UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL
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Centre for Tax Policy and Administration
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Re: USCIB comments on the OECD Public Consultation Document "Pillar One – Amount A: Draft Model Rules for Tax Base Determinations"

Dear Sir or Madam,

The Tax Committee of USCIB submits these comments in response to the OECD Public Consultation Document "Pillar One – Amount A: Draft Model Rules for Tax Base Determination" (the "rules" or the "Document"). USCIB is a multi-industry sector US trade association that promotes open markets, competitiveness and innovation, sustainable development, and corporate responsibility. Its members comprise of leading U.S.-based global companies from every sector of the US economy and professional advisory firms, both groups of which typically have operations in every region of the world.

We recognize the work that the OECD Secretariat, the members of the Inclusive Framework on BEPS (the "IF"), the Task Force for the Digital Economy ("TFDE"), and the OECD technical working parties have invested in designing the rules for the implementation of Pillar One (collectively, the "drafters").

We are pleased to provide comments on this Document and the further Pillar One Consultation Documents to be published. The comments herein generally reflect the consensus position of USCIB, unless otherwise provided. Comments we have already provided on the consultation process in our first consultation letter of February 17, 2022, are incorporated by reference.

It is hoped that we have the benefit of reviewing the next version of the draft rules on tax base in the total context of the other Pillar One rules which have yet to be published (the so-called building blocks and the multilateral convention ("MLC")). We also offer our comments considering the announced significant expansion of the Amount A income allocation system eight years from the effective date by reducing the global revenue threshold for groups from EUR 20 billion to EUR 10 billion. We consider this planned significant expansion of Pillar One even more reason that the tax base rules should not create significant additional complexity and compliance burden for in-scope MNEs. Throughout this document the USCIB has included recommendations that, in the view of our membership, could improve the consistency of the proposed rules versus Pillar Two and existing financial accounting processes, as well as the administration of the tax base rules. These recommendations concern:

- Align Pillar One and Pillar Two tax bases to the extent possible.
- Minimize the scope of policy-related adjustments.
- Extend loss carryforward periods.
- Use a profit-shortfall approach.

- Avoid retroactive adjustments if financial statements must be restated.
- Maintain existing materiality thresholds.
- M&A related issues.

As a general statement, the various provisions of Pillar One (and Pillar Two) are highly interrelated, and choices made in one area may have significant impacts on another. As a result, comments made without visibility to other parts of the Pillar One Model Rules are necessarily incomplete. Among the critical issues which could impact choices made with respect to tax base are segmentation, controversy resolution and certainty, Amount A calculations, Marketing & Distribution Safe Harbors, etc. For example, the design for determining the surrender jurisdictions, the annual administration of Pillar One, and the approach to achieving tax certainty may influence the approach (and our related advice and feedback) for determining the tax base. As another example, the Background section of the rules specifically mentions that the tax base rules for Covered Groups subject to segmentation will be released at a later date. It will be important to ensure consistent application between these rules and the forthcoming draft Model Rules that will complete the comprehensive design of Pillar One.

Tax Base Rules are a Critical Foundational Design Element for Pillar One

USCIB recommends that the drafters hold open the comment period on these rules until the entirety of the Pillar One Model Rules can be evaluated. These rules are fundamental to the overall design and implementation of Pillar One and must be a "common thread" that binds the entire design together.

There are many areas where more guidance will need to be provided (e.g., Eligible Restatements, Business Continuity Conditions, time limitations for loss carryforwards). As a result, businesses should have another chance to comment on those more detailed rules once they are available, to make sure the rules balance the need for administrability and the avoidance of anomalous results.

Importantly, the drafters should clearly state that the rules for the determination of the Pillar One tax base cannot diverge in different countries in ways that could likely result in double taxation. Consistency across all members of the IF of the determination of the Pillar One tax base should be a clearly stated and critical element of the MLC that will be required for implementation.

Symmetry in Tax Base for Pillar One and Pillar Two Calculations

USCIB recommends that the drafters should spend additional time to review the rules for the Pillar One and Pillar Two tax base calculations and consider arriving at a single tax base that can be constantly applied to both Pillars. A consistent tax base will help to improve compliance and administration of Pillar One and Pillar Two and should reduce the possibility for double taxation.

To the greatest extent possible, the tax base as determined under Pillar One should be identical to the tax base as determined under Pillar Two. Absent consistency, a risk of double taxation may exist.

Specifically, the drafters should investigate conformity in the following areas:

- <u>Book-to-tax adjustments</u>: *In order to simplify compliance for both Pillar One and Pillar Two, the USCIB suggests that a consistent tax base for both Pillars should be constructed and uniformly applied*. The rules contemplate four total categories of adjustments (tax expense, dividends, equity gains / losses, and policy disallowed expenses). In contrast, the proposed Model Rules under Pillar Two contemplate the four categories of adjustments under Pillar One, plus six additional adjustments (revaluation method gains or losses, gains or losses from certain re-organization transactions, certain foreign currency gains or losses, prior period errors and changes in accounting principles, and accrued pension expenses).

- Elective Adjustments: *To maintain consistency, USCIB suggests that any elective method of accounting made available under the Pillar Two Model Rules be extended to the tax base determination under Pillar One.* The Model Rules under Pillar Two allow for certain elections in the computation of GloBE income or loss for Constituent Entities. For example, the Model Rules under Pillar Two allow for an election to substitute the stock-based compensation expense included in financial statements with the amount of stock-based compensation expense allowed as a deduction in computing taxable income. These elections may have the impact of creating additional differences between the tax base under Pillar Two as compared to the tax base under Pillar One.

Determination of Adjusted Profit Before Tax of the Covered Group – Policy Based Adjustments

As a general matter, in both Pillar One and Pillar Two, 'policy-based' adjustments should be kept to a minimum (i.e., limited to fines and penalties imposed by a government), and must be globally consistent, as many jurisdictions adopt different policy preferences and disincentives for various business expenses. In addition, any policy exceptions should be well-defined, and adjustments should be only those which are material by the standards of the financial statements as prepared. For example, Pillar One should not require adjustments smaller in amount than the materiality standard of the financial statements overall.

Determination of Adjusted Profit Before Tax of the Covered Group – Asymmetric Financial Statement and Tax Treatment of Certain Items

USCIB recommends that the drafters should review certain significant financial statement items that may have asymmetric treatment for tax purposes and consider if additional guidance is necessary for the treatment of these items in the determination of Adjusted Profit Before Tax under the model rules.

Certain items that are typically allowed as a deduction in the determination of taxable income are not included in the computation of financial accounting profit (or loss) and may artificially increase or decrease Adjusted Profit Before Tax as determined under the model rules.

For example, differences may exist for items such as stock-based compensation and defined benefit pension plans where an element of the expense for both items is not recorded to the income statement but rather to Shareholders Equity or Other Comprehensive Income. However, a full deduction for tax purposes is allowed only when certain economic performance requirements are met.

In addition, many differences may exist between the financial statement and tax treatment for items related to mergers and acquisitions. The difference between the financial accounting and tax treatment of goodwill is an example of such a difference. Generally, book accounting does not allow for annual cost recovery of goodwill. Rather, goodwill is tested each year for impairment and if there is determined to be a decrease in the carrying value of the goodwill, a loss is recorded in an entity's financial statements. Under the tax rules in most countries, the impairment loss is a non-deductible expense to the extent that the goodwill concerned was from a stock acquisition in which there is no tax basis in the goodwill. In contrast, acquired goodwill with tax basis (for instance when the acquisition was an asset acquisition) is generally amortized for tax purposes but not for accounting purposes.

Items such as stock-based compensation, defined benefit pension plans, and more challenging merger and acquisition accounting issues have the potential to create significant differences between financial statement profit (or loss) and taxable profit (or loss). If the drafters decide to further review the conformity between the Pillar One and the Pillar Two tax base calculations, they should also consider the appropriate treatment of items that may have a significant asymmetric financial statement and tax treatment. The drafters should consider if such differences are in line with the policy intent of Pillar One (and, by extension Pillar Two) or if additional adjustments should be allowed to enable conformity between traditional concepts of taxable income (or loss) and the determination of taxable income (or loss) under Pillar One.

Determination of Adjusted Profit Before Tax of the Covered Group - Exclusion of Equity Gain (or Loss)

Covered Groups that invest in other entities will have both realized and unrealized gains and losses for such investments under both the cost method of accounting and the equity method of accounting. As noted in Footnote 3 of the Document, these gains and losses are not part of the underlying business of the Covered Group but rather are “generated by another entity”, so they should be excluded from the Amount A tax base. Additionally, these gains and losses may be reported in Other Comprehensive Income or in Other Income (on the face of the income statement), so no differentiation between where the gains and losses are recorded would be appropriate. If (i) the unrealized gains and losses measured from the mark-to-market of equity interests being held as of the balance sheet date or (ii) the realized gains and losses from the sale of equity interests during the period are included in the tax base in any way, a separate sourcing rule may be required to allocate such gains and losses to the jurisdiction(s) making the investment decisions. As such, to ensure symmetry between the two bases of accounting, both should be excluded from the determination of Adjusted Profit Before Tax of the Covered Group.

Consolidated versus Separate Jurisdictional (or Legal Entity) Accounting

USCIB recommends that the drafters consider the appropriate handling of consolidation adjustments and the interaction with the consolidated and separate jurisdictional or legal entity tax base determinations required under Pillar One.

The rules describe an approach to compute a consolidated tax base for the purposes of calculating the Amount A tax under Pillar One. However, it is important to point out that separate jurisdictional (and by extension, legal entity) accounting will also be an important aspect of the final Pillar One architecture. For example, the ability to replicate the overall Pillar One tax base approach in the calculation of jurisdiction (and by extension, legal entity) specific amounts may be important to the identifying surrendering legal entities and quantifying the surrender amount. In addition, the correct legal entity tax base will be required for the accurate determination of the Marketing and Distribution Safe Harbor. In this regard, Pillar One (and, by extension, Pillar Two) will require an emphasis on both consistent determination of tax base as well as consistent separate jurisdiction (and, by extension, legal entity) accounting.

MNEs frequently book certain journal entries in a global consolidation ledger. Recording entries in consolidation does not impact overall consolidated financial results but may impact the relative accuracy of separate legal entity accounting. The appropriate handling of consolidation adjustments will need to be carefully considered. In certain instances, consolidation adjustments will need to be eliminated to correctly determine separate entity basis financial statements that may be necessary under both Pillar One and Pillar Two. However, in other instances, these adjustments may need to be "pushed down" from the consolidation ledger to the correct legal entities to arrive at the correct single entity results necessary under both Pillar One and Pillar Two.

In certain situations, it may be possible to accurately identify the correct legal entity to "push down" journal entries booked in consolidation. However, certain consolidation adjustments may not be easily "pushed down" on a separate legal entity basis. For example, it may be challenging to accurately "push down" goodwill (and any subsequent impairment) recorded on a global acquisition to the appropriate legal entity within a Covered Group.

The drafters should consider approaches to minimize complexity associated with MNE group consolidation adjustments. For example, MNEs should be able to apply consolidation adjustments consistent with their GAAP book accounting on a legal entity basis. As another alternative, for any entries booked in consolidation, there should be an option to reflect the consolidating adjustments at the Ultimate Parent Entity level to limit complexity and reduce the compliance burden. In all instances, it is likely that the increased emphasis on accurate separate legal entity accounting in the Qualified Financial Accounting Standard will entail significant incremental time, cost, and effort on the part of MNEs to correctly comply with Pillar One (and Pillar Two). The time-consuming entity level allocation should be at the discretion of the MNE and be within scope of the Pillar One and Pillar Two process to achieve tax certainty.

Treatment of Losses, including restatements in relation to prior periods

USCIB recommends that the drafters provide additional clarification (and practical examples) on the application of the rules to loss situations and provide clarity on the profit shortfall concept captured in the October 2020 Pillar One Blueprint.

Nowhere in the rules or the Document is there reference to the concept of profit shortfalls for any tested year, a concept that was captured in the October 2020 Pillar One Blueprint. Under this concept, analogous to a loss carryforward system, a carryforward of a profit shortfall for any tested year is permitted. A profit shortfall arises when the Covered Group's profit levels are below the Amount A profitability threshold. The inclusion of this concept in the tax base rules is logical and necessary to avoid distortive impacts on cyclical businesses. It should also be explicitly included in the Multi-lateral Convention (MLC) provisions as well. Domestic tax regimes tax profits above a 0% profit margin, so that 0% margin is the dividing line below which domestic losses and loss carryforwards are defined. Amount A taxes profits in excess of a higher profit margin (i.e., 10%). That higher profit margin should be the dividing line or threshold below which Amount A losses and loss carryforwards are defined.

As noted above, in determining the potential residual profit from which Amount A will be determined, it is essential that this be assessed only on real net residual profit, considering variations over the business cycle. Many cyclical businesses may generate residual returns in positive parts of the cycle and fail to do so in economic downturns. This could be addressed using either a profit-shortfall carryforward, or an elective multi-year average method. Without a mechanism to address this, cyclical businesses (and governments of jurisdictions disproportionately focused on cyclical businesses) will be effectively subject to different rules from non-cyclical businesses, without a clear policy rationale.

General Articles and Definitions

Title 5: Determination and allocation of taxable profit

Article 5: Determination of the Adjusted Profit Before Tax of a Covered Group

Implications of Mergers, Acquisitions, and Divestitures

In general, the rules appear to take a reasonable approach to the determination of the Pillar One tax base, relying on financial accounting results with specifically identified book-tax adjustments (although as noted elsewhere, we believe that the tax base computations used for Pillar One and Pillar Two should be as closely aligned as possible). Nevertheless, we are concerned that the treatment of losses, especially the allocation of losses in connection with merger and acquisition activity, is overly formalistic and may lead to inappropriate distortions.

The members appreciate the rules' recognition that when a Group is acquired by a Covered Group, the acquired Group's historic losses should be included in the computation of Adjusted Profit Before Tax, since the acquired Group's future income will be included in the Covered Group's tax base. Likewise, the rules appropriately consider the impact of corporate divestitures and separations. However, we believe that certain modifications are needed to ensure that the treatment of losses is neither (a) inappropriately distorted by the form of a particular corporate transaction nor (b) likely to lead to a mismatch of the cumulative losses and the eventual associated income subject to Pillar One. To achieve these objectives, we recommend three refinements to the rules regarding the allocation of losses in cases of Eligible Business Combinations and Eligible Divisions. First, the rules governing Transferred Losses should align with the adjustments to financial statement income and treat similar transactions in a similar way. Second, the rules should include a successor concept where one Group succeeds to substantially all the assets of a former group. Finally, we recommend elimination of the Business Continuity Conditions, which we believe do not further any material policy objectives and which are likely to lead to unnecessary ongoing controversy. These recommendations are discussed in more detail in Annex A.

Title 9: Definitions

Consolidated Financial Statements and related definitions

Materiality standards and financial statement corrections

USCIB recommends that the drafters provide additional commentary on the reliance on existing financial accounting materiality concepts and internal controls. USCIB also recommends the drafters include additional guidance to clarify that prior year financial statement corrections that do not arise to the level of restatement should only impact the current year Amount A tax calculation.

Pillar One should not be construed or audited in such a way as to create a new or different standard of materiality for financial statements. It should also not require *immaterial* adjustments to financial statements to obtain a more perfect tax base.

The creation of a new or lower materiality standard compared to the existing financial accounting standards would create a significant, additional compliance burden and cost for Covered Groups. For example, a Covered Group would be required to re-design existing accounting processes or internal control processes to accommodate any increased level of financial statement materiality. (NB: The revenue thresholds identified as triggering tax liability in low-income countries are themselves likely immaterial for all MNEs contemplated as being in scope for Pillar One.) In addition, public financial statement auditors might be required to expand the scope of their audit procedures to perform sufficient testing to support an audit opinion for a lower materiality threshold than may be currently required to meet financial accounting audit standards. The expansion of audit scope would represent a significant additional cost of compliance for Covered Groups.

In certain situations, Covered Groups may be required to post cumulative corrections of *prior* year financial results in the *current* year income statement. Such cumulative corrections may arise due to changes in accounting estimates, changes in accounting standards or methodologies, or due to identification of an accounting error. Such corrections may not rise to the level of requiring a full restatement of prior year financial statements but may represent a significant change in the calculation of the current year tax base for Amount A. In these instances, it would be unduly complex to have to retroactively amend prior year Amount A calculations. We agree with the rule that any such adjustment should only impact the Amount A tax calculation in the year for which the accounting correction is recorded to the financial statements.

In addition, consideration should be given in cases where there are differences between IFRS and GAAP which may disadvantage U.S. multinationals. In these cases, Covered Groups should be allowed to make adjustments in their discretion.

Administration and potential relationship to Country-by-Country Reporting

Due to the potential relationship to existing reporting processes required under CbyCR, USCIB recommends that the drafters provide guidance regarding the use of CbyCR as the basis for reporting Amount A tax obligations. MNEs need an appropriate amount of time to adjust existing compliance processes.

MNE groups currently have different approaches to the construction of their Country-by-Country reports (CbyCR). Some MNE groups build the reports “bottom up” using statutory accounts prepared for each legal entity in the MNE group. Other MNE groups build the reports “top down” using the separate legal entity books maintained in the GAAP accounting of the Ultimate Parent Entity. We assume that an expanded version of CbyCR would be used to report the annual amount of Amount A tax payable by Covered Groups. In this case, certain MNEs may need to revise their approach to CbyCR to comply with any new reporting obligations under Pillar One. Any change in CbyCR approach may also need to consider the handling of consolidation adjustments described above and will likely need to allow for reconciliation from reported CbyCR amounts to amounts in the consolidated financial statements.

Book-to-tax adjustments, restatement adjustments and related definitions

FN 11 Applicable cap on the Eligible Restatement Adjustment for the Period.

The application of a cap on restatement adjustment adds additional complexity and is not consistent with the drafters’ goal of minimizing complexity and burden to Covered Groups. A restatement adjustment carryforward would not be reflective of better matching to the related closed period or consistent with the approach taken in relation to other elements of the Amount A calculation.

FN 12 Scope of adjustments for equity gains and losses, and whether gains and losses from controlling interests shall be excluded for the tax base of Amount A.

Gains and losses associated with the disposal of equity interests, including the disposition of a controlling interest, should be excluded from the Amount A tax base.

Equity gains and losses should be excluded from the Amount A tax base. Profit or loss derived from a joint venture ("JV") should also be excluded based on potential double counting at the JV level.

"Policy Disallowed Expenses"

A Policy Disallowed Expense can be the subject of a dispute (e.g., in litigation or regulatory proceedings). If a Policy Disallowed Expense is excluded in a prior year and is successfully challenged in a later year, any income from the reversal of the expense in a later year must also be excluded.

Policy-related determinations vary significantly among countries. As discussed above, the drafters should define the category for Policy Disallowed Expenses very narrowly. It would be inappropriate to use these rules to set new tax policies that supersede country policies.

Other definitions

"Business Continuity Conditions"

FN 13 Practical application of the Business Continuity Conditions and the criteria to take into consideration in assessing whether one business is "the same or similar" to another. In particular, the relevant criteria to be considered and the time periods for its prospective and retrospective application.

The continuity of business requirement imposes considerable burden on Covered Groups to track and evaluate "same or similar" businesses across the designated period (including 12 months preceding the business combination), and this subjective test would add uncertainty and controversy for taxpayers and tax authorities. Continuity of business should be viewed as implicitly met where a Covered Group enters into a business combination.

In many acquisitions, the acquired entity/assets are converted from being a principal, to undertaking similar business activities but compensated within the acquirer's group on a limited risk basis (e.g., cost-plus). The test should look to the underlying activities, e.g., R&D, rather than the specific way those activities are remunerated.

"Eligible Business Combination"

FN 14 Whether other categories of business combinations should be included in this definition.

A transfer of a portion of Transferred Group should include a portion of the losses of the Transferred Group. Such losses would have been generated partially from the underlying assets of the transferred entity or entities.

Footnote 14 provides:

"For example, sub-paragraph (b) [of Eligible Business Combination] would cover the acquisition of 95% of an existing Group where the remaining 5% is liquidated; but it would not capture cases where, for example, one Group (Seller) sells part of its business to the Covered Group, where both the Seller and the Covered Group continue to exist as separate Groups following the operation. In the latter case, the losses (if any) that may have been incurred by the Seller prior to the transfer continue to be carried forward by the Seller following the transfer, i.e., the unrelieved losses continue to be carried forward at the level of the Group in which they were generated (the Seller)."

A portion of the generated unrelieved losses would likely have been generated by the transferred portion of the Group.

"Eligible Division"

We appreciate that the drafters have treated stock and asset deals similarly for purposes of Transferred Losses to ensure the form of the deal does not change the outcome under Amount A. We look forward to further guidance on how an asset deal would qualify. We note, however, that the example provided in footnote 14 suggests that the target company would cease to exist. Since a formal liquidation may very well occur in a different period than the acquisition (liquidations often can involve time-consuming steps), a plan to liquidate or some certification of plans to liquidate or otherwise discontinue operations should be sufficient.

"Eligible Prior Period"

Length of the look-back period

General

Based on the economic rationale for permitting loss carryforwards there should be no distinction for using such losses that is related to the age of the losses. A 2020 article (Dechsakulthorn, Glenn, Law and Myszka; Tax Notes International (July 20, 2020)) found that "more than 96 percent of companies operating in the healthcare sector and nearly 80 percent of those in the information technology sector take longer than 10 years to break even." For many businesses, allowing anything less than 10 years for the carryforward of losses is not sufficient. Under the tax rules of a majority of the G20 countries, at least 10 years or more (unlimited) are allowed for the carryforward of losses. The rules should permit unlimited carryforward or, at the very least, a 15-year carryforward period. This, combined with the earn-out approach, is necessary for the "relieving" jurisdictions to fully and appropriately recover the past investments and deductions that have been granted that relate to those losses.

Pre-Pillar One implementation versus post-Pillar One implementation losses

Unlike post-implementation losses, which may be carried forward 5-15 years, Title 9, paragraph (a)(i)(B) of Eligible Prior Period provides that only 2-8 years of pre-implementation losses may be carried forward into the new regime. Pre-implementation losses should be carried forward for the same period as post-implementation losses. There should be no distinction between pre- and post-implementation losses. The rules expressly provide that it is irrelevant (for both pre- and post-implementation losses) whether the Covered Group was a Covered Group in the prior Period (see paragraph (a) of the definition of Eligible Prior Period).

FN 16 Operation of the current definition.

The first-in-first-out approach the drafters propose for the loss carryforward regime would be a logical and administrable approach.

FN 17 Introduction of time limitations to loss carry-forward.

Both pre-implementation and post-implementation loss carryforwards should not expire, there should be unlimited ability to carry forward losses to reflect accurate profitability over time and ensure the taxable base does not exceed the economic results of the Covered Group.

FN 18 Recognition of losses incurred prior to the introduction of Amount A, and the introduction of time limitations for the carry-forward of such losses.

The loss carryforward rules should be the same for pre-implementation and post-implementation losses.

FN 20, 21

The drafters should provide an exception for the audited financial statement requirement if a Transferred Entity would not, on its own, have met the scope requirements for being subject to Amount A.

We hope that the drafters find the comments in this letter to be helpful and constructive. We are available at the convenience of the drafters for discussion on any of the comments submitted in this letter.

Sincerely,

Timothy McDonald
Chair, Taxation Committee
United States Council for International Business

Rick Minor
Vice President & International Tax Counsel
United States Council for International Business

Annex

Recommendations on Transferred Losses

Recommendation: Rules Should be Aligned with the Adjustments to Financial Accounting Profit and Treat Economically Similar Transactions in a Similar Way

The rules note that the treatment of corporate transactions remains under discussion. While general comments about the treatment of Covered Groups' M&A activity is outside of the scope of these comments, we believe that the treatment of economically similar transactions should be similar and that the treatment of cumulative financial accounting losses in connection with corporate transactions should be aligned with the treatment of corporate transactions for purposes of determining the Adjusted Profit Before Tax that is used to determine Amount A.

For example, if the rules exclude income from sale of a financially consolidated entity, they should not include gains from asset sales in Adjusted Profit Before Tax, they should not exclude income from sale of a financially consolidated entity, as the decision regarding whether to sell assets or an entity is typically driven by non-tax corporate considerations. We can see competing rationales for including or excluding such gains, but in all events the results should be similar for sales of assets and financially consolidated entities. Moreover, the treatment of the gain (as included or excluded) should inform the treatment of a Group's cumulative losses. Specifically, where a Group disposes of an entity or asset that produces financial statement income that is included in its Adjusted Profit Before Tax calculation, its cumulative losses will offset that income and should not give rise to Transferred Losses. If, however, the gain from a transaction is excluded from the computation of Amount A, then the transaction should be treated as one that gives rise to the Transferred Loss rules.

With respect to Transferred Loss situations, the current rules generally provide that losses remain with the parent of a Group other than in certain very specific and rare situations. We believe that these rules are too rigid and are inconsistent with the principle that losses and business activities should remain connected. The formalistic approach of the current draft (1) creates the potential that Groups can use this rigidity to purposefully structure economically similar transactions in a manner that results in significant distortions of loss allocation and (2) will limit the ability of Groups to structure transactions in a reasonable, economic fashion. For example, the rules regarding Eligible Divisions create a distinction between a spin-off/split-off and a split-up transaction. These are economically identical—in all cases a Group is effectively divided. However, the rules create radically different results depending on whether the former Group remains in existence, which is typically a legal formality that should not impact the treatment of Transferred Losses.

We therefore believe that in the case of division of groups an appropriate allocation of losses should be made unless the division is structured in a manner where one piece of the division represents substantially all the assets of the former combined Group, in which case the administrative burden resulting from an allocation of losses to such piece may be outweighed by the benefit of a more appropriate allocation methodology. As such we propose that in the case of a division of a Group, the losses of such Group transfer to each resulting Group proportionately based on a reasonable measure such as gross or net assets, except in circumstances where the division results in one Group holding substantially all of the assets of the former combined Group.

Recommendation: Rules Should Include a Successor Concept

Footnote 6 of the Document articulates an important principle with which we agree—unrelieved losses should not disappear from the computation of Amount A when the relevant business activities continue. The footnote explains that this principle underlies the rules governing Eligible Business Combinations and Eligible Divisions. However, in addition to these rules, we believe that the rules should also provide for situations in which a Group may continue to exist as a formal matter, but where, as an economic matter, another Group undertakes substantially all the business activities of the former group.

An example of such a possibility is reflected in the example contained in footnote 14 of the Document. There, the example posits the acquisition of 95% of a Group, followed by the liquidation of the remainder. The example suggests that because of the liquidation, the acquirer will then succeed to the losses of prior Group. As written, the rule suggests that if the prior Group did not liquidate, the entity holding only 5% of the former group assets would retain all the losses. This seems to us to be overly formalistic and inconsistent with the overall objective of aligning losses with the related ongoing business operations.

We see no reason that a result similar to that described in the footnote 14 example should not occur where, for example, a Group reorganizes itself but, because of legal or other considerations, structures its transaction as a creation of a new legal entity and leaves behind certain assets. Put differently, the result in footnote 14 should not depend on either (a) whether the 95% portion of the Group is acquired or merely becomes a new group or (b) whether the remaining 5% liquidates or remains in existence. We therefore recommend adopting a successor rule in which a Group that succeeded to all or substantially all of the assets of a former group is treated as succeeding to its cumulative Financial Accounting Losses. While this requires the determination of a threshold level for "substantially all" of the assets, we believe that a threshold of 80% or 90% would appropriately balance administrative and policy considerations.

Recommendation: Framework Should Forego or Limit Application of the "Business Continuity Conditions"

As presently drafted, the rules only permit the movement of Transferred Losses among Covered Groups where the "Business Continuity Conditions" are met. To meet the Business Continuity Conditions, in general, (1) for the 12 months preceding a combination/division, the relevant portion of the Transferred Group must have been carrying on the same or a similar business and (2) for the 24 months following such combination/business, the acquiring group must carry on the same or similar business.

We believe that the potential benefits associated with imposition of the Business Continuity Conditions are far outweighed by the potential costs. Because of the factual nature of such an analysis, the imposition of this condition is likely to generate significant controversy with different standards being applied across jurisdictions and transactions. In our view, it would be extremely rare for a Covered Group to acquire another Group with cumulative losses and not continue its business operations in some way but requiring a subjective judgment of whether such continuation is "the same or similar" to the prior Group's business seems to us to create unnecessary controversy and uncertainty.

Moreover, when compared to analogous rules in specific jurisdictions, such as the "continuity of business enterprise" rules, which are a requirement to having a good tax-free reorganization under U.S. law, because the Business Continuity Conditions are focused solely on the movement of Transferred

Losses, jurisdictions are more likely to challenge taxpayers. Should the inclusive framework decide to retain the Business Continuity Conditions, we believe that it would be appropriate to limit the post-transaction application of such rules to situations where the acquiring Group will not continue the relevant business or a similar business immediately after the relevant transaction (i.e., in a manner similar to how the United States' "continuity of business enterprise" rules apply). Requiring a subjective analysis of business operations up to two years after a transaction is likely to undermine tax certainty and lead to significant disputes.