB definition. The Blueprint uses place of final delivery to the consumer as the sourcing principle for sales of goods, whether the sale is made directly or through an independent distributor. For sales through independent distributor, the indicators specified in the Blueprint are the place of final delivery as reported by the independent distributor or as indicated by other information already available to the MNE group. However, in many instances, the MNE group will not know the place of the final delivery of the good to the consumer by the independent distributor. Therefore, these indicators are not practical.

Where the MNE group does not already have the information, the Blueprint further indicates that the MNE group is expected to take reasonable steps to seek a change in the contractual arrangement with the distributor in order to require the distributor to report the information on the aggregate number and type of products sold to each jurisdiction. The Blueprint here acknowledges that this could take time to negotiate and could come at cost as a broader renegotiation. We concur in that point and believe that any requirement to renegotiate would represent an unreasonable burden contrary to the stated intent of designing the revenue sourcing rules in a way that does not result in 'disproportionate compliance costs.'

The Blueprint further indicates that further work is being done on the revenue sourcing guidance, with the expectation that there should not be any requirement to incur more than insignificant costs such as the price increase that could result from a required renegotiation of a contractual arrangement. The Blueprint specifically identifies the proposed rule regarding amendment of contracts with independent distributors as an area that is being considered from the perspective of whether this would create undue burdens or commercial competitive considerations.

In this regard, we would further note that the proposed rule would disadvantage MNE groups that follow the rule and renegotiate their contracts to collect the information relative to MNE groups that do not do so on the grounds that it would not be reasonable. In addition, collecting the information could lead to disclosure of competitive information and may be at odds with competition law. Furthermore, there are practical issues that should be considered as well, such as the fact that the transaction between the MNE group and the distributor might take place in a different fiscal year than the final delivery to the consumer, which would mean that the independent distributor would need to track and report the goods flow through inventory. We believe that the significant concerns that have been identified must be addressed and we urge the Inclusive Framework to take a different approach with respect to revenue sourcing for sales of goods through independent distributors.

Finally, we would note that in the case of a sale through an independent distributor, it is very unlikely that the MNE group would have physical nexus in the ultimate sales jurisdiction. The Blueprint indicate that a number of jurisdictions are of the view that a plus factor is needed to create nexus, which would mean that a sale through an independent distributor also should not lead to nexus under the new rules. Given the administrative burden, the potential practical difficulties, and the fact that it is debatable whether such sales actually create sustained engagement in the market, we urge the Inclusive Framework to use the location of the distributor as the place of revenue sourcing for sales of goods through independent distributors.

3. *Tax base determinations*

Segmentation

The Blueprint discusses under what circumstances a taxpayer may be required to segment its consolidated financials for the purpose of calculating Amount A. Consistent with our prior comments, we continue to believe that segmentation based on business line or geography should be at the sole discretion of the taxpayer. Such an approach would appropriately recognize the amount of data that would need to be developed and presented by the taxpayer in order to apply Amount A on a segment basis. The taxpayer should be allowed to compute Amount A based on any reasonable segmentation, supported by an overall reconciliation of the aggregate reported segment income to consolidated financial statement income. As we previously noted in our comments, guidance on Amount A could specify a consistency rule requiring taxpayers to use the same segments from year to year absent a significant business change.

We believe that the ability of taxpayers to choose reasonable segments is critical to appropriate operation of the Amount A rules. Where an MNE group organizes its operations along business lines or geographic territories, it should be permitted to segment its businesses in order to reflect a clear connection between market jurisdictions and the Amount A profit pool to which they contribute. Taxpayers could choose to segment on either a geographic or business line basis, or both, depending on what best ensures this connection.

The following examples, which are not all-encompassing, illustrate how segmentation is an appropriate mechanism for reflecting a clear connection between the market jurisdictions and the particular Amount A profit pool to which they contribute:

- *Following an acquisition, where the acquiror and the acquired business have different geographic footprints and continue to operate as such once combined*. In this case, it may be appropriate to segment the acquired business from the acquiror's legacy business in order to reflect a clear connection between the market jurisdictions and the business lines to which they contribute.
- *Where the MNE* group *has a cost contribution arrangement with two or more participants in different countries engaged in the joint development of intangible property*. In this situation, each participant holds exclusive, non-overlapping rights to exploit the jointly developed IP in specified geographic territories and each cost share participant would be identified as a surrendering entity. In this case, it would be appropriate to segment based on geography to reflect a clear connection between the each surrendering entity and the market jurisdictions within its exclusive territory.
- *Where an MNE* group *sells regulated products, some of which have not been approved for sale in every jurisdiction in the MNE* group*'s footprint.* In this situation, the product lines may have significantly different profit margins. In this case, it would be appropriate to segment based on product and geography to reflect a clear connection between the market jurisdictions and the profit pools to which they contribute.
- *Where an MNE* group *manufacturers Products X and Y in Country A and has one surrendering entity, also in Country A, with Product X only sold in Country A and Product Y sold in many countries globally.* In this case, it would be appropriate to segment between Product X and Product Y such that only profit from Product Y is subject to reallocation outside Country A in order to reflect the clear connection between the market jurisdictions other than Country A and the profit pool with respect to only Product Y to which they contribute.

In all of these examples, allowing the taxpayer to choose to segment with a view to market connection would both reflect the contribution of a market jurisdiction to a specific profit pool and account for the regional profitability variances that may exist. We urge the Inclusive Framework to specify this market connection principle as a reasonable basis on which a taxpayer could choose to segment.

As a final note, we encourage the Inclusive Framework to explicitly reference the separation of out-of-scope business lines as another reasonable basis for segmentation.

Carryovers

The Blueprint states that the Amount A tax base rules will be applied consistently to profits and losses, providing that losses will be effectively carried forward to subsequent years through an earn-out mechanism. We believe that a robust set of carry-forward rules is essential to ensuring that Amount A properly reflects net profit.

We are concerned that the Blueprint notes the potential for restrictions on such carry-forwards. We believe that any restrictions would result inappropriate distortions of the measure of the tax basis. First, the carry-forward period must be unlimited because any time limits would artificially inflate the tax base. Second, there should be clear rules specifying how an outstanding carry-forward is treated in the case of a reorganization.

In addition, we note that the Blueprint references pre-regime losses, indicating that the treatment of such losses is still being discussed and that there are differences of view among participating countries. We believe that pre-regime losses must be allowed to be carried forward and that the carry-forward period should not be limited. In addition, we believe that pre-regime investments also should be taken into consideration, even if they don't give rise to a net loss in the year incurred. We further believe that the carry-forward of such pre-regime investments should not be time limited.

Finally, we continue to believe that what the Blueprint refers to as profit shortfalls – profits below the profit threshold that is established for Amount A – must be carried forward in the same manner as a loss to avoid distortion in the Amount A tax base. Without such a carry-forward, the Amount A would be over-stated.

4. *Profit allocation*

Throw-back approach

The Pillar One Blueprint describes a three-step process for computing and allocating Amount A. In discussing the third step's allocation approach, the Blueprint specifically notes the need to address the treatment of revenue sourced in so-called ineligible jurisdictions, which are any market jurisdictions where the taxpayer is not considered to have nexus. The allocation approach outlined in the Blueprint involves allocating Amount A to each eligible jurisdiction based on the ratio of locally sourced in-scope revenue to total revenue. This would have the effect of excluding from the allocation any revenue that is sourced in an ineligible jurisdiction and is referred to in the Blueprint as the 'throw-back' system. We believe that this is the appropriate approach. Indeed, we believe that this is the only approach that would be consistent with the stated policy rationale for Amount A.

We are concerned, therefore, that the Blueprint also includes another possible approach, which is referred to as the 'throw-in' system and which would have the effect of allocating revenue sourced in ineligible jurisdictions to other jurisdictions where there is nexus. There is no principled justification for such an approach that would result in a base-less windfall for the other jurisdictions.

In allocating a portion of deemed residual profits among the eligible market jurisdictions, the allocations must be made without regard to the finding regarding nexus under the new rules with respect to any such jurisdiction. This requires that the allocations be done based on the locally sourced in-scope revenue of each market jurisdiction with nexus relative to total revenue earned by the group (or segment). The fact that the group (or segment) has one or more ineligible market jurisdictions cannot result in a higher allocation of profits to the other market jurisdictions for which the nexus threshold is met. In other words, profits that would otherwise be allocated to a market jurisdiction where there is no nexus should not to be reallocated to other market jurisdictions where there is nexus but should be remain where they are reported.

Domestic business carve-out

The Pillar One Blueprint acknowledges that under the rules developed to date Amount A could apply in situations where entrepreneurial activities of some or all of the entities of the MNE group are purely local, with revenues of the entity being generated by in-country sales to consumers or users and residual profits of the activities being taxed in the country. This situation is a broader manifestation of the circumstance addressed with the inclusion of the de minimis foreign in-scope revenue threshold as part of the scope determination. We urge the Inclusive Framework to adopt an approach where group entities that perform domestic-to-domestic activities also are excluded from the scope of Amount A to prevent potential double counting issues from arising. We believe that such an exclusion from scope would be the most effective manner for resolving these double counting issue and would represent a much-needed administrative simplification for both businesses and tax administrations.

Domestic-to-domestic activities could be defined as activities performed in a market that generate revenues almost wholly from users and consumers from that market (e.g., at a 90% level or higher) and that use a transfer pricing model that does not allow for shifting of more than marginal amounts of residual profits (or residual losses) to another country. Entities performing these activities would be excluded from the scope of Amount A. This would significantly reduce administrative costs compared to the solution reflected in the marketing and distribution safe harbor that is described in the Blueprint, which would require separate delineation of activities, allocation of profits, calculations of residual profits, etc.

A carve-out of domestic-to-domestic activities from scope also would more fully address the double-counting issue, in contrast to the marketing and distribution safe harbor which is not fully effective in neutralizing double counting. The safe harbor starts from the assumption that residual profits are always positive. Hence, Amount A allocations are eliminated only to the extent that there are residual profits allocated to the country already. However, residual profits are linked to entrepreneurial activities and such activities may result in either profits or losses. While the marketing and distribution safe harbor does eliminate allocations of Amount A for activities that already generate sufficient residual profits in the markets, it does not remove these entities as potential surrendering entities. Consequently, if some of the entities performing domestic-to-domestic activities in the group generate significant profits, while others generate losses, the profit allocation rules reflected in the Blueprint would lead to profits from the profitable entities being allocated to the loss making entities, even if their activities are not connected. Countries where the profitable entities are located will perceive this as arbitrary and unfair. Moreover, this will also mean that countries may lose revenue following the acquisition of a locally owned entrepreneur entity by an MNE group. A domestic-to-domestic activities carve-out from scope would avoid these issues, because both loss making and profitable local entrepreneurial activities would be excluded from the scope of Amount A and instead would continue to be taxed in the same way as locally owned entities with similar activities.

We also believe that the marketing and distribution safe harbor described in the Blueprint should be maintained for activities that are not fully domestic-to-domestic but that do generate residual profits in the market country above the specified safe harbor levels. For these situations, the marketing and distribution safe harbor provides a welcome solution for the double counting issue.

In addition, we note that the marketing and distribution safe harbor is described in the Blueprint as applying only for CFB activities. However, the same double counting potential also arises for ADS activities. We urge the Inclusive Framework to expand the marketing and distribution safe harbor to include ADS as well as CFB. This could be done by using the general definition of ADS for purposes of Pillar One with the addition that these activities would need to take place in the market jurisdiction to be delineated as local activities.

Finally, it is important to recognize the double counting issue does not arise only in situations where the supply chain is owned by the same group (related supply chain), but also arises where two or more independent companies each are responsible for part of the supply chain (split supply chain). If the activities in the supply chain are the same and generate the same amount of residual profits in the market country, the marketing and distribution safe harbor would set off the residual profits already taxed in the market jurisdiction against Amount A in case of the related supply chain, but the application of Amount A without such set off would result in additional tax in the market jurisdiction in the case of a split supply chain. This difference in treatment would cause economic distortions by creating tax and economic incentives to organize a supply chain as a related supply chain and to centralize the operations of the supply chain as much as possible outside of market countries so as to minimize the Amount A that would be allocated to a market jurisdiction in a split supply chain. To prevent such distortions, we urge the Inclusive Framework to expand or supplement the marketing and distribution safe harbor in order to provide a solution through which residual profits that are already taxed in the market can be taken into account and offset against Amount A in the case of split supply chains.

5. *Specific mechanisms for elimination of double taxation*

<u>Paying entities should have market connection</u>

The Pillar One Blueprint lays out four steps for identifying the so-called paying entities from which profits to be re-allocated to market jurisdictions under Amount A are to be harvested. We believe that these rules illustrate the complexity, and also the subjectivity, that is involved in making the Amount A rules work in a way that aligns to any extent with the policy rationale underlying Pillar One.

The activities and market connection priority tests are both needed to prevent arbitrary re-allocation of profits to markets that have no connection to these profits. However, application of these tests in the formulaic environment in which Amount A is established creates significant complexities and subjectivity. In our view, without these two subjective tests as part of the elimination of double taxation exercise, the allocation of Amount A would be too arbitrary to satisfy the stated policy objective of re-allocating residual profits connected to specific markets to such countries. While we continue to believe that the inclusion of the activities and market connection priority tests is essential, we urge the Inclusive Framework to further consider the complexity and subjectivity that is inherent in this area and work to identify approaches that would achieve a more sustainable balance.

Exemption method for eliminating double taxation

We believe that ensuring full elimination of double taxation with respect to any amounts reallocated under Pillar One will require that countries incorporate new double tax relief mechanisms into their domestic law that apply specifically for this purpose. The mechanism must be a 100% exemption in order to full and effective relief. This mechanism should apply for purposes of Amount A without regard to the particular double tax relief mechanism that the country applies under its domestic law for other purposes.

In addition, any expense allocation rules under domestic law that operate to limit double tax relief should not apply for purposes of Amount A, which already is a net profit amount. Also, it must be made clear that any branch profits tax provided for under domestic law would not apply to a deemed branch created by reason of Amount A. Finally, procedures must be established to ensure that the new double tax elimination mechanism applicable for Amount A can be applied effectively on a multilateral basis.

Anything less than this approach to double tax relief for Amount A would not ensure the full elimination of double tax that is essential to fair results under Pillar One.

6. Amount B

As an initial matter, we welcome the discussion in the Blueprint regarding positioning Amount B as a rebuttable presumption, which could be rebutted by the taxpayer on the basis of another transfer pricing method. We believe this approach will help ensure appropriate results under Amount B. We also welcome the Blueprint’s clear acknowledgement that Amount B would not supersede previously agreed advanced pricing agreements or MAP settlements.

With respect to the scope of Amount B, clear definitions of baseline activities and negative indicators are essential. In this regard, we suggest that the Inclusive Framework consider the prioritization of quantitative indicators that can be used as proxies to identify entities and transactions in scope of Amount B.

We also support the use of segmentation for multifunctional entities. We note that further consideration should be given to addressing situations that involve multiple taxpayers with fragmented or shared functionality in the same country or longer supply chains with functionality that is fragmented cross border. We would caution against limiting the scope of Amount B to situations that involve resale to unrelated customers predominantly in an entity's country of residence given the common use of regional distributors.

In terms of measurement, we suggest that Amount B be based on local GAAP (as opposed to group GAAP). We further suggest that the Amount B target be applied at the end of the year of assessment for the distributor (based on local statutory audited annual financial statements), to mitigate the potential for knock-on effects involving secondary adjustments, withholding taxes or customs duty.

In terms of the implementation of Amount B, we urge the Inclusive Framework to make clear that the arm's length principle, as documented in the OECD Transfer Pricing Guidelines, remains fully applicable for activities or business outside the scope of Amount B. Moreover, the exclusion of a distributor from the scope of Amount B should not be viewed as necessarily implying the existence of an intangible or premium in excess of Amount B. Rather, the effect of the exclusion from scope should merely be that the arm's length nature of controlled transactions is to be determined in accordance with the OECD Transfer Pricing Guidelines.

We believe that further consideration should be given to the interaction between Amount B and Pillar Two, especially where the deductions of a distributor could be disallowed through the operation of Pillar Two's undertaxed payments rule. Here too, MNE groups should be free to structure their affairs through controlled transactions to give effect to the full impact of Pillars One and Two in local accounts.

Finally, we believe that Amount B has the potential to bring greater certainty to transfer pricing and to reduce disputes. To achieve this potential, it is essential that Amount B be incorporated in a multilateral agreement that supplements any necessary local legislation. The application of dispute resolution processes that are mandatory and binding is also important in the context of Amount B and the interaction of Amount B with the transfer pricing analysis of activities that are beyond the scope of Amount B.

7. *Tax certainty*

We believe that the focus in the Blueprint on an early tax certainty process to prevent and resolve disputes on Amount A is critically important and that such a process is essential in providing the certainty that is needed to ensure an environment conducive to cross-border business investment and activity.

Tax certainty is the result of a combination of two things: clear legislation tailored to the particular policy objectives that comprehensively addresses all relevant issues and reliable implementation of that legislation, including a reliable dispute prevention and resolution process. To some extent, subjectivity or lack of clarity in the legislation itself can be compensated for by having a reliable dispute prevention and resolution process, but it is necessary to have clear underlying principles that can guide how to resolve any interpretation issues.

We are concerned that the policy objectives of the Pillar One construct are not clearly reflected in the design of the rules. Moreover, the proposed rules are complex and leave room for conflicting interpretations. In addition, the dispute mechanisms contemplated in the Blueprint would require countries to put their faith in a panel, in which they may not necessarily be a participant, to resolve the interpretation issues. Further exacerbating this situation is the fact that some countries continue to be unwilling to accept mandatory and binding arbitration even for cases where the rules are clear and agreed.

This combination of circumstances leads us to question the extent to which jurisdictions will fully embrace the dispute resolution mechanisms outlined in the Blueprint. It is clear that dispute resolution mechanisms as ambitious as those described in the Blueprint will be essential to ensuring that the proposed Pillar One rules will not lead to chaos. We are concerned that pressure will be put on the design of the tax certainty rules, with the consequence that they will be significantly watered down. That would result in a set of unclear and complex rules without the necessary counterweight of a reliable dispute prevention and resolution mechanism. Therefore, in our view, it is essential for the ambitious tax certainty process described in the Blueprint to be in place before any Amount A rules are implemented. If agreement cannot be reached on the tax certainty rules, the proposed Amount A rules should be re-considered with a view to replacing them with rules that are clearer and more closely tailored to the stated policy objectives of Pillar One.

II. Comments on Pillar Two Blueprint

A. Overall comments on Pillar Two

The Pillar Two Blueprint reflects substantially more technical detail than was reflected in the earlier documents on Pillar Two. It is valuable to have this level of detail in a public consultation document so that stakeholders can provide constructive and practical feedback on the specifics. Before turning to the technical elements, we want to begin with some big picture considerations regarding the overall approach spelled out in the Blueprint that we believe should be factored into the ongoing work on Pillar Two.

1. Avoiding distortion of tax system design

In our prior comments on Pillar Two in March 2019 and December 2019, we expressed concern about the potential encroachment of Pillar Two on sovereignty over tax system design. We continue to have those concerns and therefore continue to believe that the Pillar Two work should be approached with caution in order to avoid undermining the OECD's long-standing recognition that decisions as to corporate tax rate are the prerogative of each country and that low tax rates alone cannot be viewed as a harmful tax practice.

As the work on Pillar Two continues, we urge the Inclusive Framework to prioritize limiting the potential for the rules to affect the ability of countries to make tax system design choices in furtherance of their economic policy objectives. In this regard, we continue to believe that income that arises from real economic activity in a country should be excluded from the reach of the Pillar Two rules. This is important to allowing countries, including smaller and developing countries, to use their tax system choices as a tool to attract commercial activities to drive economic growth, innovation, and job creation.

Keeping the reach of Pillar Two narrowly targeted also will serve to limit the distortion in tax system design that will result. As the OECD's economic impact assessment report makes clear, the construct of Pillar Two could have the effect of driving a country to increase its corporate income tax rate in order to protect income generated through local economic activity from being subjected to a top-up tax imposed by another country. That translates into the country being driven to choose greater reliance on corporate income tax, a form of taxation that the OECD has long recognized is an extremely inefficient form of taxation in terms of its adverse effects on economic growth. Such an effect is particularly troubling in the current economic environment.

2. Avoiding distortion of business decisions

Just as it is important to avoid distortions of tax system design decisions, it is in our view equally important to avoid distortions of business decisions. We urge the Inclusive Framework to focus on ensuring neutral treatment as the work on Pillar Two continues.

In this regard, we believe that the income inclusion rule (IIR) is the component of Pillar Two that is most aligned with the principle of neutrality. The importance of neutrality is another factor that supports giving priority to the IIR over both the undertaxed payments rule (UTPR) and the subject to tax rule (STTR). The transactional nature of the UTPR and the STTR, together with their application to related-party payments, results in different types of income being treated differently. This can have a distortive effect that is inconsistent with the principle of neutrality.

3. Form of consensus

As the Inclusive Framework continues to work toward consensus agreement on Pillar Two, it is important to be clear what form that consensus will take. The expectation is that, in contrast to Pillar One, consensus on Pillar Two will not require a commitment by each country to fully implement the Pillar Two rules. Is Pillar Two to be done in the form of minimum standard? Alternatively, is it to be a recommendation or will it take some other form? We urge the Inclusive Framework to spell out the intended form even as the design work continues because the form could well affect some core design decisions.

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We also urge the Inclusive Framework to be clear about how it intends to ensure that countries that choose to implement the Pillar Two rules do so in a manner that is consistent with the parameters of Pillar Two. Such consistency is essential to ensuring that the rules interlock in the intended manner and that the result of Pillar Two is not taxation in excess of the agreed minimum rate due to the imposition of multiple top-up taxes. Here too, the intended mechanism for ensuring consistency could well affect design decisions.

4. Interaction of Pillar One and Pillar Two

As discussed above in connection with Pillar One, we believe it is essential that there be clear coordination of the rules being developed under the two pillars so that the new rules do not combine to result in inappropriate taxation. The necessary coordination includes both the initial application of each set of new rules and how any adjustment that is made subsequently based on the rules under one of the pillars affects the application of the rules under the other pillar. Such ordering and coordination rules should be viewed as an important part of the design work with respect to each pillar. And any consensus must include an agreement to implement the agreed ordering and coordination rules.

5. Implementation process

Even though consensus on Pillar Two is not expected to involve a commitment by all countries to implement the rules, an orderly implementation process for Pillar Two is important. The Inclusive Framework should be involved in overseeing and monitoring all aspects of implementation.

As in the case of Pillar One, the work of the Inclusive Framework also should continue beyond implementation in order to ensure that the new rules are being applied appropriately in practice and the dispute resolution processes are working effectively. This should include a peer review process, with a workable procedure for stakeholder input so that taxpayers can provide information on how the new rules are being applied in practice without fear of reprisal and with the expectation that any practices that are not consistent with the consensus agreement will be called out and addressed promptly and effectively. Finally, a schedule should be laid out for periodic review of the operation of the new rules together with a process for making any adjustments to the rules that are found to be needed during such review.

6. Deliberative process

Finally, as with Pillar One, there clearly is substantial additional technical work still to be done on Pillar Two. This work must be completed in order to have a clear set of rules that countries that choose to implement Pillar Two will be able to incorporate into their domestic law and apply in practice in a way that yields consistent results. Consultation with stakeholders also will be important. Unrealistic deadlines should not be allowed to interfere with the continuation of the collaborative process for completing the necessary technical work.

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B. Comments on Pillar Two Blueprint details and questions in consultation document

1. GILTI coexistence

The Pillar Two Blueprint notes the Inclusive Framework's recognition that an agreement on the co-existence of the pre-existing US GILTI rules will be necessary to achieve a political agreement on Pillar Two. To that end, we believe that it is essential that the treatment of the GILTI rules in the context of Pillar Two be spelled out clearly and be considered as a core component of the Pillar Two construct.

We urge the Inclusive Framework to make clear that the GILTI rules constitute a pre-existing IIR that is considered to be Pillar Two compliant and that takes priority over any other IIR implemented in connection with Pillar Two. As such, the GILTI rules also would take priority over any UTPR because of the ordering rule that positions the UTPR as a backstop to the IIR. This also must be clear.

As discussed in more detail below, we believe that the Inclusive Framework should reconsider the current proposal with respect to the STTR that would effectively give it first priority among the Pillar Two rules. We believe the only way the Pillar Two construct could be made to work appropriately would be to specify that the IIR takes priority over the STTR just as it takes priority over the UTPR. Under this approach, the GILTI rules also would take priority over the STTR. We believe that the GILTI rules taking priority over any STTR is essential to the necessary GILTI co-existence agreement.

Consistent with the Blueprint, we believe that the treatment of GILTI as a Pillar Two compliant IIR should remain in place without any time limitations, absent any enactment of legislative changes that are agreed to have the effect of materially reducing the burden of the GILTI rules.

2. Scope

<u>Further limitations on scope</u>

Under Pillar Two, the Inclusive Framework seeks to develop a systemic solution addressing remaining base erosion and profit shifting (BEPS) issues by designing rules that provide jurisdictions with a right to "tax back" where another jurisdiction has not exercised its primary taxing right or a payment is otherwise subject to low levels of effective taxation. The systemic approach described in the Pillar Two Blueprint is characterized by a broad application across business sectors, the use of one-size fits-all approximations of levels of effective taxation, and a complex set of rules with layers of backstops. The natural consequence is that the overall construct may apply beyond the intent of the policy makers and may cause distortions where the rules do not take into account differences between industries and diversity in capital structures. This potential for overreach and distortion will undermine the objective of achieving a consensus-based solution that will result in a stable and coordinated network of rules around the world. We believe these concerns can be addressed by carefully reconsidering the scope of Pillar Two to more narrowly target the rules. We believe that appropriately narrowing the rules also will prevent unnecessary administrative costs for both tax administrations and businesses.

As an initial matter, in our view, MNE groups that have a high effective tax rate (ETR) at the group level should be recognized as representing a low risk of BEPS for governments. We urge the Inclusive Framework to consider the development of a gateway test that would exclude MNE groups from the Pillar Two rules based on a simplified ETR test linked to the group's global operations. We would note that this gateway test should not be confused with the global blending approach that has been discussed in the context of the design of the GloBE rules (i.e., the IIR and the UTPR). In contrast to global blending, the global tax rate to be used in this gateway test would not be used for purposes of a top up to the minimum tax rate. Rather, it would be used to make an overall risk assessment of what category of companies should be subjected to application of the Pillar Two rules. This global gateway test should use a relatively high rate (e.g., 20%) as the global ETR threshold for the scope determination. If the global ETR of an MNE group does not exceed this threshold, the Pillar Two rules would be applied to the group (absent another applicable exclusion). For purposes of implementation of the Pillar Two rules, the Inclusive Framework could consider using phased approach for this gateway test, with the global ETR threshold initially set a lower level and phased up over time to allow tax administrations to gain experience with the Pillar Two rules by focusing initially on MNE groups with particularly low global ETRs that may pose greater BEPS risks. Finally, while an agreement on GILTI co-existence will be a necessary part of a Pillar Two consensus, we would note that the scope exclusions under an appropriately designed global ETR gateway test would reduce the situations where the special GILTI rules would need to be applied.

This type of global ETR based gateway test also could indirectly address concerns about the inappropriate effects of Pillar Two on capital-intense industries such as the extractives and energy sector. MNE groups in these industries often have a high ETR at the global level. At the same time, making an appropriate ETR determination by jurisdiction can be complex because of the significant timing differences and other complexities associated with long-term investment. These same challenges related to long-term capital investment also exist for the utilities sector and other business that heavily invest in local infrastructure. In addition to the gateway test, it would be appropriate to address these challenges directly. We encourage the Inclusive Framework to consider the merits of an exclusion for capital-intensive, infrastructure-focused businesses. It should be recognized that these industries have strong nexus with the economy in which they operate and play an important role in economic recovery plans of governments and. The local jurisdiction where the investment occurs is therefore best placed to design and implement the most appropriate tax environment for these businesses. We believe the sovereignty of Inclusive Framework members in this regard should be recognized by crafting an exclusion from the scope of Pillar Two for these locally-connected businesses.

Exclusion for investment funds

In order to preserve the tax neutrality of investment funds, the Pillar Two Blueprint excludes investment vehicles meeting the specified conditions for qualification as an Excluded Entity. Under the Blueprint, importantly, these exclusions should apply for purposes of both the GloBE rules and the STTR. An investment vehicle satisfies the Excluded Entity conditions where the entity (1) meets the Investment Fund definition provided in the Blueprint and (2) is otherwise the Ultimate Parent Entity (UPE) of the MNE group. However, in certain cases, an investment vehicle may not clearly satisfy the Excluded Entity conditions as drafted and could be subject to the Pillar Two rules notwithstanding its intended tax neutrality. Therefore, adjustments to the Excluded Entity conditions are needed to ensure that the exclusion applies properly.

Investment Fund definition – There are two areas where clarifications are needed to ensure that the Investment Fund definition works properly. The first clarification involves the portion of the Investment Fund definition that refers to an entity or arrangement designed to pool assets from an Excluded Entity or a number of investors (at least some of which are not connected). The Blueprint commentary states that the definition requires that there be an Excluded Entity as an investor or at least two unconnected investors, which could be read as precluding an investment vehicle with only one investor from being an Investment Fund even though the entity is designed to pool assets of a number of investors. The commentary should be revised to be consistent with the Investment Fund definition by confirming that an investment vehicle qualifies as an Investment Fund when the design of the entity is to pool assets of more than one investor even if there is a period when there is a single investor or if the fund is part of an MNE insurance company that is pooling investments of multiple policyholders.

The portion of the Investment Fund definition that refers to an "entity that is wholly-owned or almost exclusively wholly owned… to hold assets or invest assets" also needs clarification. An issue may arise, for example, when minority investors acquire direct interests in a holding company that is owned by an Investment Fund, because this could cause the holding company to no longer qualify as an Investment Fund under this language. To correct for this result, a purpose test could be used instead of the wholly-owned or almost exclusively owned test, so that the Investment Fund definition applies when the "main purpose" of an entity or arrangement is holding assets or investing funds for an Investment Fund or other Excluded Entity.

UPE condition – An Investment Fund that is owned by an asset manager, insurance company, or other Excluded Entity may not be the UPE of the MNE group. In such cases, the UPE condition as drafted would prevent these Investment Funds and the entities they own from qualifying as Excluded Entities, potentially subjecting them to the GloBE rules through the application of the split ownership rules for the IIR or the UTPR if payments are made by the Investment Fund to another entity in the MNE group. To ensure that the tax neutrality of the Investment Fund is not jeopardized, the UPE condition could be eliminated or the investment vehicle entities could be treated as tax transparent entities for purposes of application of the GloBE rules.

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Exclusion for entities subject to tax neutrality regimes

In addition to the Excluded Entity rules, the Blueprint also provides for special treatment of entities that are subject to a tax neutrality regime. Like the Excluded Entity rules, these rules are aimed at preserving the tax neutrality treatment that is provided to certain entities under their home jurisdiction's tax system. We believe two clarifications would be valuable in eliminating any potential ambiguity. First, it should be made clear that an Excluded Entity that owns an interest in an entity that is subject to a tax neutrality regime would be considered to be an owner that satisfies the criteria for the tax neutrality regime exclusion. Making this clear would ensure that an investment made by an Excluded Entity through an entity that is subject to a tax neutrality regime is accorded the same treatment under the GloBE rules as an investment made directly by the Excluded Entity, thus protecting the tax neutrality that is the basis of both these exclusions. Second, it should be made clear that the tax neutrality regime exclusion, like the Excluded Entity rules, applies for purposes of the STTR as well as for the GloBE rules. The policy rationale that underlies both the Excluded Entity rules and the tax neutrality regime exclusion is the same and it fully supports exclusion from both components of Pillar Two.

3. Calculating the ETR for foreign branches

The discussion in the Blueprint on calculating the ETR for purposes of the GloBE rules does not clearly address how taxes assessed in the parent jurisdiction (and paid by the parent MNE) on foreign branch earnings should be assigned when the branch also is subject to tax in the local jurisdiction. Numerous questions arise, including whether a branch's ETR should be determined by reference to tax principles of the branch jurisdiction or the parent jurisdiction, how the branch income should be determined, how taxes paid in the parent country should be assigned if to the branch, and how disregarded transactions should be considered if treated differently by the relevant jurisdictions.

We encourage the Inclusive Framework to consider a simplifying rule that would deem a branch to have an ETR above the minimum rate if the parent jurisdiction's ETR is above the minimum threshold and the branch is not eligible for an exemption or reduced rate through a territorial system. In this regard, it should be recognized that the operations of the home office and the branch are inextricably linked. This simplifying rule would be limited in its application but would avoid complex technical issues involved in assigning taxes from the home office to the branch for those situations where there is an ETR that is safely above the threshold.

4. Carry-forwards and carveout

Carry-forwards

The Blueprint relies exclusively on a system of carry-forward rules to address timing differences with respect to the imposition of covered taxes or with respect to the recognition of income for financial accounting purposes. We are concerned that the proposed rules are not sufficient to fully address these differences and to ensure that the application of the GloBE rules does not result in taxation that extends beyond the intended aim of Pillar Two. We continue to believe that the use of deferred tax accounting would better align with the objectives of Pillar Two and would be significantly simpler than an approach that is based on carry-over rules. We urge the Inclusive Framework to further consider how deferred tax accounting can be appropriately incorporated.

With respect to the carry-forward approach that is reflected in the Blueprint, the fact that the loss carry-forward rules are not time limited is important. However, the Blueprint contemplates that the excess tax carry-forward rules will be time limited. We believe it is essential that these carry-forwards be unlimited in duration as well. The rationale for not time limiting the tax carry-forwards is exactly the same as the rationale cited in the Blueprint for not limiting loss carry-forwards – ensuring the proper level of tax on overall economic income. We do not believe that concerns about potential administrative burdens are sufficient to justify what would be excessive taxation if excess tax carry-forwards are allowed to expire. In this regard, the burden of proof could be on the taxpayer to maintain and provide information regarding the carry-forwards.

Moreover, we believe that eliminating time limits alone is not sufficient to ensure the appropriate economic results. In addition to unlimited carry-forwards, a refund mechanism should be put in place to ensure that all carry-forwards can be used. Given the diminishing value of a carry-forward that cannot be used promptly, we believe that this refund mechanism should not require the significant passage of time before it can be accessed. We also urge the Inclusive Framework to consider incorporating carry-back rules as another way to ensure that the full benefit of the amount being carried over can be realized.

Finally, we note that the Blueprint specifically addresses pre-regime losses and allows them to be carried forward in order to avoid over-taxation. We believe that pre-regime investments also should be taken into consideration, by allowing excess local taxes in pre-regime years to be carried forward as well. Here too, the burden of proof could be on the taxpayer to maintain and provide information regarding the pre-regime taxes in order to be able to get the benefit of the carry-forward mechanism.

Formulaic substance-based carve-out

The Blueprint includes a formulaic substance-based carve-out that provides an exclusion from the GloBE rules for a fixed return on specified costs associated with substantive activities in a jurisdiction. The Blueprint describes this carve-out as being intended to focus the GloBE rules on "excess income," such as intangible-related income, which is considered to be most susceptible to BEPS risks.

As an initial matter, we note that this particular carve-out is extremely narrow. As discussed above, we continue to believe that a broader exclusion for substantive economic activity is necessary to preserve the right of the local jurisdiction where the economic activity occurs to determine how that activity is taxed. At a minimum, we urge the Inclusive Framework to provide an exclusion for situations involving activity in a country that is consistent with the work on BEPS Action 5, under which a low or no tax jurisdiction or regime is not considered to be a harmful tax practice if there is sufficient substance. Such an exclusion is a natural extension of Action 5, which is a minimum standard to which all members of the Inclusive Framework have committed, and which is also subject to ongoing peer review to ensure timely and accurate implementation of the standard and thus safeguard the level playing field.

With respect to the narrow carve-out provided in the Blueprint, we would suggest adjustments in two areas to improve its operation. First, it should be recognized that intangible-related income has a routine element. Therefore, it would be appropriate to expand the carve-out to include a risk-free return based on the value of intangibles. Second, the current formulation of the carve-out requires that it be applied on a year-by-year basis, which is overly restrictive. Given timing differences and cyclical effects, it would be appropriate to allow a carry-forward in situations where the carve-out amount exceeds the income base for the GloBE rules for the year in order to ensure that the full effect of the carve-out can be realized.

5. Simplification options

We appreciate the inclusion in the Blueprint of a section focused on simplification options as this is a very important area. The complexity of the Pillar Two rules will create significant administrative burdens for both businesses and tax administrations. Moreover, this complexity will be the source of substantial uncertainty which will exacerbate those burdens.

We encourage the Inclusive Framework to continue to develop the concept described in the Blueprint of a *de minimis* profit exclusion as an elective simplification option. In this regard, we favor the approach of combining both a fixed threshold and a relative threshold. However, we believe that the fixed threshold component should be set at a higher level than the EUR 100,00 amount that is referenced illustratively in the Blueprint, as such an amount would be very low for MNE groups that are of the size that would be within scope for the GloBE rules. Similarly, we believe that consideration should be given to setting the level for the relative threshold higher than the 2.5% amount that is referenced illustratively in the Blueprint in order to ensure that real simplification is provided.

6. Undertaxed payments rule

The UTPR is intended to operate as a backstop and therefore should in principle apply only in limited circumstances. This limited role is important because, as the Blueprint recognizes, the UTPR carries with it considerable compliance costs and does not include mitigation features like the IIR credit. However, in practice, the UTPR will result in a significant burden to MNE groups and tax administrations around the world because the UTPR can apply in any situation where there is no applicable IIR. Moreover, the suggestion in the Blueprint that a UTPR would be compatible with existing treaty obligations could well inspire the introduction of unilateral UTPR-type measures and create controversy regarding the application of the UTPR.

As UTPR application depends on many datapoints, its potential application requires complex administrative processes relying on information that currently may not be available in a coordinated manner within an MNE group. Because the UTPR will be applied by each individual jurisdiction in which a UTPR Taxpayer is a resident, there is significant risk of inconsistency, both in terms of the substantive application of the rules and in terms of the administrative requirements that must be satisfied to comply with the rules. In order to reduce complexity and administrative burden for businesses and tax administrations alike, we encourage the Inclusive Framework to focus additional work on targeting the UTPR to situations in which base erosion is a particular concern and ensure that there is a connection between the UTPR Taxpayer and the low-taxed entity.

In this context, it would be helpful to clarify that the allocation of the top-up tax is linked to cross-border deductible payments. The UTPR should not apply in domestic situations because the Pillar Two rules aim to address cross-border base erosion. Any concerns about potential domestic tax rate arbitrage should be addressed locally.

In addition, we believe that the second step in the allocation of the top-up tax to UTPR Taxpayers requires further consideration. It raises significant policy concerns and is clearly in conflict with existing tax treaty obligations. This step aggregates remaining pools of low-tax income and allocates them to UTPR Taxpayers that may have no direct relation with the low-tax constituent entity. However, in the absence of related party payments to that entity, the tax base of the UTPR Taxpayers cannot be considered to have been eroded. Therefore, a reallocation of any part of the profits of the low-tax constituent entity to the UTPR Taxpayers would not align with the policy objectives of Pillar Two. In this regard, we would note that Pillar Two is intended to provide a right to “tax back” where the jurisdiction of a low-taxed constituent entity has not exercised its primary taxing right or a payment is subject to low levels of effective taxation. The second step of the allocation does not involve either of these circumstances.

Finally, the proposed approach for applying the UTPR to low-tax income in the UPE jurisdiction involves significant complexity. We believe that there are more effective and efficient mechanisms to address BEPS concerns related to the UPE jurisdiction. We encourage the Inclusive Framework to reconsider this proposed aspect of the UTPR.

7. Special rules for associates, etc.

The Blueprint includes special rules for applying Pillar Two in situations involving associates and joint ventures. This seems to be prompted by concerns about the potential for leakage and the possibility of unfair results, but these risks have not been substantiated. The special rules in practice will create a significant burden for minority shareholders that may not have access to the information required to apply the rules. Moreover, there are situations involving associates and joint ventures, where there clearly is no potential for any leakage, such as where the associate or joint venture entity is a UPE of an MNE group that itself is subject to the Pillar Two rules.

We believe that these special rules add complexity that is not justified and urge the Inclusive Framework to consider a much more targeted approach.

8. Role of the subject to tax rule

The Pillar Two Blueprint reflects a positioning of the STTR that is a significant departure from the previous description of the Pillar Two concepts. In the earlier documents on Pillar Two, the STTR was paired with the UTPR in the same manner as the switch-over rule is paired with the IIR, and all four rules together made up what was called the GloBE. In contrast, the Blueprint for the first time separates the STTR from the other rules and treats GloBE as referring only to the other three rules without the STTR. At the same time, the Blueprint makes clear that there is substantial work still to be done on the development of the STTR.

As the work continues on Pillar Two in general and the STTR in particular, we urge the Inclusive Framework to reconsider the Blueprint's repositioning of the STTR. We believe that the Pillar Two mechanism can be made to work appropriately only if all four rules are interlocking with priority assigned to the IIR. As the OECD has long recognized, gross-basis withholding taxes are an extremely blunt instrument. The use of gross income as the tax base, without recognition of the expenses incurred in generating such income, necessarily results in unequal treatment and can lead to a tax burden in excess of the actual net income.

The Blueprint states that the principal mechanism for achieving the Pillar Two objectives is 'the income inclusion rule (IIR) together with the undertaxed payments rule (UTPR) acting as a backstop.' However, this description is not consistent with the proposed positioning of the STTR, which would apply the STTR first and effectively give it priority over the IIR. We believe this approach would lead to inappropriate results and is not aligned with the concept of a top-up tax to an agreed minimum rate.

As the Blueprint makes clear, an effective tax rate concept cannot be used with the STTR. Therefore, the starting point for application of the STTR would have to be different than the other rules. Moreover, the Blueprint correctly acknowledges that the minimum rate for the STTR would have to be set at a lower level than for the other rules. However, the Blueprint suggests that the rate could be set at a level that would result in a net tax burden that is comparable to the minimum effective rate established for the other rules. It must be recognized that it would be impossible to achieve any comparability as a practical matter given the differences in cost profiles.

The issues associated with an STTR are exacerbated when it is given priority over the other rules. Therefore, we believe that as part of the further work on an STTR, it is essential that it not be structured in a way that gives it priority over the IIR. Moreover, we urge the Inclusive Framework to give further consideration to the appropriateness of including a withholding tax as any part of the Pillar Two rules given the inability to align a gross basis tax with an agreed minimum effective rate.

9. Implementation and coordination

We recommend the development and adoption of a public international law instrument to facilitate consistent implementation of the proposed Pillar Two measures, address the interaction of the GloBE rules with existing tax treaty obligations, and provide a legal basis for effective dispute prevention and resolution mechanisms.

The suggestion in the Blueprint that both the IIR and the UTPR do not conflict with existing tax treaties raises legal, policy, and certainty concerns. In general, the analysis in the Blueprint seems to be based on the premise that 'tax treaties are not intended to restrict a jurisdiction's right to tax its own residents.' However, as the OECD Model Commentary also acknowledges, the objective of most treaty provisions is to restrict the right of a state to tax residents of another state. The GloBE rules present an approach for domestic legislation that effectively taxes income from non-resident entities. This represents a shift in the allocation of taxing rights reflected in the treaty. It is also noted that the saving clause, included in the OECD Model Tax Convention in 2017, as not been widely adopted.

The analysis for the UTPR is particularly concerning as it is at odds with the current Commentary and undermines the arm's length principle embodied in the existing treaty network. The points made in this regard in the Blueprint seem to be self-serving rather than analytical. The specific category of entertainment expenses is not comparable to the general scope of intra-group payments to which the UTPR will be linked. Deduction limits for entertainment expenses are generally used as a way to distinguish between commercial costs (deductible) and expenses that have a personal element (non-deductible). For that reason, entertainment expenses are non-deductible whether paid to an associated enterprise or a third-party. More fundamentally, the deductibility of expenses is "subject to the provisions of the Convention," as specifically confirmed in the Commentary to Article 7 of OECD Model. We urge that the discussion in the Blueprint be reconsidered, particularly in light of an already emerging trend of undermining treaty obligations and denying access to MAP.

Therefore, we believe that it is essential that the implementation of Pillar Two specifically address the interaction of the GloBE rules with tax treaties to provide the certainty and stability that is needed. This could be done by amending existing treaty provisions or by concluding a new public law instrument that supersedes the relevant tax treaty provisions.

As noted in the Blueprint, a new public international law instrument can also support the consistent implementation of the Pillar Two rules by jurisdictions that choose to adopt them and thus increase certainty for taxpayers. In addition to defining common terms and codifying key design elements of the rules, the instrument should also include dispute resolution mechanisms that ensure the consistent interpretation of its provisions.

In addition, implementation must include the adoption of effective mechanisms for the elimination of double taxation. The risk of double taxation and controversy with respect to the Pillar Two rules and their potentially inconsistent implementation is significant. The statement in the Blueprint that the Convention on Mutual Administrative Assistance in Tax Matters is a tool that mitigates the risk of double taxation is not convincing. While that agreement allows for the exchange of tax information, it does not require tax administrations to align their interpretation of either facts or tax rules. It is this potential misalignment that will be a major source of controversy and dispute.

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The global EY team that prepared this submission welcomes the opportunity to discuss these comments in greater detail and to continue to participate in the dialogue as the OECD and the member countries of the Inclusive Framework advance the work on this important project.

If there are questions regarding this submission or if further information would be useful, please contact me at +1 202 327 5824 or barbara.angus@ey.com.

Yours sincerely, on behalf of EY,

Barbara M. Angus
EY Global Tax Policy Leader