KPMG

Memo

To Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

From KPMG International

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Ref Comments on the Public Consultation Document for Pillar One – Amount A: Extractives Exclusion

Professionals in the member firms of KPMG International[1] ("KPMG") welcome the opportunity to comment on the OECD's public consultation document entitled "Pillar One – Amount A: Extractives Exclusion" released on 14 April 2022 (the "Consultation Document").

The Consultation Document contains the Draft Model Rules on the Extractives Exclusion, which determine when Extractive Activities of a Group (as defined in the Model Rules) will be excluded from the scope of Amount A and, therefore, will not be subject to the detailed provisions outlined in the Model Rules. As highlighted in the Consultation Document, the Extractives Exclusion is intended to reflect the policy goal of excluding the economic rents generated from location-specific extractive resources that should only be taxed in the source jurisdiction while not limiting the exclusion in respect of profits generated from activities beyond the source jurisdiction or later in the production and manufacturing value chain.

The Consultation Document provides for an exclusion from Amount A for Extractive Activities, defined by a product test and an activities test. The exclusion applies when the Group derives revenue from the sale of Extractive Products and the Group has carried out the relevant Exploration, Development or Extraction activities. Prior to applying any Extractives Exclusion, the Group must

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determine if it is in the scope of Amount A per the general scope rules. The Group must have consolidated Revenue (including activities covered by the Extractives Exclusion) or a disclosed segment (where the exceptional segmentation rules apply) that exceeds EUR 20 billion and a profit margin above 10 percent. For the purposes of our submission, we have assumed that the general scope rules have been satisfied such that steps 2 through 7 of the Extractives Exclusion require consideration.

Given the importance of all aspects of the building blocks for Pillar One, we urge that the to-be-developed commentary for the new regime should be the subject to a future public consultation, including the areas noted in footnotes for many of these public consultation documents.

KPMG's comments on the Consultation Document are presented below. In light of the two-week turnaround, our comments are limited to broad themes. We note there exist complexities and differences amongst the various participants within the extractive industries that create challenges with the development of a broad-based approach. Complexities require additional consideration to prevent Pillar One from creating significant economic inefficiencies. Therefore, we recommend the OECD consider allocating additional time to permit more interaction and consultation with extractive Groups and their industry organizations to address the complex issues related to the potential application of Pillar One to any part of the extractives value chain.

We hope the Task Force will find our comments constructive as it moves forward in finalizing its work on the Amount A scope rules.

1. ***The definition of Extractive Activities should not require the product test and activities test to be met when both tests are satisfied in the same State but not necessarily within the same Group***

The Extractive Activities definition contains a dual test—the product test and the activities test—and both tests must be satisfied. In Step 2, the Group must sell the Extractive Product and it must conduct Exploration, Development or Extraction to qualify for the Extractives Exclusion. The Consultation Document notes that revenue from trading only, without having conducted the relevant extractive activity, or revenue from performing the extraction service without owning the Extractive Product would not qualify for the exclusion. It is also noted that the test is intentionally designed to be straightforward and to achieve parity with the ordinary application of the Amount A rules.

The dual test appears to prevent certain revenue and profits of a Group from qualifying for the Extractives Exemption if the Group purchases an Extractive Product from a third party in State A and the Group performs Qualifying Processing within State A. For example, if the Group has a facility in State A that liquifies natural gas, which meets the definition of Qualifying Processing, the Group would not be afforded the Extractives Exemption because the Group did not also perform the Extractive Activities. However, all the profit from the Extractive Activities remains attributed to State A and subject to tax regime of that State. This failure to be captured in the Extractive Exclusion seems to be inconsistent with the policy goal of excluding the economic rents generated from location-specific extractive resources that should only be taxed in the source jurisdiction.

The definition of Extractive Activities also appears to assume that all Groups that perform Extractive Activities have sufficient scope and scale to undertake all the activities across the value chain within the Group. Smaller producers may not have the operational or financial capacity to undertake multiple components of the value chain. As a result, these producers may sell their Extractive Products to third parties within the State. If the Groups that are subject to Amount A are not given an exclusion for Extractive Products purchased within the State, the smaller producers may be disadvantaged and may find that they must sell their Extractive Products at a discount or they may need to be acquired by larger Groups. In our view, such outcomes are not the intended policy objectives of Pillar One and modifications to the definition of Extractive Activities should be considered.

2. The Delineation Point as currently defined may result in certain sales and distribution revenues and profits not forming part of the Extractive Exclusion

The Delineation Point is the deemed end point of the excluded Extractive Activities. The Consultation Document provides three Delineation Points: (a) a sale of the Extractive Product to an Independent Party, (b) an Intra-Group transaction transferring the Extractive Product from one State to another, and (c) an Internationally Recognized Reference Price.

The Consultation Document notes the revenue from commodity trading only (without having conducted the relevant extractive activity) will not qualify for the exclusion. Commodity trading is the marketing/sales and distribution of the Extractive Product and the revenue and profit of this marketing/sales and distribution activity for the Extractive Product should form part of the Extractives Exclusion. Consider, for example, the North American crude oil market whereby a Canadian-based Group undertakes Extractive Activities. Due to crude oil price differentials between markets, the Group desires to maximize its revenue and profit by selling its Extractive Product to a third-party refinery in the United States Gulf Coast. In this case, the Delineation Point would appear to be at the US Gulf Coast where the transaction occurred at the third-party price. But for various operational considerations, the Canadian Group may have the upstream entity sell the crude oil to the Group's Canadian marketing entity, who sells the crude oil to the Group's related US marketing entity at the Canada-US border, who sell the crude oil to the third-party refinery. The Delineation Point becomes the Intra-Group price at the Canada-US border per subparagraph 27(b). All marketing revenue and profit past the Canada-US border would no longer be exempt. Such trading transactions are common and there exist industry accepted market prices that support the transfer price is consistent with the arm's length principle, thus ensuring the taxation of profits is properly realized in the two jurisdictions.

These marketing and trading activities can differ in many ways amongst Groups. Some may sell from the production location, while others may sell through related and unrelated intermediaries. Joint ventures may appoint a single participant to market all output. It is unclear why these trading/marketing/sales and distribution activities should not be exempt given they relate to the sale of the Extractive Products; there does not appear to be a misalignment of the economic rents generated from the location-specific extractive resources. Similar considerations arise when the best market for the Extractive Product is overseas and requires transport by ship rather than pipeline or

railcar. Such transactions are not subject to the same challenges arising from the digitisation of the economy and do not need the formulary apportionment mechanism of Pillar One to resolve the taxation rights of each jurisdiction.

3. How are hedging activities treated?

The prices for Extractive Products are subject to considerable price variation over time. Extractive companies regularly use various hedging arrangements to manage this price risk. For example, a Group may want to hedge part of its production to ensure it has the required cash flow to fund capital expenditure programs. The hedging activities are related to the Extractive Activities, but the hedging may not be attributed to specific volumes or transactions; rather the hedging may focus on the broader portfolio of physical Extractive Products. Hedging gains and losses related to Extractive Activities should be captured within the Extractives Exclusion.

4. It is unclear why a kilometre limit should be placed on the exception in paragraph 27(f)

The Delineation Point per subparagraph 27(b) exists where an Intra-Group transaction transfers the Extractive Product from the State where Extraction takes place to another State. Paragraph 27(f) provides an important exception whereby the Intra-Group transaction is deemed not to be transferred to another State if the activities performed in the other State would have been Qualifying Processing if performed in the first State. Paragraph 27(f) proposes to extend the Delineation Point to a location that is within a certain distance (to be determined) of the border of the State.

It is reasonable for Groups to determine the most operationally sensible and cost effective location to undertake the Qualifying Processing activities. The location may be immediately adjacent the location of the Extractive Product, near the third-party purchaser in another State, or in a third State.

The exception granted in paragraph 27(f) is favourable as it recognizes the possibility that the Qualifying Processing facility is not in the same State as the Extractive Product. However, it is unclear why there should be a distance limit to the exception. The Group should determine the optimal location for the facilities based on operational merits and the Extractives Exclusion should not dictate the specific location relative to the location of the Extractive Product.

5. Industry complexities and differences exist

There exist complexities within operational structures and value chains of both the mining and oil and gas industries, and differences between the two industries can exist. In our view, additional consideration and consultation should be undertaken to ensure the Pillar One regime captures these complexities and does not create inequalities in the treatment across different extractive Groups.

6. Tax Policy Alignment

The Consultation Document indicated the policy intent for the exclusion for Extractive Activities was to exclude "…the economic rents generated from location-specific extractive resources that should

only be taxed in the source jurisdiction, while not undermining the comprehensive scope by limiting the exclusion in respect of profits generated from activities taking place beyond the source jurisdiction, or later in the production and manufacturing chain."[2]

It is not clear that economic rents generated from location-specific extractive resources are being materially impacted by the midstream and downstream activities related to the Extractive Activities. Furthermore, at this time it is unclear if the non-excluded activities as currently defined will generate sufficient profit margin to cause both the revenue and profit thresholds to be met. The current design of the exclusion will create a significant administrative burden for both taxpayers and tax authorities, thus raising questions regarding the merits of Groups undertaking costly and time-consuming efforts to demonstrate they are not subject to Pillar One.

By their very nature, the Extractive Products are commodities with well-established markets and generally observable third-party prices. Market participants are price takers operating in a competitive and open market. The *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "OECD TP Guidelines") have been successfully applied to the Extractives industry for many years. We fail to see how these OECD TP Guidelines are apparently no longer able to be reliably applied to intercompany transactions involving Extractive Activities, including activities such as trading, transportation, and refining and distribution of related products. In our view, the most appropriate approach is to apply the OECD TP Guidelines in conjunction with Pillar Two. The application of Pillar One to Extractives appears to be trying to find a new solution when a workable solution already exists.

In our view, an attempt to limit the Extractives Exclusion by disqualifying midstream and downstream activities is both impractical and unnecessary to preserve the comprehensive scope of Amount A. Rather, including any portion of the Extractives jeopardises the policy intent of taxing the economic rents in the source jurisdiction and may introduce artificial economic distortions between different Groups. We recommend a full exclusion or, at a minimum, a substantially simpler exclusion, determined in consultation with a range of extractive Groups, to ensure that the diverse operational structures and value chains across the industry are reflected within the rules.

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[2] Consultation Document, page 2.