International Environment House 2
Chemin de Balexert 7-9
POB 228, 1211 Geneva 19
Switzerland
Tel.: +41(0)22 791 80 50
E-mail: south@southcentre.int
Website: www.southcentre.int

South Centre Comments on Draft Model Rules for Domestic Legislation on Scope

I. Background

The South Centre is the intergovernmental organization of developing countries that helps developing countries to combine their efforts and expertise to promote their common interests in the international arena. The South Centre has 54 Member States coming from the three developing country regions of Africa, Asia, and Latin America and the Caribbean. It was established by an Intergovernmental Agreement which came into force on 31 July 1995. Its headquarters are in Geneva, Switzerland.

The South Centre in 2016 launched the South Centre Tax Initiative (SCTI). This is the organisation's flagship program for promoting South-South cooperation among developing countries in international tax matters.

The South Centre offers its comments to the OECD Inclusive Framework's Task Force on Digital Economy (TFDE) on the Draft Model Rules for Domestic Legislation on Scope.

As a procedural matter, the extremely rapid pace of discussions is a matter of great concern for developing countries, a matter also raised by the African Tax Administration Forum (ATAF).[1] While an urgent solution is needed to the taxation of the digitalization of the economy, this must mean one which incorporates the interests of developing countries.

Providing lengthy policy documents to Inclusive Framework delegates for inputs with minimal response time, sometimes just a single day[2], will have the practical result of the Two Pillar solution reflecting solely the interests of developed countries and snatching away the taxing rights of developing countries. This will further undermine the legitimacy of the Two Pillar solution, which is already on shaky ground, and further encourage developing countries to reject Pillar One and opt for alternative measures, which they are in their full sovereign rights to do.

The South Centre therefore strongly urges that delegates from developing countries be given adequate response time for documents, and the same principle must be applied for documents provided for public consultation.

[1] https://www.ataftax.org/itr-global-tax-50-2021-22-logan-wort
[2] Ibid.

SOUTH CENTRE

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II. Specific Comments

i. Prior Period Test

Para (2)(b)(ii) of the draft rules provides for the pre-tax profit margin of the group to be greater than 10% in "two or more of the four Periods immediately preceding the Period", called the 'prior period test'. There was no mention of such a test in the 8 October 2021 political agreement on the Two Pillar solution. The relevant section on scope from that agreement says,

"In-scope companies are the multinational enterprises (MNEs) with global turnover above 20 billion euros and profitability above 10% (i.e. profit before tax/revenue) calculated using an averaging mechanism…"

Thus, only an averaging mechanism was agreed upon. The prior period test violates this political agreement and has been "slipped in" to the draft rules. This amounts to a contravention of what the Inclusive Framework (IF) delegates agreed to.

Practically, the prior period test will be an additional filter that will reduce the number of companies in the scope of Amount A, which will mean reduced tax revenues to be redistributed to the developing countries.

Recommendation: The prior period test should be removed from the draft rules.

ii. Average Test

Duration

Para (2)(b)(iii) of the draft rules provides for the pre-tax profit margin of the group to be greater than 10% "on Average across the Period and the four Periods immediately preceding the Period", called the 'average test'.

A five-year period for averaging is too long and will have a higher chance to reduce the number of companies in-scope. Since the objective was to target the largest and most profitable companies in the world, an extremely high threshold of EUR 20 billion was agreed upon. This was despite developing countries finding even the EUR 750 million threshold too high. There is no reason why further exemptions must be included which allow these hugely profitable companies to escape.

An overly long duration of five years is also administratively burdensome for the MNEs and tax administrations.

Recommendation: The duration of the average test should be not more than two years preceding the tested period.

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Scope

Para 2(b) of the draft rules ask whether averaging should be applied only to profitability or also to total revenues.

The rationale behind averaging as mentioned in the draft rules is to bring neutrality and stability and ensure that MNEs with volatile profitability are not brought into scope. Volatility is a characteristic which does not apply to revenues which remain stable while profitability can be volatile between periods.

Revenue averaging thus has no rationale. It is unnecessary and will in fact act as yet another filter to allow MNEs to escape the scope with the implication of reduced tax revenues for developing countries.

Recommendation: Averaging should be applied only to profitability.

Permanent Feature or Entry Test

Para 2(b) of the draft rules ask whether the average test should apply permanently or whether it should only be an 'entry' test. A permanent averaging mechanism would mean the MNE carries out the test each year while the entry test means once it is in-scope it remains in-scope and will be out of scope only in those specific years when its revenues and profit margins do not meet the criteria.

The other building blocks of Pillar One already take the 'entry' test approach. The loss-carry forward rules on tax base determination for example say that the losses of an MNE will be carried forward even from those years when it is not in scope. Thus, the same approach should be applied here.

Such an approach will also make the administration of Amount A more stable and reduce compliance costs. MNEs will only need to consider the revenues and profit margins in that particular year. It will also be easier for tax administrations.

Apart from the obvious simplicity and superiority of the entry test approach, there is an important reason why the permanent averaging mechanism should not be considered.

Paras 488-491 of the Pillar One Blueprint discuss the concept of "profit shortfalls" in the context of the carry-forward regime. The idea is that if an MNE's profitability falls below the Amount A threshold for a given period, which could be a number of years, the difference should be treated as a "loss" that can be carried forward and reduce the taxes to be paid. The developed countries argue in its favor while developing countries argue against it, with various reasons such as the fact that a profit below the Amount A threshold is still a profit and not a loss. Para 491 of the Blueprint concludes

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by saying a decision is required to determine whether to include profit shortfalls in the Amount A carry-forward regime.

The decision was reflected in the 8 October 2021 political agreement which did **not** mention profit shortfalls. Thus, it was to be **completely removed both in form and substance** from the design of Pillar One.

However, the permanent averaging mechanism appears to be an attempt to re-introduce profit shortfalls, as the underlying structure is the same, i.e averaging of profitability over a number of years as a permanent feature and using that to reduce the amount of taxes to be redistributed to the developing countries and delay the distribution of profits by the Amount A mechanism for MNEs who were already in scope of Amount A.

Thus, introducing the permanent averaging mechanism would also mean going beyond the 8 October 2021 political agreement, by surreptitiously including the profit shortfall mechanism which was explicitly rejected by the IF Members.

Recommendation: The averaging mechanism should function solely as an entry test.

Mergers and Demergers
The applicability of the averaging mechanism to business reorganizations such as Group mergers and demergers mentioned in para 3 may be complex and likely to raise compliance costs.

Recommendation: A simple, efficient and easy to administer approach would be to exclude averaging for mergers and demergers.

iii. Anti-Fragmentation Rule
Para 5 contains the anti-fragmentation rule. It remains unclear whether a fragmentation that is executed in stages across different time periods would be captured by the rule in its current form. This is especially if these happen through seemingly minor transactions. The revised rules and commentary must ensure this aspect is covered.

iv. MNEs that are close to the scope but do not use Qualified Financial Accounting Standards
Para 7 of the draft rules says:

> "Where the UPE of a Group does not prepare Consolidated Financial Statements in accordance with a Qualifying Financial Accounting Standard, it must produce Consolidated Financial Statements, for

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the purposes of this Act, that would have been prepared if it had been required to prepare such statements in accordance with a Qualifying Financial Accounting Standard."

The draft rules ask whether a materiality threshold should be included to capture MNEs that would have been in-scope if they used a Qualifying Financial Accounting Standard but presently do not.

The risk that using different financial accounting standards can affect the determination of profit (called a "material competitive distortion") is also recognized in the draft rules on tax base determination.

Recommendation: A materiality threshold should be devised which is relatively close to the Amount A scope thresholds.

v. Definition of Excluded Entity

The 8 October 2021 political agreement solely mentioned Extractives and Regulated Financial Services as excluded from the scope of Pillar One. However, the definition of an "Excluded Entity" on page 8 includes new entities such as pension funds, investment funds and real estate investment vehicles.

It is problematic to see that the rules on scope include many elements which have been "slipped in" and are a violation of the political agreement reached by IF delegates. An expansion of the exclusions of scope only means fewer taxpayers and lesser tax revenues for the developing countries. Such undemocratic changes further undermine the legitimacy and trust of the Inclusive Framework, which already suffers from a lack of transparency and accountability as a forum of international tax standard-setting. It sends out the signal that IF political agreements do not really matter and will be undermined to appease the developed countries.

Recommendation: The definition of excluded entity should be limited to extractives and regulated financial services.

The forthcoming Schedule "F" relating to Exclusion of Revenues and Profits from Extractives must ensure that it is substantive and comprehensive; i.e complete exclusion. Many developing countries, especially from Africa, demanded an exclusion of extractives from scope as it would negatively affect their taxing rights, and this must be reflected in the design of the rules.

The definition of an entity is also meant to be one "where at least 95% of the value of the Entity is owned (directly or through a chain of Excluded Entities) by one or more Excluded Entities…"

However, it is not clear what 'value' refers to.

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Recommendation: It must be specified that the value refers to *shareholding*. This will make it precise and easier to administer.

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