ICAEW
REPRESENTATION 113/20

BEPS PILLAR ONE AND TWO: CONSULTATION RESPONSE

Issued 14 December 2020

ICAEW welcomes the opportunity to comment on the Base erosion and profit shifting (BEPS): Reports on the Pillar One and Pillar Two Blueprints published by OECD on 12 October 2020 a copy of which is available from this link.

This response of 14 December 2020 has been prepared by the ICAEW Tax Faculty. Internationally recognised as a source of expertise, the Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business.

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KEY POINTS

SUMMARY

1. Pillar One addresses the allocation of taxing rights between jurisdictions and considers various proposals for new profit allocation and nexus rules.
2. Pillar Two calls for the development of a co-ordinated set of rules to address the ongoing risks from structures that allow Multi National Enterprises (MNEs) to shift profit to jurisdictions where they are subject to no or very low taxation. These are referred to as the Global Anti-Base Erosion (GloBE) rules.
3. This response is in relation to both the Pillar One and Two proposals.
4. ICAEW Tax Faculty assesses new tax policy using 10 core principles (see appendix). Given the complexity already inherent in developing any new framework to be applied internationally, we recommend wherever there is a choice among policy proposals that would achieve similar outcomes, the GloBE regime adopts the most pragmatic policy proposal. A pragmatic approach is more likely to be accepted than a perfect but over engineered solution. ICAEW believes that every opportunity should be taken to simplify the rules and take businesses which will not be significantly affected (ie, not much additional tax payable) out of scope.
5. We welcome the delay in finalising the agreed rules until mid-2021 to allow time for a consensus to be reached. We urge the OECD to collaborate pro-actively with the governments of member territories in designing the rules, thereby reducing the incentives for member territories to adopt unilateral measures which would then be subsequently reversed.
6. Whilst there is logic in having a co-ordinated approach to cross—border tax avoidance, there does not appear to be any reason (other than potential resistance from the governments of some member territories) why Pillars One and Two would need to be introduced together, given that one is focussed on the redistribution of tax revenues arising from the digital economy and the other is aimed at ensuring at least a minimum level of taxation of a much broader range of commercial activities than just the digital economy. As such, whilst there is merit in progressing both legs of the project together, lack of progress in one should not hold up progression in another.
7. ICAEW believes that it would assist all interested parties if the OECD published a roadmap setting out a path towards implementation. For example, this could set out how many countries must have domestic legislation in place implementing the agreed proposals before they can go live.
8. One way of easing in implementation of the rules could be to adopt a phased approach. For example, a global turnover test higher than the currently proposed EUR 750 million could be applied initially, so that a smaller number of businesses are initially subject to the rules. Once the rules are seen to be implemented effectively the turnover threshold could be lowered.

COMMENTS ON PILLAR ONE

9. We believe that the methodologies developed, especially the allocation of Amount A between different territories, are still unnecessarily complicated.
10. In particular, we believe that the splitting of revenues between automated digital services (ADS), consumer-facing businesses (CFB) and out-of-scope activities may be difficult to achieve in practice as this kind of segmentation is brand new and not already built into all MNE's financial systems. Instead, lines could be drawn between these activities based on existing segments in an MNE's accounting system. This may mean that the classification differs a little from one MNE to another. However, this should not necessarily constitute a problem provided that the amounts identified are allocated to individual territories on a consistent basis.

11. We believe that the turnover threshold tests should be applied individually to ADS and CFB activities (not combined) so that more businesses can be brought out of scope and only the ADS or CFB activity above each threshold is subject to taxation.
12. As stated in point 8 of our general comments, a global revenue threshold higher than EUR 750m could be set at first so that tax administrations only need to deal with a smaller number of MNEs being subject to the rules while they get to grips with the system.
13. We also believe that groups with results that fall below the agreed de minimis threshold should have the ability to opt into applying Pillar One where not doing so would put them at a competitive disadvantage. We see such a disadvantage happening in two main ways:
    a) Double tax relief mechanism – If, as we recommend, the double tax relief mechanism for Amount A operates through exemption rather than a credit method, then the application of Amount A principles could, for certain taxpayers, result in a lower total tax liability on a global basis (broadly, those businesses established in high tax territories which are selling into relatively lower taxed markets). This could mean that businesses below the threshold (wherever it is ultimately set) could be at a competitive disadvantage compared to their larger competitors, depending on the specific factual circumstances of where they are established, where their key markets are and how tax policy in each varies over time.
    b) Tax certainty processes – Businesses that fall below the threshold may have less ability to obtain certainty on their global affairs than their larger competitors. The current blueprint appears to suggest that the enhanced dispute prevention and resolution mechanisms would initially be targeted at the application of Amount A within Pillar One. However, given the overlap with many principles of international tax, it is possible that these mechanisms could end up considering (and ultimately providing a degree of certainty over) wider matters of relevance to the operation of an international group.
14. We understand that there is ongoing debate around the mechanism for the mitigation of double tax. As a general principle, we recommend that the mitigation of double taxation by exemption should be favoured over the mitigation of double taxation by credit. Credit systems are inherently complex, both to self-assess and administer, and it is very challenging to gain a high level of certainty that any credit mechanism will provide effective relief for all business circumstances.
15. We understand the rationale for including nexus rules and different plus factors and sourcing principles to particular sources of revenue but, nevertheless, believe that there is considerable scope for greater simplicity. Many of the rules will be difficult to apply in practice. For example, the place of nexus for a direct sale of goods is the place of final delivery of the goods. This could be difficult to determine in practice where there is an intermediary between the business concerned and the end consumer. The business concerned is expected to take reasonable steps to determine where the end consumer is located but it is not clear what constitutes ‘reasonable’. We suggest that the nexus rules should be simplified significantly to give MNEs the greatest possible chance of complying with them.
16. A simpler approach would be to adopt the model tax treaty article 12B proposed by the UN Committee of Experts on International Cooperation in Tax Matters. This would grant additional taxing rights to countries where an automated digital services provider’s customers are located. To ensure that the approach is applied only to the largest of businesses, de minimis thresholds should be set as in Pillar One for consolidated worldwide revenue and for revenue from each individual territory to which taxable revenue can be allocated.
17. Under the proposed Article 12B, income from automated digital services could be taxed in the country where the customer is located even if the company providing the service has no fixed place of business there. The article defines income from automated digital services very broadly to include income from online advertising services, online search engines, social media platforms, online gaming, and cloud computing services.

18. The advantage of this approach is that it places the onus on individual territories and affected businesses to identify revenues derived from those territories with reference to the users and customers who are based there, rather than dividing up total related revenue based on allocation keys. Provided the underlying accounting systems used to record such transactions can identify the territories in which revenues are generated, the allocation should occur automatically.
19. We recognise that the proposed Article applies to a much narrower set of services and activities than those to which Pillar One would apply. However, we believe that the Article is targeted at those activities that most governments are concerned are generating revenues in their respective territories without any significant taxation being suffered there. It is no coincidence that such activities are therefore the focus of the Digital Services Taxes being increasingly introduced unilaterally in various countries across the globe.

COMMENTS ON PILLAR TWO

20. The proposals appear to be responding as much to the setting by some territories of low corporate tax rates as to the shifting of activities by MNEs into those low tax territories. To that end, focus could instead be shifted towards greater co-operation between territories to set tax rates that are not a 'race to the bottom'.
21. One way to do this would be to create and manage a blacklist of territories which fail to satisfy certain criteria determined by the OECD including low corporate tax rates, among other criteria. Any territory not on the blacklist would not be subject to the GloBE rules, hence significantly simplifying the administration involved in administering the regime. Further details on how this might be operated are set out in our response dated 2 December 2019 to the previous Pillar Two proposals. Amongst the potential positive outcomes from this approach are:
    a) OECD would have greater control over what constitutes 'reasonable' tax policy by adding or removing territories from the blacklist
    b) taxpayers and tax authorities would bear a much lower compliance burden as the relevant rules would be much more targeted.
22. Assuming Pillar Two goes ahead broadly in its current form, we welcome the restriction of the rules to MNE Groups reporting a minimum consolidated revenue of EUR 750 million or more in their consolidated financial statements. We believe that the definition of 'revenue' should only include income generated from business activity. This would help to bring larger non-profit organisation out of the scope of the rules. The income of most charities includes charitable gifts and grants, which are treated as revenue items in the charity's financial statements but are not derived from a business carried on by the charity. If this income is not excluded, a charity that is offered a large gift or grant that would take it over the threshold would be faced with a difficult choice between accepting the gift and taking on the burden of Pillar Two compliance or rejecting the offer of support.
23. There is also an inherent challenge as to how a global revenue threshold could be maintained on implementation into domestic policy. The governments of some territories may be tempted to set a lower threshold to bring more entities within the scope of Pillar Two and it is difficult to see how the OECD could police this. That could result in the application of the principles to a much broader set of businesses than that provided for in the blueprint.
24. We also welcome the exclusion of certain entities at the top of the ownership chain of a MNE, which includes 'non-profit organisations'. These measures would go a long way to ensuring that most charities are out of scope of the GloBE rules. However, they raise some definitional concerns which need to be addressed if the inadvertent inclusion and penal taxation of such charities is to be avoided. Further details are provided below in the section headed 'non-profit organisations'.
25. Overall, we believe that the calculations that businesses will need to make in order to comply with Pillar Two rules would be highly complex and onerous. The interplay between the

Subject to Tax rule (STTR), the Income Inclusion Rule and Under-Taxed Payments Rule (UTPR) only adds to that complexity.

26. Calculations will need to be made considering multiple legal entities and jurisdictions and, if carried out during the year end process before required tax compliance deadlines, will be labour intensive and costly as well as leading to duplicated effort. Groups may find it very difficult to source the required data within the timescales required. This is particularly because a constituent entity is defined as such regardless of whether or not it would be consolidated within the Group financial statements on size or materiality grounds.
27. Potential double taxation may also arise due to the definition of an 'Investment Fund', meaning that some entities would be taxable at both the fund and investor level. Further details are provided below in the section headed 'Investment Funds'.
28. Whilst they increase the level of complexity, we broadly welcome the carry forward and carve-out rules set out in Chapter 4 of the OECD paper on Pillar Two which aim to reduce the tax burden in situations where the economic and practical circumstances of the businesses concerned warrant it. However, we believe that they do not go far enough in making up for the timing differences that arise between tax and accounting results that could in some cases result in very unfair results. We are also aware of wide concerns across MNEs in respect of permanent double taxation arising as a result of the rules not addressing effectively timing differences. Further details of a specific example of this are provided in the section below headed 'Timing differences: Insurance Industry', however they apply to other sectors with extended business cycles equally such as mining / oil and gas.
29. Ideally, we recommend that a deferred tax type solution is found to the issue of timing differences (with possible adjustments only for uncertain tax treatments/deferred tax asset recoverability should that be considered necessary to remove judgement).
30. It is essential that full value for pre-entry timing differences and losses is given, and that these are not limited by arbitrary time-limited look-back periods. Therefore, if the effective tax rate (ETR) model is still used instead of a deferred tax mechanism, we recommend that this includes a more comprehensive set of pre-commencement rules. In particular, we suggest that carried forward timing differences and tax losses should be recognised on entry to the GloBE regime through an ability for businesses to look back at least 3-5 years prior to commencement to recognise historic timing differences. Indeed, special provisions could be introduced for those sectors with extended business cycles.
31. As an example, you could have a construction business where, due to timing differences, losses under tax rules are significantly higher prior to commencement than the accounting losses. These tax losses should be allowed to be recognised for GloBE purposes on commencement of the regime to prevent unintended GloBE tax liabilities arising.
32. There is a need for further clarity about the read across impact of the potential grandfathering of the US' Global Intangible Low-Taxed Income (GILTI) rules. The GILTI rules have a different approach, perhaps most notably focusing on (broadly) a principle of global blending of minimum tax rates, as opposed to jurisdictional blending as included in the blueprint. If the US were to retain its GILTI regime, or adopt something that applies similar principles, this could undermine the whole basis of a globally agreed approach. Indeed, it might encourage other territories to adopt similar rules if they are seen as easier to administer and less likely to impact upon inward investment decisions.
33. The STTR is likely to lead to systematic over-withholding in situations where revenues received are almost completely matched with expenses and liability increases, such that the tax withheld can far exceed the profit arising on the overall arrangement. A good example of this is the insurance sector where insurance premiums are largely matched, in the vast majority of cases, by claims expenses and liability increases. If Pillar Two is to go ahead in the form proposed, we recommend that industries such as insurance and reinsurance are not included within the high-risk services identified.
34. We particularly welcome the proposed CbCR ETR safe harbour, as this would provide groups with the opportunity to calculate the accounting base under these rules which many affected businesses are already familiar with. However, we do not see why CbCR results

cannot be used as the default option as this would significantly reduce the compliance burden on MNEs that are already reporting global results under this regime.

35. We also support the following options put forward for simplification within the Blueprint which could collectively reduce the administration burden suffered by affected entities to a significant degree:
    a) De minimis profit exclusion;
    b) Single jurisdictional ETR calculation to cover several years; and
    c) Tax administrative guidance.

NON-PROFIT ORGANISATIONS

36. The proposed definition of a non-profit organisation (NPO) is based on the definition of an Active Non-financial Entity (NFE) used in the OECD Standard for Automatic Exchange of Financial Account Information in Tax Matters, otherwise known as the Common Reporting Standard (CRS). It covers both charitable bodies and a range of other non-profit distributing organisations that aim to provide mutual benefit to their members rather than the wider public benefit that is required of a charity.
37. The proposed definition sets out six criteria that must be met by a NPO to be an excluded entity. Two of these criteria pose particular problems for some charities:
    (i) the requirement that the NPO is ‘wholly exempt’ from income tax in its jurisdiction of residence;
    (ii) the proviso that excludes a NPO that carries on a commercial trade or business that is not directly related to the purposes for which it is established (an ‘unrelated business’).
38. While it is often the case that in practice charities do not have any income that is subject to income tax in their home country, it is also the case that the legislation of several states does not grant charities a complete exemption from income tax; instead, the state grants exemption to particular categories of income if the charity meets certain conditions. In the 27 EU states remaining after Brexit, for example, only 5 states grant a complete exemption from income tax to charities established in their jurisdiction (Comparative Highlights of Foundation Laws, European Foundation Centre, 2015 at pp.47-48).
39. As regards mutual organisations, while one would expect most states to exempt income arising from mutual transactions with their members, this exemption does not necessarily extend to transactions with third parties or income from their investments.
40. The distinction made between a trade or business that is directly related to the purposes of the organisation and one that is unrelated to those purposes is generally found in domestic legislation regulating the taxation of charities, but not typically in the provisions covering mutual organisations where the more important distinction is between transactions with members (exempt) and transactions with non-members (taxable).
41. The practice of different states varies as regards whether a charity is permitted to carry on an unrelated business directly or can only do so through a related non-charitable entity. As many charities engage in the sale of goods and services at fundraising events, some states exempt the income from such events provided that they are held on a small scale that is not liable to distort competition with other businesses. The granting of income tax exemption on this basis should not debar a charity from being an excluded entity.
42. Charities may derive income from an unrelated business not only when they directly carry on a commercial business but also when their investments are deemed to constitute an unrelated business. The latter situation commonly arises when a charity invests in an unrelated commercial entity that is treated as transparent for tax purposes so that its owners are liable to tax on their share of the commercial entity’s income, whether it is distributed to its investors or not.

43. Where a charity derives income from an unrelated business we believe that this should not prejudice the charity in its entirety, resulting in all of the charity's income becoming subject to the GloBE rules. Instead, we believe that it would be more appropriate to treat the charity's unrelated business income as falling within the scope of the GloBE rules, while the charity's other income is excluded from these rules.
44. The definitions of the other entities that are proposed to be excluded from the GloBE rules (governments, international organisations, investment funds and pension funds) all extend the definition to include a wholly-owned entity that does not carry on a business and is established almost exclusively to hold assets or invest funds for the benefit of the parent organisation. Since charities establish similar subsidiaries for the same reasons the definition of a NPO should be extended in the same terms.
45. Charities also commonly set up trading subsidiaries to allow them to generate income which will be applied to benefit the purpose for which the charity was set up. Whilst the subsidiary's results will be consolidated within the group's financial statements, its income will not be beneficially owned by the group since it will be required to apply it to its charitable purposes and cannot be distributed to a private person or non-charitable entity. In such cases, we believe that the subsidiary should also be treated as an excluded entity.

INVESTMENT FUNDS

46. Investment funds are widely used to pool investments, with the basic principle being that the funds are not taxable entities as any profits are taxable at the investor level – this ensures that the capital markets covering trillions of pounds are efficient.
47. The Pillar Two provisions attempt to provide for this by including a category of exempt entity (the investment fund). However, this only applies to entities that are parent entities at the top of a corporate chain. Many investment fund structures are consolidated into wider groups as a result of accounting standard requirements. As drafted, the Pillar Two rules provide a wide range of issues including:
    - double taxation resulting from additional jurisdictional tax being applied at the location of the fund if it is not in the same jurisdiction as investors; and
    - potential application of the undertaxed payment rule (UTPR) on payments to investors should timing differences cause their effective tax rate to fall below the GloBE minimum.
48. These and other related issues impact asset management and insurance groups at the corporate level, but in reality will result in double taxation on returns for millions of individual investors in those groups.

TIMING DIFFERENCES: INSURANCE INDUSTRY

49. Under the proposed rules, the ETR is calculated on a jurisdictional basis by dividing covered taxes (without taking timing differences into account) by the amount of income within the company's financial accounts that are prepared under the same accounting standard that is used by the parent, with certain adjustments. Typically, timing differences are not adjusted for and this can create discrepancies that are especially significant in the insurance industry.
50. Further details on these issues are set out in the responses to the consultation set out by The Association of British Insurers (ABI) and the Global Federation of Insurance Associations (GFIA). In brief, however, we note that significant timing differences arise over the life of insurance contracts that will not reverse in full until the business is closed and runs off. This commonly takes many years or decades.
51. ABI's response demonstrated how this collectively leads to £billions worth of timing differences on the balance sheets of insurance companies. Adequately addressing these on transition into a Pillar Two regime is essential to avoid distortive, penal outcomes arising.

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Arbitrarily limited look-back periods as envisaged by the Blueprint are unlikely to be appropriate in view of the size and duration of insurance company timing differences. Hence, in accordance with point 6 of our comments on Pillar Two above, we suggest that a deferred tax type solution is found to the issue of timing differences to prevent unfair outcomes arising in the insurance and other sectors where long term business cycles lead to timing differences remaining unreversed over years or decades.

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APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see https://goo.gl/x6UjJ5).

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