Keidanren
Policy & Action

Comments on the Public Consultation Document concerning Pillar One - Amount A: Draft Model Rules for Domestic Legislation on Scope

April 20, 2022
Business Infrastructure Bureau, KEIDANREN

We appreciate the opportunity to submit our comments, and do so bearing in mind the need to strike a balance between accuracy and administrative simplicity. This document is submitted by the Keidanren's Business Infrastructure Bureau, based on discussions held by the "Corporate Liaison Group on Pillar 1 - Amount A[1]".

1. General Comments

We broadly agree with the design of the rules for determining whether an MNE Group is in the scope of Amount A based on the global revenue test and the profitability test. In particular, we appreciate the fact that the latter test is designed to limit the effects of temporary fluctuations in profitability.

Attention is required where revenues derived from domestic activities in the jurisdiction of the Ultimate Parent Entity (UPE)/Constituent Entities account for a significant proportion of total in-scope revenues of that MNE Group. In such a case, there will be an enormous administrative burden placed on the MNE Group to determine its Amount A exposure, including the risk of disputes, despite the small amount of potential Amount A reallocation to other jurisdictions.

In addition, there is a possibility that Amount A might be affected by the revenue sourcing rules in other business segments in a case where its source of revenues is clearly limited to the jurisdiction where the UPE/Constituent Entities are located, which creates the result that Amount A is allocated to other jurisdictions. Therefore, we call for the introduction of a test for exclusion from scope in such cases, with reference to the de minimis foreign in-scope revenue test proposed in paragraphs 182-184 of "Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint".

Furthermore, the various definitions employed to determine scope should be consistent throughout Pillar 1, including the revenue sourcing rules and the calculation of Amount A. The numerator and denominator of the Pre-Tax Profit

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[1] Please see footnote 1 of our comments on the revenue sourcing rules:
(https://www.keidanren.or.jp/en/policy/2022/018.html)

Margin calculation should be based on figures already available to an MNE Group from its consolidated financial statements, as stated in our previous comments on tax base determinations[2]. This will minimise the adjustments required for Amount A purposes. A simpler system should be considered to calculate the "pre-tax adjusted profit"[3] (the numerator of the Pre-Tax Profit Margin calculation), eliminating the need for detailed adjustments to the accounting figures.

Scope should generally be assessed at the MNE Group level. We cannot necessarily agree with the exceptional assessment of scope on a disclosed segment level, as this prevents MNE Groups from obtaining certainty about the application of Amount A. We intend to express our opinion on this issue in the relevant public consultation.

2. Specific Issues

2.1 Tests for determining scope

We believe it is a prerequisite that changes in economic conditions are properly taken into account in the tests for scope, as both global revenue and profitability will fluctuate as a result of such changes.

In addition, to reduce the administrative burden, clear guidance should be provided on the order in which the global revenue test and the profitability test should be applied. We would like to confirm that it is unnecessary to conduct the profitability test if the global revenue threshold is not met.

It should be clarified that if an MNE Group is excluded from scope as a result of these tests, the MNE Group does not need to take any further steps such as calculating tax base or sourcing Amount A revenue.

Some MNE Groups significantly exceed the revenue and profitability thresholds. It is not rational for these MNE Groups to be required to make detailed adjustments to the figures in the consolidated financial statements when it is clear the MNE Group will be subject to Amount A. Therefore, when global revenue and the profitability in an MNE Group's consolidated financial statements are highly likely to exceed the thresholds, consideration should be given to exempting the Group from conducting the revenue and profitability tests.

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[2] https://www.keidanren.or.jp/en/policy/2022/020.html

[3] Defined as "the Financial Accounting Profit (or Loss) of the Group for the Period after making the Adjustments set out in paragraph 2 of Article 2 of Title 5 for the Period" in the Draft Model Rules for Domestic Legislation on Scope (hereinafter "the pre-tax adjusted profit")

Measures should also be developed to exclude from scope MNE Groups whose revenues derived from domestic activities account for a significantly large proportion (e.g., 90% or more) of the global revenue.

2.1.1 The global revenue test

The TFDE is to consider whether to implement the prior period test and the average test in relation to global revenue, in the same way as for profitability test. We believe this should be discussed in conjunction with the issues of prior year currency conversions and the administrative burden. The objective should be to eliminate temporary fluctuations and increase certainty for MNE Groups.

2.1.2 The profitability test

The TFDE is discussing whether an 'entry test' could be applied to deal with situations where non-recurring extraordinary losses are inappropriately booked in a given fiscal year. However, if only the period test is applied after the requirements of the 'entry test' are met, this could result in an MNE Group being in scope in a fiscal year as a result of recording a non-recurring profit. This would undermine certainty for MNE Groups. Therefore, an 'entry test' should not be implemented. We agree with the implementation of the prior period test and the average test on a rolling basis.

With respect to the average test, in the event of a Group Demerger, we would like to confirm whether the Demerger Period is the fiscal year that includes the date on which the Demerged MNE Groups are no longer consolidated. In addition, required information on the Total Revenues of the Demerging Group in the Demerged Period may not be available if the Demerged Group has been integrated or absorbed by a third party. Guidance should be provided on how to handle such cases.

For both Group Mergers and Demergers, the Commentary should provide several examples of the calculation of the profitability test, including cases where a Group Merger or Demerger takes place in the middle of a fiscal year.

When performing the prior period test and the average test in the initial fiscal year after the Commencement Date, the elimination of certain adjustments to consolidated financial statement figures should be considered. For example, where it is difficult to ascertain Policy Disallowed Expenses and other items, such adjustments could be omitted.

2.2 Total Revenues

Firstly, the definition of revenues should be clarified, particularly where definitions differ from those used in CbC reporting. In particular, we would like to confirm whether Total Revenues refers to revenues attributable to an MNE Group, excluding the amount attributable to minority interests.

In addition, as stated in our previous comments, the inclusion of certain equity gains (or losses) in Total Revenues would artificially ”create” revenues for the purpose of Amount A which are not recognized in the financial accounts. This is a serious concern, and applies particularly to the revenue of JVs recorded using the equity method.

In principle, a JV is not consolidated in financial statements because an MNE Group does not truly control a JV. It would be extremely difficult to collect information in a timely and sufficiently accurate manner to comply with the complicated revenue sourcing rules. Therefore, JV revenue recorded using the equity method should be excluded from Total Revenues.

2.3 Pre-Tax Profit Margin

With respect to the pre-tax adjusted profit (the numerator in the profitability calculation), we would like to emphasise that our previous comments should be taken into account. In particular, as stated in 2.2, investment gains and losses from JVs recorded using the equity method should be excluded.

However, if gains and losses of certain JVs are to be included in pre-tax adjusted profit, 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 (we understand that profits and losses corresponding to non-controlling interests are not included)
- ✓ The corresponding amount of JV revenue and how to source such revenue
- ✓ The revenue sourcing rules for JVs should
  - a) be as simple as possible, because the collection of information is extremely challenging; and
  - b) never deviate from financial accounting practice as stated above

Furthermore, consideration should be given to excluding immaterial JV gains and losses from the tax base (e.g., where such gains and losses account for less than a certain percentage of the financial accounting profit (or loss) of an MNE Group).

2.4 Other material issues to be considered

2.4.1 Currency conversion

Clear guidance on exchange conversion should be provided.

In particular, the prior period test and the average test require figures from previous fiscal years. Even if exchange rates at the time of preparation of the consolidated financial statements are used, figures for Constituent Entities may be converted several times (e.g., local currency ⇒ EUR ⇒ USD ⇒ JPY) before consolidation at the UPE level. For simplicity, the use of direct conversion from the local currency to the UPE jurisdiction currency, or other reasonable approach to currency conversion between the sub-consolidation level and UPE consolidation level, should be permitted, avoiding a multi-step conversion process.

2.4.2 Mergers

Firstly, "Existing Group" is defined as an exception, arising only in cases where there is no Acquiring Group. More concrete guidance should be provided as to the type of Group which will be considered an "Existing Group".

Secondly, in the event that the accounting standards for the consolidated financial statements of the Acquiring Group differ before and after a Group Merger (assuming that both are considered Qualifying Financial Accounting Standards), we would like to confirm that no special pre- and post-merger adjustments are required when performing the profitability test.

2.4.3 Excluded Entities

Where there are Excluded Entities, guidance should be provided on how to exclude them from the figures in the consolidated financial statements of an MNE Group.

2.4.4 Others

When Constituent Entities are excluded from the consolidated financial statements on the basis of materiality, it should be clarified that no additional adjustments are required in relation to these excluded entities when determining if the MNE Group is subject to Amount A.