Keidanren
Policy & Action

Comments on the Public Consultation Document concerning Pillar One - Amount A: Draft Model Rules for Tax Base Determinations

March 4, 2022
Business Infrastructure Bureau, Keidanren

We appreciate the opportunity to submit our comments. We would like to provide the following comments bearing in mind the need to strike an appropriate balance between simplicity and accuracy. This document is submitted by the Business Infrastructure Bureau, Keidanren, based on discussions at the "Corporate Liaison Group on Pillar 1 - Amount A[1]".

1. General Comments

To the extent possible Tax Base Determinations should be based on figures already available to Covered Groups during the preparation of their consolidated financial statements, and adjustments for Amount A purposes should be minimized.

In addition, regardless of which Qualifying Financial Accounting Standard is adopted by the Covered Group, it should be made clear that the portion of profit or loss attributable to non-controlling interests is definitively excluded from the financial accounting profit (or loss).

We understand that the Adjusted Profit Before Tax constitutes not only the Tax Base but also the numerator used in the calculation of profitability when assessing whether a company is in scope for Amount A. The profitability test should use a simpler approach that does not use the Adjusted Profit Before Tax, because this requires detailed adjustments to the accounting figures. We intend to revisit this issue at a future public consultation on “Scope”. We also understand that MNEs that do not exceed the thresholds will not be required to make any calculations related to Amount A.

2. Specific Issues

2.1. Tax Expense

The Public Consultation Document (hereinafter “the Document”) assumes that tax expense consists of the items that are not deductible for corporate income tax purposes (footnote 1). We would like to confirm the reason that interest charges for late payment of tax are not included in tax expenses. Is this because such interest charges are deductible? Some jurisdictions allow the deduction of interest[2]. Conversely how are taxes which are not deductible in some countries going to be treated? For example, delinquent taxes[3], additional taxes for understatement[4], and substantial additional taxes[5]?

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[1] Please see the foot note 1 of our previous comments: (https://www.keidanren.or.jp/en/policy/2022/018.html)

[2] Amount equivalent to interest in the case where a taxpayer applies for an extension of the due date for a corporate income tax return.

[3] Amount equivalent to interest when a corporate income tax is not paid by the legally mandated due date.

[4] Taxes imposed on a corporate tax based on amended tax returns or correction decisions

[5] Taxes imposed in cases of disguised concealment of a corporate income tax.

2.2. Equity Gain or Loss

2.2.1. Gain and Loss of JV

If equity gains (or losses) are to be included in the tax base of Amount A (i.e., the Adjusted Profit before Tax, which is the numerator in the calculation of profitability), it seems theoretically necessary that the corresponding amount of revenue be included in the denominator as well, from the perspective of balance. However, this would result in artificially “creating” revenues for the purpose of Amount A that are not recognized in the financial accounts and gives rise to a serious concern. Gains and losses recognized under the equity method are typical examples.

Therefore, from the perspective of simplification, all investment gains and losses under the equity method including those of JVs should be excluded from the tax base of Amount A. A JV is not consolidated in financial statements because a Covered Group does not truly control a JV. Even if gains and losses of JV were included in the tax base of Amount A, it would be extremely difficult to collect enough information in a timely and appropriate manner to comply with the complicated revenue sourcing rules.

Nonetheless, if gains and losses of certain JVs are to be included in the tax base, the following should be clarified.

- ✓ Typical examples of JVs that are subject to the equity method AND "jointly controlled".
- ✓ Scope of JV gains and losses that should be included in the tax base (of course, we understand that profits and losses corresponding to non-controlling interests are not included).
- ✓ The corresponding amount of revenue of the JV and how to identify the source of that revenue (the revenue sourcing rules for JVs should be as simple as possible because the collection of information is extremely challenging and should never deviate from financial accounting practice as stated above).

Furthermore, consideration should be given to not including immaterial gains and losses of JVs in the tax base, such as where gains and losses of a JV are below a certain percentage of the financial accounting profit (or loss) of a Covered Group.

2.2.2. Controlling Interest

We understand that the pros and cons of including gains (or losses) associated with disposals of Controlling Interests in the tax base are being considered, from the perspective of consistency with the inclusion of gains (or losses) associated with disposal of assets in the tax base (footnote 12). We would like to point out the following as additional factors to be considered if such gains (or losses) were to be included.

- ✓ The definition of a Controlling Interest should be clarified. It would be natural to define this based on whether the interest is consolidated for financial accounting purposes or not. Where the shareholding ratio exceeds 50%, this can be defined as a Controlling Interest.
- ✓ The capital gain of a Controlling Interest may reflect the after-tax profit of the corporation that issues the shares, which may result in double taxation if included in the tax base (for this reason, we understand that a capital participation exemption is provided in several jurisdictions.).
- ✓ Changes in the fair value of a controlling interest are not included in the tax base but

capital gains are included upon disposal. This difference should be explained.

- ✓ A simple and clear method should be established to identify the source of revenue for the disposal of a controlling interest. Creating a new category for revenue sourcing would add complexity.

2.2.3. Others

We have no specific issues with the treatment of equity gains (or losses), except for the issues listed in 2.2.1. and 2.2.2. Our understanding from the current draft is that such gains (or losses) are excluded from the tax base regardless of where they are presented in the consolidated financial statements (for example, whether they are classified as operating income or not). We also understand that step-up gains under purchase accounting are excluded.

2.3. Policy Disallowed Expenses

Adjustments under this category ("Policy Disallowed Expenses") should be very limited, such as illegal payments (e.g., bribes) and fines/penalties. In some jurisdictions, there are some items that are fully recorded as expenses for accounting purposes but partially deductible for corporate income tax purposes (e.g., entertainment expenses and donations). For the sake of simplicity, it should not be necessary to make adjustments for Amount A purposes (i.e., adding back these Policy Disallowed Expenses to increase the tax base of Amount A). Also, the treatment should not differ depending on the situation in each jurisdiction. Further, even if additional items are subject to adjustment, those that are not material in amount should be excluded.

We understand that book-to-tax adjustments listed in 2.1~2.3 are made using the currency with which the consolidated financial statements are prepared.

2.4. Restatement

Restatement is defined as "a restatement of Financial Accounting Profit (or Loss) of a Period(s) that preceded the current Period under a Qualifying Financial Accounting Standard". We understand that "correction of errors" and "retrospective application due to changes in accounting standards" are reasons for restatement. We would like to confirm whether our understanding is correct. If there are other reasons, they should be clearly explained with examples. We understand that restatement is required under Qualifying Financial Accounting Standard. Adjustments unique to Amount A should not be introduced. If the amount reviewed by auditors is not material, there should be no restatement.

In order to limit complexity due to carryforwards, it is recommended that the limitation (cap) on restatement be removed.

2.5. Deducting Net Losses

In general, the longer the carry forward period for Net Losses, the more advantageous it is for the taxpayer. At the same time, it should be also consistent with the carry forward period of Net Operating Losses for corporate tax purposes and the related documentation requirements. Given this, the carry forward period should be at least 10 years. Regardless of the internationally agreed carry forward period, the requirements for document retention should reflect the fact that the OECD's stated approach to auditing for compliance with the regulations is focused on internal controls at a system level, not on individual transactions.

Furthermore, it is desirable that the fiscal year that begins (or ends) within five years prior to the Commencement Date (the implementation date of Amount A) should be considered as the Eligible Prior Period.

2.6. Business Combination/Division

2.6.1. Transferred Losses

According to the Document, relevant transferred losses based on an Eligible Business Combination or an Eligible Division would be added to the Net Losses of the Covered Group (Article 5, 3., b.). We would like to confirm that the transferred losses can not only be added to the financial accounting loss of the Covered Group, but also deducted from the financial accounting profit of the Covered Group. We consider that there is no rational reason to treat the transferred losses differently in cases where a profitable Covered Group acquires a loss-making start-up, and in cases where a profitable Covered Group establishes a start-up within the group which makes losses in its initial years of operation.

In addition, some Covered Groups conduct dozens of business combinations or divisions every year, and the administrative burden of identifying transferred losses for Amount A purposes could be significant. It should be acceptable to allow taxpayers to elect to recognize transfer losses, or to limit the scope of transferred losses to those disclosed as significant business combinations in the notes to the consolidated financial statements.

2.6.2. Business Continuity Conditions

Of the Business Continuity Conditions, the requirement that the Covered Group carries on the same or similar business(es) throughout the twenty-four months immediately following the Eligible Business Combination or Eligible Division needs to be reconsidered in accordance with the reality of business operations. It is common for a Covered Group to review the business of acquired companies (or groups), including discontinuation, during PMI (Post Merger Integration) to create synergies through business combinations/divisions. For example, the twenty-four months requirement could be replaced with a system where transfer of losses is restricted only when there is a definite future PMI plan, such as consolidation of businesses within a Covered Group, at the time of the business reorganization.

Numerical standards using existing accounting data such as assets and headcount figures should be established to enable easier determination of whether businesses are "the same or similar".

2.7. Others

Is it correct that the profit (or loss) of a subsidiary that is excluded from the consolidated financial statements based on materiality need not be taken into account in the tax base determinations for Amount A?