Tel: +32 2 778 01 30
Fax: +32 2 778 01 43
@: bdo@bdointernational.com
www.bdo.global

BDO International Limited
Contact address:
The Corporate Village, Brussels Airport
Elsinore Building, Leonardo Da Vincilaan 9 – 5/F
1930 Zaventem, Belgium

Organisation for Economic Co-operation and Development
Centre for Tax Policy and Administration
Tax Treaties, Transfer Pricing and Financial Transactions Division OECD/CTPA

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Subject: Comments on OECD Public Consultation Document:
Pillar One — Amount A: Draft Model Rules for Tax Base Determinations

BDO is one of the largest full-service audit, tax, and advisory organisations in the world. We have over 97,000 people in over 1,700 offices in 167 countries and territories. Our global organisation focuses on supporting entrepreneurially spirited, ambitious businesses.

We appreciate the opportunity to submit our comments on the public consultation document titled **"Pillar One — Amount A: Draft Model Rules for Tax Base Determinations"** (Draft Model Rules) that was released by the OECD on 18 February 2022 and to provide our input on the OECD's ongoing work in respect of this important tax policy matter.

Our comments on the Draft Model Rules reflect three overarching themes:

- The right balance between accuracy and practicality;
- The pressure unclear rules may exert on the binding dispute resolution mechanism; and
- The bifurcation of guidance into Model Rules and a future commentary.

More specifically, our comments on the 18 February 2022 Draft Model Rules address the following key points:

- **Book-to-Tax Adjustments** – In the interest of striking a balance between practicality, simplicity, and accuracy, we would recommend that the Task Force on the Digital Economy (TFDE) consider eliminating adjustments under Article 5(2)(a) (ii), (iii) and (iv). Alternatively, we suggest that the TFDE consider setting a materiality threshold for adjustments (ii) and (iii), such as a percentage of total revenue for the Covered Group (the "Group"), while eliminating adjustment (iv).
- **Restatement Adjustments** – If the TFDE believes that restatement adjustments must be considered in the determination of the tax base for Amount A, the treatment under GAAP should be followed by restating the determination of the Amount A tax base for previous years, with no impact on the current year unless it, too, must be restated. We would recommend that there be no cap on the restatement adjustments to be made under the Model Rules.
- **Net Losses** – We would suggest that the carry forward of net losses not be time-limited, either in terms of how many pre-implementation periods could be brought into account for carry forward purposes, or how long any losses can be carried forward for offset to recognise the life cycles of different industry sectors and businesses.

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- **Business Combinations** – The global companies that will be subject to Pillar One and therefore required to determine the tax base for Amount A tend to operate diversified lines of business or divisions and rarely operate only one specific business, line of business or division. We suggest that the Model Rules address the application of the "same or similar" business requirement in this context.
- **Alternative Approach** - We recommend that the TFDE consider an approach that would involve the following steps:

    1. Start with Qualifying Financial Accounting Standards (QFAS) net income for the Group;
    2. Add back (or deduct) Tax Expense (Tax Income);
    3. Add back (deduct) Unusual Non-Operating Losses (Gains); and
    4. Deduct Net Losses.

The resulting amount could be considered a "modified operating margin" that would serve as Amount A. The advantage of this approach over the one proposed in the Draft Model Rules is that under this alternative, all the adjustments would be derived from items reported directly on the Group's audited consolidated QFAS Financial Statements.

There is widespread agreement that the taxation of the digital economy needs to be addressed. But rather than introducing further complexity, any proposed solution should be as simple as possible. In the case of the tax base determination rules, that solution should rely on the application of GAAP, the OECD *Transfer Pricing Guidelines for Multinational Taxpayers and Tax Authorities*, and existing transfer pricing models and methods to ensure that the objectives of accuracy and practicality are achieved.

Our comments, developed by a BDO global working party, are set out in detail below. We hope they will be of assistance to the OECD and the TFDE. If you have any questions or would like any further detail, please do not hesitate to contact us. We look forward to working with you and supporting you as you continue your work in this area.

Mark Schuette
Partner, BDO USA, LLC
mschuette@bdo.com
+1 404 942 2929

COMMENTS ON OECD PUBLIC CONSULTATION DOCUMENT
PILLAR ONE — AMOUNT A: DRAFT MODEL RULES FOR TAX BASE DETERMINATIONS

We applaud the work done by the TFDE on these Draft Model Rules for the determination of the tax base for Amount A of Pillar One. We realize that this is a work in progress and that the TFDE is seeking input at this point to guide the additional work to be done on the Draft Model Rules. We offer our comments in a spirit of cooperation, and hope to assist the TFDE to amend the Draft Model Rules so that the final Model Rules are based on readily available financial data to make the rules easier to understand, implement, comply with and verify.

Book-to-Tax Adjustments

The starting point for the determination of the Amount A tax base is the Group's Financial Accounting Profit, that is, the Group's consolidated net income calculated using QFAS. The objective in relying on QFAS is to ensure that the determination of profit is not impacted by accounting practices that do not align with common practice. Using consolidated net income determined in accordance with QFAS provides a starting point that is subject to the least amount of manipulation and/or uncertainty.

Included in QFAS are the International Financial Reporting Standards (IFRS) and the Equivalent Financial Accounting Standards, which are in turn defined as generally accepted accounting principles (GAAP) in several countries, including the European Union and European Economic Area member states.

To calculate the Group's Adjusted Profit Before Tax, the following adjustments must be made:

- Four book-to-tax adjustments;
- Restatement adjustments; and
- Net Losses.

Under Article 5(2)(a) of the Draft Model Rules, the four book-to-tax adjustments are:

i. Add back income tax expense (deduct income tax income): We expect this amount to be readily available from the consolidated profit and loss statement (P&L);
ii. Deduct dividend income: While this amount may be readily available from the P&L or the notes to the financial statements, and we understand the logic for adding it back, we wonder if the amount would be material to the Ultimate Parent Entity (UPE).;
iii. Deduct equity gains (add back equity losses): Again, while these amounts may be readily available from the P&L or the notes to the financial statements, and we understand the logic for deducting/adding them back, we wonder if these amounts would be material to the UPE; and
iv. Add back policy disallowed expenses: We do not expect this information to be readily available at the UPE level and, therefore, the gathering and verification of this data would require entities subject to Pillar One to put a system in place to track these expenses, by entity, to be reported to the UPE.

In the interest of striking a balance between practicality, simplicity and accuracy, we recommend that the TFDE consider eliminating adjustments listed under Article 5(2)(a) (ii) to (iv) of the Draft Model Rules. Alternatively, we suggest that the TFDE consider setting a materiality threshold for adjustments (ii) and (iii), such as a percentage of total revenue for the Group, while eliminating the adjustment under Article 5(2)(a)(iv).

The Draft Model Rules refer to “book-to-tax adjustments and restatement adjustments.” The TFDE may want to consider a different terminology for these adjustments, given that they do not adjust from book basis to tax basis accounting, but rather adjust from Financial Accounting Profit to Adjusted Profit before Tax when combined with the impact of restatement adjustments and net losses. Perhaps a more accurate term would be “book-to-Amount A adjustments.”

Restatement Adjustments

Restatement adjustments are very rare for the large global companies that will be required to determine the tax base for Amount A.

Under QFAS, restatement adjustments (prior period adjustments) are booked to retained earnings after a restatement of prior years’ P&L statements and the filing of amended tax returns for those years (or paying for a reassessment in the current year under which the tax authority adjusts prior years).

To prevent or minimize the manipulation of Amount A, reliance on GAAP should be instructive as to the appropriate accounting treatment, thereby eliminating the need to make further adjustments. Financial statements prepared pursuant to GAAP are already relied upon for investment and lending decisions and should be reliable for the OECD’s objectives in addressing the taxation of the digital economy and the reallocation of taxing rights based on where revenue is earned. Those objectives can surely be met without the need for additional unnecessarily complicated calculations that place an unreasonable burden on taxpayers and taxing jurisdictions.

If the TFDE believes that restatement adjustments must be considered in the determination of the tax base for Amount A, perhaps the treatment under GAAP should be followed by restating the determination of the Amount A tax base in previous years, with no impact on the current year unless it, too, must be restated. We recommend that the Model Rules do not set a cap on restatement adjustments.

Net Losses

We noted in a BDO submission to the OECD on the Secretariat’s Public Consultation Document on the Reports on the Pillar One and Pillar Two Blueprints, dated 14 December 2020:

> We see symmetry in the treatment of profits and losses as key in ensuring the fairness and optimal simplicity of the regime. The carry forward of losses should not be time-limited (either in terms of how many pre-implementation periods could be brought into account for carry forward purposes, and also how long any losses can be carried forward for offset) in order to recognise the life cycles of different sectors. This could be subject to a burden of proof on the existence of the losses, enabling taxpayers to determine their own use of resources in seeking to ‘prove out’ the existence of losses, and how many years they wish to go back. Preferably, there would be no separate pools of losses, to keep the rules as simple as possible to administer. Consideration should be given to ensuring the ability to secure up-front certainty from tax authorities on "proven" pre-regime losses.

We believe similar principles should be considered in determining the tax base under Amount A.

The Draft Model Rules address three types of losses:

- Losses incurred by the Group before the first year of implementation of Pillar One;
- Losses incurred by the Group after the introduction of Pillar One; and
- Losses acquired from another entity pursuant to a business combination.

Net losses – like many other tax adjustments, such as policy disallowed expenses – are applied in the income tax return for each Group. Net losses are not included in the determination of net Income under QFAS, nor are they included in the determination of operating margin under the OECD transfer pricing guidelines.

It is important to recognize that the Net Losses that may be carried forward and deducted for tax purposes will differ from the Net Losses determined under the Draft Model Rules, thereby adding to the administrative burden of each Group subject to Pillar One.

We suggest that the carry forward of net losses not be time-limited, either in terms of how many pre-implementation periods may be brought into account for carry forward purposes, or in terms of how long any losses can be carried forward for offset. This practice would recognise the life cycles of different industry sectors and businesses.

Business Combinations

The Draft Model Rules regarding business combinations are complex, which, if the rules were finalized as currently drafted, may place a substantial burden on taxpayers and tax administrations alike. If the Groups subject to Pillar One are allowed to rely on the applicable GAAP of the UPE, then we should rely on GAAP, by using the consolidated Financial Statements as a starting point, with minimal adjustments. If we start with Net Income and make appropriate adjustments, we essentially could end up with the Group's operating margin or an amount that can easily be reconciled with that amount.

The business combinations provisions in the Draft Model Rules address the use of Net Losses acquired during a business combination, allowing those Net Losses – referred to as Transferred Losses --to be used in the determination of the Amount A tax base if those losses are applied against income from the same or a similar business.

Interestingly, the Draft Model Rules regarding the carryover of Net Losses in an eligible business combination would apply to both asset purchases and share purchases. This might be a positive policy for Groups since, generally, a Group does not acquire Net Losses in an asset deal. This aspect of the Draft Model Rules may require further consideration by the TFDE.

The global companies that will be subject to Pillar One and therefore will be required to determine the tax base for Amount A tend to operate diversified lines of business or divisions and rarely operate only one specific business, line of business or division. We suggest that the Model Rules address the application of the "same or similar" business requirement in this context.

Alternative Approach

The tax base determination rules rely, in part, on GAAP and on the arm's length principle that is the foundation on which the OECD transfer pricing guidelines are based. However, the Draft Model Rules for calculating the tax base for Amount A represent a departure from both GAAP and the arm's length principle. We would like to suggest an alternative approach that minimizes

the departures from GAAP and from the OECD transfer pricing guidelines by aiming to arrive at a tax base for Amount A that is more closely aligned with Net Income under GAAP and operating margin under the OECD transfer pricing guidelines. This approach would involve fewer adjustments to determine an appropriate tax base for Amount A. Fewer adjustments to existing financial data would increase the practicality and simplicity of the Draft Model Rules, which would in turn reduce the overall compliance burden associated with Pillar One. As a result, uncertainty and the incidence of disputes would also be reduced.

The OECD transfer pricing guidelines are based on the premise that related or commonly controlled parties should comply with the arm's length principle. The determination of the tax base for Amount A should, to the extent practicable, correspond with the transfer pricing guidelines and the arm's length principle. Under those guidelines, the operating margin for a set of comparable companies may be used to determine the arm's length operating margin that an affiliated entity should earn. The operating margin would exclude items such as tax expense, financial expenses (gains) and unusual losses (gains) that are not part of the Group's normal operations.

We recommend that the TFDE consider an approach that would involve the following steps:

1. Start with QFAS net income for the Group;
2. Add back (deduct) tax expense (income);
3. Add back (deduct) unusual non-operating losses (gains); and
4. Deduct net losses.

The resulting amount could be considered a "modified" operating margin that would then serve as the Amount A base.

The benefit this alternative approach would provide is that the amounts in steps 1 to 3 would be taken directly from the Group's audited, consolidated QFAS Financial Statements. The amount in step 4 would be based on the Group's audited, consolidated QFAS Financial Statements for previous years, adjusted for steps 2 and 3, above.

Looking beyond the tax base determination to arrive at Amount A, we recommend that the TFDE consider a calculation using the type of analysis used under the OECD transfer pricing guidelines for the residual profit split method. This recommendation would involve:

- Using the modified operating margin as Amount A for Pillar One;
- Determining the routine returns attributable to the entities in the Group using the transactional net margin method (TNMM), with the aggregate routine return serving as Amount B for Pillar One; and
- Allocating the residual returns to the relevant Group entities and market jurisdictions using an appropriate allocation key or keys.