January 6, 2022

To: The Chairs & Members of Working Party 11 on Aggressive Tax Avoidance (WP11)

c/o Pascal Saint-Amans, Grace Perez Navarro and Achim Pross
OECD Centre for Tax Policy and Administration (CTPA)

Dear Chairs and Members of WP11,

As promised, we are writing to you about the 20th December 2021 Pillar Two Model Rules[1]. The *Business at OECD* (BIAC) Pillar Two Business Advisory Group ("BAG"), and the broader Tax Committee have identified two major policy issues which we believe may mean that the Model Rules cannot achieve their intended purpose (in addition to also identifying one overarching technical issue). We have in the past been very clear that we do not intend to "relitigate" your policy calls. However, in these two cases we respectfully ask you to consider amending the specific provisions otherwise we do not believe that the Model Rules can work to achieve the overall policy goals that you have articulated. Before getting to those details, however, we would ask you to note a number of caveats about this letter:

- First, the fact that we have only mentioned one technical issue, and two significant policy inconsistencies as being potentially fatal to the operation of the Model Rules, does not mean that we have not identified other technical or policy issues that we believe will need addressing in either the Commentary or the Implementation Framework if the rules are to operate smoothly and fairly, avoid double taxation, and not adversely affect cross border trade and investment. We will be writing to you about all of those issues shortly.
- Second, we, as you, are operating on very short timetables, and coordinating across many interests and geographies. We, therefore, ask you to understand that while we will do everything we can to get you comments as soon, and as comprehensively, as possible, we may well also have to continue to raise issues on a rolling basis, as they come to light.

Fundamental Technical Issue – Complexity

While we have identified no single technical issue that would prevent the Model Rules from being capable of working, we are very concerned that the combination of all of the rules could have that cumulative effect. We fear that the Model Rules may prove such an administrative and compliance struggle for many tax authorities (even some of the largest and best resourced given the proposed timeframes) as well as for taxpayers given less than 12 months to implement[2] as yet unwritten, detailed laws, that 2023 (and possibly 2024) could be years of significantly increased uncertainty and instability. We believe that safe harbors, which we understand are being worked on, will be crucial in this respect. Nevertheless, we also urge a relentless focus in the coming months, wherever possible, on reducing complexity in the Model Rules consistent with Pillar Two's stated policy objectives.

[1] *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)* ("Model Rules")
[2] Including the need to rebuild businesses' complex information collection systems ("ERPs"), which can only be undertaken once national laws are known.

<u>Fundamental Policy Inconsistency 1: Article 4.1.5 – Pillar Two tax owing even when no income in a jurisdiction in a year</u>

The preamble to the Model Rules states the policy intent of the rules is to:

> *"provide for a coordinated system of taxation intended to ensure large MNE groups pay a minimum level of tax on the **<u>income</u>** arising in each of the jurisdictions where they operate. It does so by imposing a top-up tax on **<u>profits</u>** arising in a jurisdiction whenever the effective tax rate, determined on a jurisdictional basis, is below the minimum rate."* [emphasis added]

However, Article 4.1.5 of the Model Rules applies Top-up tax in circumstances where there is <u>no net GloBE income</u> for a jurisdiction, and where Adjusted Covered Taxes are negative and are less than the GloBE Income or Loss for that jurisdiction multiplied by the Minimum Rate. We believe this tax charge, when there is no income, is fundamentally inconsistent with the overall policy goals articulated in the preamble.

We understand the policy concern sought to be addressed is that a permanent difference benefit (e.g., an additional tax deduction) should not result in additional GloBE attributes (e.g., a tax loss that can be carried forward) that may shelter undertaxed income. However, it seems contrary to the "minimum tax" concept to levy tax in a year when there is no income. We have previously suggested, alternatives which we believe are more consistent with the policy intent of Pillar Two, and we would urge you to consider these again. These would involve either reducing the attribute generated so undue benefit would not be gained in future years, and/or applying Top-up Tax in the year in which the attribute of concern benefits the MNE. We would be glad to discuss again the alternative approaches that we believe would appropriately address the specific policy concern in a manner consistent with the overarching policy objective. We do firmly believe that the policy of Pillar Two dictates that in a year where there is no economic profit, there should not be Pillar Two tax.

Another consequence of this article is to subject to Top-up Tax any permanent difference benefit that arises in a jurisdiction in a year in which a tax loss has resulted. This will occur, <u>regardless</u> of the materiality of that benefit relative to the profit or income in the jurisdiction, and whether that permanent difference will in fact have the effect of resulting in the effective tax rate of the jurisdiction to reduce below the minimum tax rate.[3]

Finally, the Top-up Tax is applied to an attribute when it arises <u>with no regard given to whether that attribute is ever utilized</u> or whether any economic benefit is ever received by the MNE (for example, where the resulting tax loss is never utilized). Again, this seems inconsistent with your articulated overall policy goals.

<u>Fundamental Policy Inconsistency 2: Article 4.4.1 – Deferred tax attributes limited to minimum tax rate, even if jurisdiction has higher tax rate</u>

The October 2020 Blueprint acknowledged the appropriateness of smoothing the Effective Tax Rate ("ETR") of the jurisdiction over a period of time, regardless of whether fluctuations in the ETR arise from temporary or permanent differences. Specifically, the Blueprint states in paragraph 306:

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[3] It is not clear whether Article 4.4.1(e) is an attempt to neutralize this effect where the permanent difference benefit is in the form of a tax credit. There is no definition of "tax credit" in the Model Rules. Regardless, we do not believe the above outcomes are appropriate or necessary where the permanent benefit is not in the form of a "tax credit".

> "*There will be many cases in which the tax rate in a jurisdiction exceeds the minimum rate by an amount sufficient to avoid GloBE tax liability even after taking into account a permanent difference. By incorporating mechanisms that take into account the effects of temporary and permanent differences on the computation of income and tax liabilities over a period of years, the rules* ***neutralize*** *the consequences stemming from application of the annual accounting concept under the GloBE rules*." [emphasis added]

We believe it has remained a fundamental policy concept of Pillar Two that it is appropriate to look at ETR over a period of time to neutralize the consequences stemming from application of the annual accounting concept.

Article 4.1.5 is one example where the Model Rules have fundamentally departed from this policy principle. The other example of departure from this policy principle arises in Article 4.4.1 which recasts deferred tax at the Minimum Rate, regardless of whether the actual tax rate in that jurisdiction is substantially higher than the Minimum Rate.

The requirement that deferred tax balances be recast at the minimum rate we believe undermines the ability of the rules to achieve the policy objective of smoothing the ETR noted immediately above. Recasting deferred tax amounts at the Minimum Rate does not provide recognition of the actual rate of tax that will be borne in respect of the relevant underlying timing difference when looking at the annual ETR, and will result in Top-up tax both in respect of timing and permanent differences. This consequence will arise notwithstanding that the true ETR borne by the MNE over time is higher than the minimum rate. For example, Top-up tax will arise in circumstances where there are loss carry-back rules under local legislation or where tax losses are being utilized and there is a permanent difference, regardless of the materiality of that permanent difference or its impact on the effective tax rate, and regardless of the level of tax paid by an MNE over time. The outcome of this is double taxation.

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Both separately, and especially when applied in combination, these two elements of the Model Rules do not, we believe, deliver the stated policy objectives articulated in the Blueprint of "*net taxation of income, avoid double taxation and be as simple and administrable as possible.*" Again, we hope that you will feel able to bring these provisions into line with the underlying intent of Pillar Two.

Looking Forward

In closing, we should note that we are concerned that there are numerous other elements of the Model Rules which – while not rising to the level of fundamental technical or policy issues – could result in double taxation. For example, where there is a decrease in an entity's liability for tax related to a previous Fiscal Year an adjustment is required to be made to the GloBE calculations for that previous Fiscal Year (unless it is immaterial) under Article 4.6.1. However, the rules do not appear to provide an ability for the MNE to make a corresponding adjustment to a previous Fiscal Year in respect of an increase in the entity's tax liability in that previous year. One-sided adjustments such as these pose the potential for double taxation. We will include further examples in our follow-up letter.

Very importantly, there are two as yet unquantifiable issues that will nevertheless also require attention:

- First, there will be interactions between Pillar One and Pillar Two (once outstanding Pillar One issues have been resolved) that will need to be addressed to avoid double taxation.
- Second, if it were ultimately determined that the U.S. Global Intangible Low-Taxed Income (GILTI) regime was not a Qualified IIR, as defined in the Model Rules, then further work will also need to be done to reduce uncertainty and instability to the greatest extent possible.

We hope that many of these issues – along with a host of other technical details – can be dealt with in the Commentary and the Implementation Framework. We are pleased that both of those documents will be worked on in the coming months, and we welcome your recently stated intention to involve business (and other stakeholders) in the formulation of that guidance.

Please let us know any questions on any of the above, and we look forward to constructively engaging with you on these important topics throughout 2022.

Sincerely,

Alan McLean
Chair, *Business at OECD* (BIAC)
Committee on Taxation and Fiscal Affairs

William Morris
Chair Emeritus

Cc: Hanni Rosenbaum, Executive Director, *Business at OECD* (BIAC)