

OECD launches public consultation on Pillar One draft Model Rules for domestic legislation on scope

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In brief

On 4 April 2022, the OECD released [draft Model Rules](#) for domestic legislation on the scope of Amount A of Pillar One. Comments to the draft Model Rules are due by 20 April 2022. This alert provides a short overview of the draft Model Rules and some initial observations. This is the third in a series of public consultations on the Pillar One Amount A Model Rules that the OECD is expected to release over the coming months, with very short comment periods, as part of a 'rolling consultation.' The first release covered the revenue sourcing and nexus rules, for which we prepared [this short overview](#), and the second release covered the rules for tax base determinations, for which we prepared [this short overview](#). The scope rules determine when a Group will be in scope of Amount A. The consultation document notes that the rules covering the scope exclusions for extractives and regulated financial services and the application of Amount A to a disclosed segment will be released at a later date.

It is particularly important to note that the Inclusive Framework has not agreed to these draft rules – rather, for the moment, they represent the work of the OECD Secretariat. They may, therefore, be subject to change, unrelated to the consultation process. The consultation document specifically identifies several open issues that the Task Force on the Digital Economy (TFDE) is currently exploring and invites input from stakeholders. It also identifies several defined terms (i.e., 'Consolidated Financial Statements' and 'Controlling Interests') that have been modified since the publication of the draft rules on [Tax Base Determinations](#).

In detail

Overview

The consultation document states that the TFDE is preparing four separate, but related, authoritative and explanatory documents through which Amount A of Pillar One will be implemented: a Multilateral Convention (MLC) and its Explanatory Statement as well as Model Rules for domestic legislation and related Commentary.

The draft Model Rules on scope ('scope rules') introduce two threshold tests to determine if a business is in scope of Amount A. The first test is a global revenue test, where businesses must determine if the total revenues of the

Group for the period in question are greater than EUR 20 billion, pro rata for a period of less than 12 months. The second test is a three-part profitability test that is designed to determine if a business consistently earns above 10% profitability (pre-tax profit margin) as measured against total revenues.

The scope rules are intended to apply at the level of a Group, in accordance with the general design of Amount A. The concept of Group is defined by reference to the Ultimate Parent Entity (UPE) where consolidated financial statements are commonly prepared under financial accounting standards. This definition of 'Group' appears narrower than that used for the purpose of the Pillar Two GloBE rules (for GloBE, the Group also includes entities excluded from the consolidated financial statements in certain circumstances). The scope rules include a small number of exceptions which provide that certain entities cannot be a UPE to ensure a standardised approach to define a UPE. The rules also introduce an anti-abuse rule as a deterrent to prevent a UPE of a Group that is owned by an excluded entity, investment fund, or real estate investment vehicle from restructuring in order to circumvent the scope rules (i.e., the 'anti-fragmentation rule').

The scope rules include a placeholder for 'exceptional scoping provisions' which may apply to a disclosed segment as reported in a Group's consolidated financial statements. The consultation document notes that these rules will operate in limited circumstances to bring a disclosed segment in scope of Amount A where the disclosed segment meets the revenue and profitability thresholds, discussed above, on a standalone basis, but the Group as a whole does not.

Consistent with the Inclusive Framework's [October 2021 Statement](#), the scope rules include exclusions for Extractives and Regulated Financial Services, but leave the details on these exclusions to be clarified by future model rules. The exclusions will apply to the revenue and profits generated by excluded activities. This means that the global revenue test and profitability test needs to be reapplied to a Group after the removal of the excluded revenues and profits. If, after the reapplication of those tests, the Group is below either threshold, it will not be in scope of Amount A.

Global revenue test

Paragraph 2(a) of Article 1 of the scope rules outlines the global revenue test – the first of two threshold tests to determine if a Group is a 'Covered Group' and therefore in scope of Amount A (unless an exclusion applies). The global revenue test is met if the Total Revenues of the Group for the Period are greater than EUR 20 billion. Where the Period is shorter or longer than twelve months, the EUR 20 billion amount is adjusted proportionately to correspond with the length of the Period. The term 'Period' is defined as a reporting period with respect to which the UPE of a Group prepares Consolidated Financial Statements. The consultation document notes that the TFDE is exploring coordination issues related to currency fluctuations.

For purposes of applying the global revenue test, the starting point for the calculation of 'Total Revenues' is revenues reported in the Group's Consolidated Financial Statements prepared in accordance with a Qualifying Financial Accounting Standard (QFAS). This means that the items of income included in Total Revenues are determined by the applicable QFAS, subject to specific adjustments.

In addition to adjustments for dividends, equity gain or loss, restatements, and revenue from excluded entities, Total Revenue must also be adjusted to account for the Group's share of revenues from any Joint Venture in proportion to the Group's share of profit or loss derived from the Joint Venture. Footnote 22 provides that this adjustment is necessary because accounting standards do not require revenues derived from an interest in a Joint Venture to be reported in the revenue line of Consolidated Financial Statements. Instead, under the equity method, accounting standards only require the recognition of the profit or loss arising from the Group's interest in the Joint Venture. Therefore, the adjustment under the definition of Total Revenues ensures equitable treatment such that the revenues from a Joint Venture are taken into account for the purposes of the global revenue test.

The consultation document notes that the TFDE is exploring whether to introduce an averaging mechanism and prior period test to the global revenue test (i.e., to determine whether a Group's Total Revenues exceed EUR 20 billion), similar to the averaging mechanism and prior period test under consideration for the 10% profitability test (which is discussed below).

Observation: In the event that the Inclusive Framework introduces an averaging mechanism and prior period test (for either or both of the global revenue test and the profitability test), businesses are likely to already be in the relevant look-back period. This assumes that the rules would be introduced in 2023 and that the look-back period considers the four periods prior to the current period (as well as the current period for the averaging test). In such a scenario the look-back period would include the periods 2019, 2020, 2021, 2022 (+ 2023 under the averaging test)).

The Inclusive Framework's October 2021 Statement states that the revenue threshold will be reduced to EUR 10 billion, contingent on successful implementation including of tax certainty on Amount A, with the relevant review beginning seven years after the agreement comes into force, and the review being completed in no more than one year.

Profitability test

Paragraph 2(b) of the scope rules outlines the second threshold scope test – the profitability test. If the global revenue test is met, a Group must apply a three-step profitability test that is designed to determine if the Pre-Tax Margin of the Group is consistently greater than 10%.

The scope rules provide that a Group's profitability must exceed the 10% threshold not only in the current Period (the 'period test') but also in at least two of the four prior Periods (the 'prior period test') and on average across those four prior Periods and the current Period (the 'average test'). The consultation document notes that these rules seek to deliver 'neutrality and stability' to the operation of Amount A, and ensure Groups with volatile profitability are not inappropriately brought into scope, which, it notes, limits the compliance burden placed on taxpayers and tax authorities.

As currently drafted, paragraph 2(b) requires that the prior period test and the average test are applied permanently on a rolling basis. However, the consultation document notes that this is an open issue and discussions at the TFDE are ongoing with regard to whether these tests could, alternatively, apply solely as an 'entry test' in situations where a Group has not previously met the scope thresholds but, once met, the prior period test and the average test would no longer apply to that Group in later Periods.

The consultation document notes that introducing an averaging mechanism solely as an 'entry test' would reduce the instances where the average calculations apply, and prevent a Group that is ordinarily profitable and meets the profitability test from incurring extraordinary losses in one year and, as a result, being scoped out for multiple periods based on its average profitability. Input from stakeholders is requested on this point.

Paragraph 3 of the scope rules includes provisions for applying the prior period test and the average test where there has been a Group Merger or Group Demerger. Generally, these rules are designed such that the financial data from existing Consolidated Financial Statements is utilised rather than requiring retrospective recalculation of financial data for Amount A purposes where a Group Merger or Group Demerger occurs.

Observation: Rules to be released later on disclosed segments likely will coordinate closely with the profitability test, and perhaps include anti-avoidance elements, in order to determine how any changes in identified segments or their scope will affect the calculations.

With respect to the Amount A carryforward regime, the [October 2020 Pillar One Blueprint](#) raised the issue of whether it should apply exclusively to economic losses or be extended to cover ‘profit shortfalls’ (where the profit of a group or segment falls below the profitability threshold). The draft Model Rules on Tax Base Determinations do not include a profit shortfall approach. The averaging mechanisms introduced in the scope rules also do not account for profit shortfalls as they do not adjust the tax base for Amount A.

Excluded entities

In addition to Extractives and Regulated Financial Services (yet to be defined terms), the scope rules exclude certain entities from Amount A. In particular, the definition of ‘Group’ and ‘Group Entity’ specifically exclude ‘Excluded Entities,’ which includes government entities, international organisations, non-profit organisations, pension funds, certain investment and real estate investment funds, and an entity where at least 95% of its value is owned by one of the aforementioned Excluded Entities.

Observation: The definition of Excluded Entities in the scope rules is consistent with the approach adopted in the Pillar Two GLoBE rules.

Anti-fragmentation rule

Paragraph 5 of the scope rules introduces an anti-fragmentation rule as a “targeted deterrent and anti-abuse rule” to prevent a Group from restructuring in order to circumvent the scope threshold tests. It applies only where the UPE of a Group is controlled by an Excluded Entity, Investment Fund or Real Estate Investment Vehicle, where an incentive may exist for a Group to artificially bifurcate its holding structure in order to inappropriately create more than one ‘Fragmented Group,’ whereby the Fragmented Group(s) has total revenues of less than EUR 20 billion, thereby ensuring the Fragmented Group is not in scope for Amount A.

If a Group restructures in a way that some of its operations are owned by an excluded entity and it is reasonable to conclude that the principal purpose of the transaction(s) was to fail the global revenue test, the Group still would be considered in scope of the rules (the total revenues of the Fragmented Groups are re-aggregated). It is noted that commentary will elaborate on the practical application of the ‘principal purpose test’ in paragraph 5(c), including through examples and guidance on the relevant facts and circumstances that would be relevant to the determination of whether failing the global revenue test was a principal purpose of the Internal Fragmentation.

The term ‘Fragmented Group’ is defined as a Group that results from ‘Internal Fragmentation’ with a UPE that is owned directly or indirectly by an Excluded Entity, an Investment Fund or a Real Estate Investment Vehicle with a Controlling Interest in the UPE. ‘Internal Fragmentation’ is generally defined as as a transaction or series of transactions of one or more Group entities after a certain date (see observation below) where the the Group is bifurcated into separate Groups, but the separated Groups have UPEs that are still owned by the same Excluded Entity, Investment Fund or Real Estate Investment Vehicle that has a Controlling Interest.

Finally the consultation document notes that discussions are ongoing at the TFDE on the different conditions contained in this rule (including administration), and commentary will elaborate on its practical application.

Observation: Footnote 32 of the consultation document points out that the reference to a date in the definition of what constitutes an Internal Fragmentation effectively operates as a ‘grandfathering’ clause, so that taxpayers have certainty that the anti-fragmentation rule does not apply to holding structures in place before a set date. The date before which an Internal Fragmentation event would be grandfathered under the Amount A rules has not been communicated, but the consultation document notes it could be as early as the date of the release of the public consultation document, i.e., 5 April 2022. It could also be set as the date of the signing ceremony for the Multilateral Convention (expected mid 2022) or the date on which Amount A enters into effect (2023).

Requirement to prepare Qualified Financial Accounting Statements

Paragraph 7 of Article 1 introduces a requirement to prepare Consolidated Financial Statements in accordance with a QFAS. Footnote 11 elaborates by noting that the intention of this rule is to require Groups that are 'close' to meeting the scope thresholds to prepare Consolidated Financial Statements in accordance with a QFAS to ensure that the operation of Amount A is based on consistent financial information. The consultation document notes, however, that the rule may need further refining in order to ensure that it does not impose a disproportionate administrative burden on Groups that will clearly not come 'close' to meeting the scope thresholds. It proposes a potential materiality threshold and solicits input from stakeholders on the most appropriate approach to be adopted.

Observation: Covered Groups are likely to already be subject to a requirement to prepare Consolidated Financial Statements in accordance with a QFAS to the extent that they are in scope for the Pillar Two GloBE rules. However, the definitions of 'Group Entity' for Amount A vis-a-vis 'MNE Group' for GloBE appear to be somewhat different. Does it follow that multinational groups which are subject to both sets of rules will be required to prepare varying sets of Consolidated Financial Statements, with different entities consolidated in each, depending on which entities are in the 'Group'?

The Amount A tax base determination rules require all Covered Groups to prepare tax base calculations under a QFAS on the basis that most Covered Groups will already be using a QFAS (which means IFRS and Equivalent Financial Accounting Standards). Clearly, this issue will become more important if the global revenue threshold is reduced in the future. Clear lines need to be drawn to ensure that businesses will not be required to prove negatives year after year.

The takeaway

There continue to be many unresolved issues and policy decisions for Amount A that still need to be addressed. The consultation document on the scope rules notes that discussions are ongoing within the TFDE on many aspects of these rules. The consultation document also notes that future commentary will elaborate on the practical application of these rules. Stakeholder input is specifically requested on almost all aspects of these rules – most notably on whether the threshold scope tests should apply averaging mechanisms as an initial 'entry test' or permanently on a rolling basis.

Let's talk

For a deeper discussion of how the draft Model Rules might affect your business, please contact:

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