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OECD Centre for Tax Policy and Administration
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OECD Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint

Dear Sir/Madam

We refer to our letter of 14th December 2020 with our comments on the aspects of the Blueprint detailed in the Public Consultation Document.

In Section 3 of our letter, we raised the practical difficulties, which we believe will be presented in the application of the Pillar 2 approach to branches. We have been giving further thought to the issues that need to be addressed in order to contribute to the development of rules, to be effective in achieving the objectives of Pillar 2 which are practical for both taxpayers and Tax Authorities.

With regard to entities, which are subject to a "worldwide" basis of taxation, we would like to reiterate our concerns about the considerable challenges in "disintegrating" the results and taxes paid in the Head Office jurisdiction. Where a single entity has branches in multiple jurisdictions, yet further complexity is encountered. And from a practical perspective, the different approaches taken by jurisdictions in computing the taxable results of branches only compounds the challenges in achieving the objectives of Pillar 2.

A critical factor in the ability to conduct banking operations is the capital available to support operations. The strength and allocation of a bank's capital is carefully managed from a commercial and treasury funding perspective. Further, a bank's capital is one of the key factors scrutinised, reviewed and controlled by regulators seeking to ensure the bank's soundness and, ultimately, the protection of its customers. Within these commercial and regulatory constraints, branch operations allow for the most efficient deployment of capital and funding to support the requirements of its customers. Banks will therefore present the challenges being considered in significant size.

One of the challenges, which will need to be addressed is the consequence of losses whether in the Head Office or in branch locations. We understand that the question of losses is being considered currently and have attached as an Appendix a paper, which sets out some of the difficulties presented. We believe that some of the issues detailed in the Appendix are being considered and we trust that it will contribute to this work.

We remain of the view that the application of a “worldwide” basis of taxation is a robust equivalent of the Income Inclusion Rule and offers opportunities for a simplified approach to achieve Pillar 2’s objectives. We are concerned, however, that the complexity, which will be generated in addressing entities with multiple branches is considerable and risks generating counterintuitive results.

We remain available and should be pleased to discuss any issues the paper presents or generates. Should you have any questions or require additional input please contact us.

Yours sincerely,

Appendix - UK Finance paper 23 March 2021

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23 March 2021

A consideration of the application of the Pillar 2 approach to a Head Office subject to a "Worldwide" basis of taxation and its branches

The purpose of this note is to (1) recommend simplification of the issues presented by branches and in its absence a temporary simplification regime for qualifying taxpayers and (2) examine, by way of example, some of the issues to be addressed by an entity with multiple branches, subject to a worldwide basis of taxation, in seeking to appropriately allocate taxes paid in the country of its Head Office (HO) to the countries of the HO and of its branches, for the purposes of Pillar 2.

1) Simplified approach

The need for intricate rules governing the allocation of losses, income and taxes among HO and branches of an MNE is clearly demonstrated by the examples provided by HMRC and is amplified by the examples detailed below. Note that several simplifying assumptions (e.g. an absence of permanent or temporary differences between in the tax base) belies the true complexity. The need for legislative language is particularly acute since successful implementation is predicated on the applicable jurisdictions operating under a uniform set of rules.

The expedited timeframe during which the OECD must articulate the rules and provide implementing legislative language further exacerbates the challenge. If the simplification proposals (such as that submitted by IBFed to the OECD consultation) are not adopted, we believe that temporarily allowing MNEs to adopt a simplified branch rule will reduce compliance burdens, which is justified in cases where there is very limited potential for abuse. This will also allow additional time to develop a more complete and harmonised set of rules for branches. We would respectfully ask that in due course, after an initial, successful implementation of Pillar 2, the OECD further consider the appropriate treatment of branch income. At such time, it will be easier to ascertain whether the simplified approach has been successful in implementing the policy objective of Pillar 2, particularly given the incentive for jurisdictions to raise their tax rates due to the introduction of the initial measures under Pillar 2 (e.g. the income inclusion rule). Furthermore, the practical insights gained in the initial years of the implementation of Pillar 2 will be very valuable in drafting comprehensive and nuanced rules allocating items of income, loss and taxes among branches and HO jurisdictions.

Under the simplified approach, branches would not be treated as constituent entities where certain conditions are met. The simplified approach would only be made available if:

1. the choice to operate in branch format was made for predominantly business, and not tax, reasons;
2. the income earned by a branch is subject to current taxation in the MNE's HO on the same basis and at the same rate as income earned by the MNE through its HO; and
3. the rate of home-country tax is equal to or greater than a specified minimum rate (which may exceed the minimum rate imposed under Pillar.

The above criteria ensures that only entities that are presently subject to rates of tax above the GloBE minimum rate are able to avail themselves of the temporary simplification and, further, that the use of branches must be capable of being qualitatively justified by commercial rather than tax reasons. We acknowledge that MNEs that fail to meet the aforementioned requirements may be subject to double taxation under the currently proposed rules. Given that such MNEs are operating in branch form for predominantly non-business reasons, they have the option to incorporate the branch to avoid the inequitable tax result. Such option is, unfortunately, not available to MNEs that operate in branch form for business reasons and, as is the case for the US financial services sector, operated in such form when it created large additional US tax liabilities.

2) Issues facing MNEs with branches

Considerable complexity is generated by the approach of "disintegrating" the results of a single entity at the level of the HO. As will be seen from the simplified example below, vastly varying results also arise dependent on what methodology is followed.

Some of these issues may have been addressed for other purposes e.g. in establishing domestic limitations for foreign tax credit purposes, but whether these rules are sufficient, appropriate and consistent enough for the purposes of Pillar 2 is questionable. Together these factors make the issue particularly eligible for simplification.

Example

1. Results

In this example, Bank A has its HO in Country A and branches in each of Countries B, C, D, E and F. The bank earns 1,000 in the relevant year and within this result, Branch B, C and D each have locally taxable profits for the year of 100, Branch E has a local taxable loss of (100) and Branch F has a locally taxable loss of (60):-

Bank A (including branch results)	1,000
Branches	
B	100
C	100
D	100
E	(100)
F	(60)

2. Assumptions

For the purposes of the simplified example, it is assumed:-

Consistency of recognition

- There is a common basis of capital attribution in all countries.
- There are no permanent or timing differences between the calculations of the tax base in any of the countries.
- There are no differences between the accounting and taxable results in or between any countries.
- There are no differences in tax rates between any countries.
- All countries recognise intra Bank A transactions for tax purposes and do so consistently.

Such assumptions are wholly unrealistic, but they serve to isolate the issues demonstrated in the examples. In practice the fallacy of these assumptions raises yet further complexities.

Head Office (Country A)

- Country A has a worldwide tax system.
- Bank A has tax losses carried forward of 300 in Country A (assumed to have arisen in Country A)
- Bank A is part of a consolidated tax group in Country A. The consolidated taxable profits of the group (including Bank A) are 6,000, being the sum of entities with profits 8,000 and with losses (2,000).

Branches

- Branch B has tax losses available for carry forward of 200 against local taxable profits.
- Branch C is part of a consolidated tax group in Country C. There are two affiliated entities in Country C, which individually generate a locally taxable profit of 250 and a locally taxable loss of (300), in the year. Including Branch C's profit, this results in a locally taxed consolidated profit of 50.
- Branch D has no carry forward tax losses and is not part of a local consolidated group.
- Branch E is part of a consolidated group and surrenders (30) of its loss and carries (70) forward. Branch F carries forward its loss of (60).

3. Some issues to be addressed

The example will consider some factors effecting how much of the tax paid in the country of the HO, Country A, are attributable to Country A and how much to the countries of each branch. Some of the questions, which arise, together with <u>some</u> potential approaches are set out below.

It should be noted that the resolution and result of any one of the issues raised in respect of any branch or the HO may depend upon the resolution of the other issues and indeed the order in which the issues or the branches are addressed.

Thus, the example considers the following complexities raised by "disintegrating":-

Location	**Issue**
Head Office Country:-	
Bank A (in its entirety)	Current year branch losses
	Loss brought forward
	Consolidation loss – loss received
Branch Countries	
B	Loss brought forward
C	Consolidation loss – loss received
D	No losses of any nature
E	Consolidation loss – loss surrendered
F	Current year loss carried forward

Conclusion

The results of the Head Office and the Branches are inextricably interlinked and the method and order of their "disintegration" has consequences for the countries of the Head Office and of all the branches (including solely profitable branches) in establishing each's Effective Tax Rate (ETR). Where the Head Office applies a worldwide basis of taxation, it is the equivalent of the Income Inclusion Rule under Pillar 2 and offers the opportunity to simplify the application of Pillar 2 and ensure its objectives are met.

Given the range of approaches for the treatment of losses and the potential outcomes for the ETR for all countries involved, if the simplification proposed is not followed, it is critical that either:-

a) a uniformed method for the purposes of Pillar 2 is developed and accepted, or

b) the method of the Head Office is accepted and followed by all countries involved in

computing the ETR of the branch and HO locations for the purposes of the IIR and UTPR.

Examination of the issues raised by the example

Head Office Country A - Country A's treatment of losses at an entity level

1. **Head Office Country A's treatment of branches with current year losses**

   Against which income are branch losses of the year deemed to be set off in Country A? Some possible approaches:-

   a) Rateably against Bank A's domestic and branch gross profits – in which case:-

      (48) ((160) x 300/1,000) of Countries E and F losses are attributed to Branches B, C and D reducing HO taxes attributed to and ETR of Countries B, C and D (net of any Foreign Tax Credits (FTCS) otherwise available). Assuming such allocation is rateably, it leaves HO tax on profits of 252 (300-48) to be attributed to each of Countries B, C and D (net of any FTCS available).

      (112) ((160 – 48)) of Country E and F losses are attributable to HO, reducing HO taxes attributable to and the ETR of Country A.

      Losses of Countries E and F are attributed to and reduce the ETR of Countries A, B, C and D.

   b) Profitable branches first – in which case:-

      (160) of Country E and F losses reduce the HO tax attributable (net of any FTCS otherwise available) to Branches B, C and D. Assuming such allocation is rateably, it leaves HO tax on profits of 140 (100+100+100-100-60) to be attributed to each of Countries B, C and D (net of any FTCS available).

      Losses of Countries E and F are attributed to and reduce the ETR of Countries B, C and D.

c) Domestic income first - in which case:-

There is no restriction on HO taxes attributed to Branches B, C and D.

Losses of Country E and F are attributed to Country A.

2. Losses Brought Forward

In which order are losses brought forward set off against taxable income of the year in Country A?

Some possible approaches:-

a) Rateably against domestic and total branch net income – in which case **(ignoring effect of 1 above)**:-

(42) (140/1,000 x 300) of Country A losses are attributed to Branches B, C and D reducing HO tax attributed to Countries B, C and D (net of any FTCS otherwise available).
258 (300-42) of Country A losses attributed to Country A.

Losses of Country A reduce HO taxes attributed to and ETR of Countries A, B, C and D.

b) Profitable branches first – in which case **(ignoring effect of 1 above)**:-

300 of Country A losses are attributed to Branches B, C and D. No HO taxes are attributed to Branches B, C and D (no FTCS are available).

Losses of Country A reduce HO taxes attributed to and ETR of Countries B, C and D.

c) Profitable branches first but after set off of other branch losses – in which case **(ignoring effect of 1 above)**:-

(140) (100+100+100-100-160) of Country A losses are attributed to Branches B, C and D reducing HO taxes attributed to Branches B, C and D (net of any FTCS otherwise available).

160 (300-140) of Country A losses are attributed to Country A.

Losses of Country A reduce HO taxes attributed to and ETR of Countries A, B, C and D.

d) Domestic income first – in which case **(ignoring effect of 1 above)**:-

300 of Country A losses attributed to HO, reducing HO tax attributed to and ETR of Country A. There is no restriction on HO taxes attributed to Branches B, C and D (net of FTCS, available).

Losses of Country A reduces HO tax attributed to and ETR of Country A

3. Consolidation losses received at an entity level

In which order are consolidated losses of the year set off in country A?

a) Rateably amongst profitable consolidated entities in which case (ignoring the effect of 1 and 2 above) (250) (1,000/8,000 x (2,000)) of loss is attributed to Bank A in total and then:-

   a. Rateably against domestic and total branch net income – in which case (ignoring the effect of 1 and 2 above):-

      (35) (140/1,000 x (250)) of Country A losses are attributed to Branches B, C and D reducing HO taxes (net of FTCS otherwise available) attributed to and ETR of Countries B, C and D. Assuming such allocation is rateably, it leaves HO tax on profits of 105 (300-160-35) to be attributed to each of Countries B, C and D (net of any FTCS available).

      (215) (250-35) of Country A losses are attributed to HO reducing HO taxes attributed to and ETR of Country A.

      Losses of Countries A, are attributed to and reduce the ETR of Countries A, B, C and D.

   b. Profitable branches first – in which case (ignoring the effect of 1 and 2 above):-

      250 of Country A losses are attributed to Branches B, C and D. HO taxes attributed to Countries B, C and D are reduced, by HO tax on (250) of losses (net of any FTCS otherwise available). Assuming such allocation is rateably, it leaves HO tax on profits of 50 (300-250) to be attributed to each of Countries B, C and D (net of any otherwise FTCS available).

      Losses of Country A are attributed to and reduce the ETR of Countries B, C and D.

   c. Profitable branches first but after set off of other branch current year losses – in which case (ignoring the effect of 1 and 2 above)

      (140) (300 -160) of Country A losses are attributed to Branches B,C and D reducing HO taxes (net of FTCS otherwise available) attributed to and ETR of Countries B, C and D.
      (110) (250-140) of Country A losses attributed to HO reducing HO taxes attributed to and ETR of Country A.

Losses of Country A are attributed to and reduce the ETR of Countries A, B, C and D.

d. Domestic income first - in which case (ignoring the effect of 1 and 2 above):-

There is no restriction on HO taxes attributed to Branches B, C and D.

Losses of Country A are attributed to Country A.

b) Bank A first and then to profitable branches first – in which case (ignoring the effect of 1 and 2 above)

(300) of Country A losses are attributed to Branches B, C and D reducing HO taxes (net of FTCS otherwise available) attributed to and ETR of Countries B, C and D.

(700) (1,000-300) of Country A losses are attributed to and reduce the ETR of Country A.

Losses of Country A are attributed to and reduce the ETR of Countries A, B, C and D.

c) Bank A first and then rateably against domestic and total branch net income – in which case (ignoring the effect of 1 and 2 above)

(280) (140/1,000 x (2,000)) of losses potentially attributed to Branches B, C and D, but limited to total branch net income of 140 (100+100+100-100-60), reducing HO tax (net of any FTCS otherwise available) attributed to Countries B, C and D.
(1,860) (2,000-140) of losses potentially attributed to Bank A, but limited to total remaining Bank A profits 860 (1,000 – 140) reducing taxes attributed to and ETR of Country A.
Remainder of consolidated losses of (1,000) (2,000 – 140 – 860) attributed to other affiliates in Country A

Losses of Country A are attributed to and reduce the ETR of Countries A, B, C and D.

d) Bank A first and to the extent of domestic income only – in which case (ignoring the effect of 1 and 2 above)

860 (1,000-140) losses are attributable to Bank A and reduce tax on domestic income.

The consolidation losses cause ino restriction on HO taxes attributed to Branches B, C and D (net of FTCS available).

Losses of Country A attributed to Country A.

4. Head Office treatment of branches with loss carried forward locally in a branch?

What is the impact in the Head Office of Branch B's loss carried forward?

Assuming similar conditions occurred in the year in which Branch B's losses were generated, Branch B's loss will have been set off against Country A taxable profits of HO and / or another profitable branch (please see 1 above). This will have reduced the HO tax paid on the HO and / or whichever countries' branches were profitable that year. In turn the ETR of Countries A and /or of any profitable branch (not Branch B) would have been reduced in that year.

In the current year, the carry forward loss reduces the local tax of Branch B, but not the tax paid by HO on Branch B income. In turn this potentially generates a greater attribution of HO taxes to Branch B (lower FTCS are available from Branch B in the period).

The net effect over the period of the carry forward is that HO taxes are misallocated amongst countries (HO and branches) and the carry forward mechanism does not appear capable of resolving this.

5. Head Office treatment of consolidation losses received in the country of a branch (i.e. set against branch profits)

In which order are consolidated losses of the year in Country C deemed to be set off by Country A?

a) Rateably on profitable entities – in which case (ignoring the effect of 1,2,3 and 4)

HO taxes attributed to Country C are reduced by the HO tax on 86 ((100/(100+250))x300), net of any FTCS otherwise available.

b) Branch C's profits first – in which case (ignoring the effect of 1,2,3 and 4)

HO taxes attributed to Country C are reduced by HO tax on profits of 100, net of any FTCS otherwise available, to zero.

c) Domestic entities first (i.e. Branch C's profits last) – in which case (ignoring the effect of 1,2,3 and 4):-

Taxes attributed to Country C are reduced by HO tax on 50 (100 – (300-250)), net of FTCS otherwise available.

In each case, losses of Country C losses impacts the HO taxes attributed to and the ETR of at least Countries A and C.

6. Head Office treatment of profitable branches

What is the impact on Branch D, when it is profitable and unaffected by losses carried forward, losses of the year or consolidation losses?

On the assumptions set out, Branch D itself does not generate additional complications. Nonetheless, as noted above the attribution of HO taxes to Branch D is directly and substantively effected by the resolution of the issues presented by the other branches.

7. **Head Office treatment of consolidation losses in the country of a branch , where the loss is provided by the branch (i.e. branch is loss making)**

   What is the consequence of the consolidation in Country E of Branch E's loss?

   In providing losses as part of the group consolidation in Country E, Branch E's current year local tax liability is not effected. Depending on the choice of set off of Branch E's loss in Country A, the attribution of HO taxes to other branches in the year of Branch E's loss may however be affected, directly (e.g. please see 1. above) or indirectly (e.g. please see 3. a) b.).

   The ETR of Country E itself may appear more "reasonable" in the year of loss, reflecting the effect of the local consolidation. However, to the extent the loss is provided to other entities in Country E, the "misattribution" of HO taxes in the current year, potentially becomes permanent.

8. **Head Office treatment of branch loss carried forward**

   What is the consequence of Branch F's loss carry forward?

   Please see Branch B's carry forward – please see 4 above.

9. **Head Office treatment of each of these losses for the purposes of foreign tax credit limitations?**

   Is the method of attribution of losses raised in these questions for the purposes of Country A's FTC limitations capable of delivering results consistent with the objectives of Pillar 2?

   A worldwide system provides for credit against tax in the HO jurisdiction for foreign taxes paid. Typically such FTCS for any period are limited by a number of factors, which may include:-

   a) Foreign taxes paid on the relevant profits of the period
   b) Taxes which would be due in the country of the HO under that country's domestic measure of the relevant profits of the period
   c) Taxes on the total profits of the entity for the period due under the rules of the country of the HO

   Steps may be taken to seek to address restrictions due to timing differences e.g. by allowing foreign taxes paid in excess of these limitations for the period to be eligible for relief in subsequent periods.

   It might be assumed that as the effect of any FTC limitations (e.g. b) and c)) is to restrict the eligibility of foreign taxes actually paid (a)), the result of the restrictions is to over attribute HO taxes to the countries of branches and under attribute HO taxes to the country of the HO in any one period. However the carry forward of excess credits and the comingling of attributes of countries inherent in a worldwide system would suggest that this is not the case. We understand that concerns have been identified that, in some countries of the HO, the relevant profits in restrictions a) and b) are not limited to those of each individual branch, but pool the results and taxes of more than one branch. As will be seen from this simplified example the comingling of attributes under a worldwide system goes far beyond foreign taxes paid.

Whether all of the issues raised by this example will have been addressed in calculating foreign tax credit limitations in all countries is untested. However, with so many variables, clear and predictable results, which can be consistently produced for the purposes of Pillar 2 are highly unlikely. Accordingly without simplification the objectives of Pillar 2 are undermined.

Conclusion

The results of the Head Office and the Branches are inextricably interlinked and the method and order of their “disintegration” has consequences for the countries of the Head Office and of all the branches (including solely profitable branches) in establishing each’s ETR. Where the Head Office applies a worldwide basis of taxation, it is the equivalent of the Income Inclusion Rule under Pillar 2 and offers the opportunity to simplify the application of Pillar 2 and ensure its objectives are met.

Given the range of approaches for the treatment of losses and the potential outcomes for the ETR for all countries involved, if the simplification proposed is not followed, it is critical that either:-

a) a uniformed method for the purposes of Pillar 2 is developed and accepted for, or

b) the method of the Head Office is accepted and followed by all countries involved in

computing the ETR of the branch and HO locations for the purposes of the IIR and UTPR.