

OECD issues public consultation document on Pillar One - Amount A: Extractive Exclusion

22 April 2022

In brief

The OECD released the public consultation document on the [Pillar One - Amount A: Extractive Exclusion](#) on 14 April 2022. Comments on the consultation document are due by 29 April 2022. This alert provides a short overview of the proposed approach to the Extractives Exclusion and some initial observations.

It is particularly important to note that these draft rules for the moment represent the work of the OECD Secretariat. The Inclusive Framework has not approved the draft rules yet. They may, therefore, be subject to change, unrelated to the consultation process. The consultation document specifically identifies several open issues that the Task Force on the Digital Economy (TFDE) is currently exploring and invites input from stakeholders. Detailed commentary on a number of technical items is also expected at a later date.

In detail

Overview

The Extractives Exclusion is intended to exclude from the scope of Amount A the profits from 'Extractive Activities.' In a narrative format, the consultation document outlines that the exclusion applies where a Group both derives revenue from the exploitation of 'Extractive Products' and has carried out the relevant 'Exploration, Development or Extraction.' Hence, the definition of Extractive Activities contains two elements: a 'product test' and an 'activities test,' both of which must be satisfied. This means, for example, that revenue from commodity trading only (without having conducted the relevant extractive activity), or revenue from performing extraction services only (without owning the Extractive Product) will not qualify for the exclusion.

The consultation document lays out the seven steps that a Group covered by the Extractive Exclusion would follow to apply Amount A as a whole. Steps Two and Three (see the flowchart in the Annex with a particular focus on these steps) are specific to the Extractives Exclusion:

Step Two: After applying the **general scope rules** as Step One (i.e., EUR 20 billion global revenue test and 10% profitability test) and subtracting third party revenue derived from Extractive Activities from the Group's consolidated revenue figure, a Group must re-determine whether the EUR 20 billion revenue threshold is met by testing only the in-scope (i.e., non-Extractives Activities) revenue. If this is not above EUR 20 billion, the Group is not in scope. If it is above EUR 20 billion, then the profitability should be tested (Step Three).

Step Three: Re-determine whether the 10% profitability threshold is met by isolating the Extractives profits and testing the profit margin of the remaining in-scope profits. If this profit margin is above 10%, the Group is in scope of Amount A.

The consultation document notes that work is ongoing in considering how the application of the Extractives Exclusion can be simplified, particularly for Groups that exceed the revenue threshold, but whose in-scope profit margin is consistently below the 10% profitability threshold. It also notes consideration will be given to whether an initial transition period is needed, while Groups adjust their systems to comply with these rules.

As noted in the consultation document, the approach taken reflects 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 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.

Identify Extractive Activities, carve-out revenue derived from Extractive Activities, and reapply the Revenue Threshold to in-scope revenue

The test in Step Two is proposed to be straightforward and achieve parity with the ordinary Amount A scope rules. If a Group conducts Extractive Activities, it must determine whether it generates third party revenue from the sale of Extractive Products. If so, the Group subtracts this revenue and reapplies the global EUR 20 billion global revenue test to the remaining in-scope revenue. Groups that do not generate third party revenue from the sale of Extractive Products before a defined 'Delineation Point' may also qualify for the Extractives Exclusion, but such Groups must skip Step Two and immediately move to Step Three to test profitability of in-scope activities.

The Delineation Point sets the boundary for the Extractive Exclusion, and is the earliest of:

- Where there is a sale of the Extractive Product made from the Group to an Independent Party; or
- Where there is an Intra-Group transaction transferring the Extractive Product from the State where the Extraction takes place to another State (subject to an undefined proximity exception); or
- There exists an 'Internationally Recognised Reference Price' for the Extractive Product (which meets the specifications of the physical commodity benchmarked by the reference price) in which case the deemed revenue amount for purposes of the exclusion is calculated by multiplying the reference price with the physical quantity of the Extractive Product.

Step Two only excludes identifiable third party revenue derived *prior* to the boundary of the Extraction Activities (i.e., the Delineation Point). For the purpose of Step Two, there is no subtraction for 'deemed' or intra-group revenue.

Observation: This boundary of Extraction Activities may be reached prior to identifiable third party revenue being realised. For example, the boundary of Extraction Activities may be where there has been an international intra-group sale, where the product meets the qualification for an International Recognised Reference Price or where further non 'Qualifying Processing' takes place prior to a sale to an Independent Party (e.g., where the 'backstop' provision applies).

While this approach should simplify the process for applying Step Two, it is expected to result in a higher number of taxpayers being subject to the more complex Step Three rules (and the Pillar One rules more broadly) than would be the case if the global revenue threshold excluded the value of Extraction Activities whose boundary is reached prior to a sale to an Independent Party. We expect this to be a key area of focus in submissions.

Calculating the profit margin of in-scope revenue

Groups that meet the conditions of Step Two will need to identify the profits derived from Extractive Activities and exclude these from Amount A. Groups will also need to identify the remaining profits from in-scope activities to test whether these profits surpass the 10% profitability threshold. Step Three effectively treats the in-scope part of the Group as a standalone business apart from the Extractive Activities of the Group for the purpose of determining profitability.

The consultation document acknowledges that this step is more complex than Step Two because it may require identifying intra-group revenue and performing cost allocations. Two approaches are outlined for calculating the profit margin for in-scope revenue: the Disclosed Operating Segment approach or, where this approach is not applicable, the Entity-level approach. Both approaches result in the potential application of Amount A to 'disclosed segments / bespoke in-scope segments,' which the document acknowledges creates additional complexity when applying the scope averaging mechanism and loss carryforward rules.

Identifying profits using the Disclosed Operating Segment Approach

This approach is designed for groups with a Disclosed Operating Segment (DOS) where the revenues and allocable costs can be reliably determined. In order to rely on the DOS approach, the Group must meet two conditions:

- First, the Group must determine whether its disclosed segments *predominantly* (see below) generate revenue that is excluded, or predominantly generate in-scope revenue; and
- Second, the Group must undertake a cost allocation exercise to ensure costs are appropriately and reliably allocated between the segments.

In determining whether a Group predominantly generates revenue that is excluded under the first condition, the Group will need to perform the 'predominance test.' This is done by applying the Delineation Point (see above for an explanation of this concept) to determine whether any of the Group's segments are made up of at least [75% - 85%] (this percentage is yet to be agreed) of excluded revenues (i.e., including third party, intra-group and deemed revenue). The consultation document proposes a cap of [EUR 1 billion] (also a figure yet to be agreed) of in-scope revenue applied per segment (in-scope revenue under this amount is disregarded in determining if the segment as a whole qualifies for the Extractives Exclusion).

Some further points to note on the predominance test:

- If the predominance test is met such that the DOS predominantly generates revenue that is excluded, the entire segment qualifies for the Extractives Exclusion and no further work is required to identify the profits and profitability of the in-scope revenue in that segment. The fact that some profits relate to in-scope activities will not limit the exclusion to the DOS.
- Segments that have at least [75% – 85%] of in-scope revenue are in-scope segments. The profit margin applicable to the segment may include profits relating to excluded activities but this is proposed to be dealt with by multiplying the profit margin by the actual in-scope revenues of the DOS to ensure that only in-scope revenues are reallocated via Amount A (i.e., a 'proxy' approach).

- An adjustment may be needed for 'unallocated costs' or overheads that are not attributable to any specific segment in the financial statements. Such costs will be allocated using objective criteria (unspecified in the consultation document).
- 'Mixed segments' will be deemed to exist where a DOS has excluded revenues < [75% - 85%] or in-scope revenues > [EUR 1 billion], but also in-scope revenues do not exceed [75% - 85%] of the DOS revenues. For mixed segments, a Group must calculate the amount of in-scope revenues (using the Delineation Point) and also reliably allocate previously unallocated and allocated expenses to in-scope and excluded revenues within the segment.

Identifying profits using the Entity-level approach

Groups that do not have Disclosed Operating Segments or cannot reliably attribute revenue and costs required under the DOS approach must identify profits using the Entity-level approach. Generally, the Entity-level approach follows the same methodology as the DOS approach except it is applied on an Entity level rather than a segment level. Each entity within a Group will apply a predominance test (i.e., [75% - 85%] of excluded revenue) and [EUR 1 billion] cap on in-scope revenue. If these conditions are met, the entire Entity is considered excluded under the Extractives Exclusion.

If an Entity does not meet the predominance test and in-scope revenue cap, the Entity would be identified as an 'in-scope' Entity and will need to calculate the amount of in-scope revenue it generates. This is done by subtracting the excluded revenue (as defined by the Delineation Point) from the total revenue of the Entity. Rather than computing a profit margin on an entity by entity approach, the Group would combine the in-scope Entities into a 'consolidated bespoke segment' for Amount A purposes. A Group would then need to apportion its expenses, including indirect and unallocated costs, to its in-scope revenue and determine its in-scope profits - which must be tested against the 10% profitability threshold.

Observation:

The stated advantage of the DOS approach, according to the consultation document, is that it offers "*an advanced starting point from which to make these adjustments and can potentially remove entire segments from the need to calculate the profits and profitability, and that there is a simplified profit margin proxy approach for segments that are predominantly in-scope.*" The fact that a DOS with predominantly excluded revenues (notwithstanding that it may have some in-scope revenues) is excluded in its entirety is welcomed insofar as it reduces complexity.

The predominance test will, however, introduce complexity for Groups seeking to use the Extractives Exclusion. Tax administrations may struggle to verify the positions adopted by businesses in relation to excluded or in-scope segments, unless they formally request the documentation from the taxpayer or launch an audit or enquiry with respect to the taxpayer. This stresses the importance of the advanced tax certainty mechanism.

While the DOS approach will allow qualifying Groups to leverage existing segment accounting to assess the profitability of in-scope activities, detailed analysis and categorisation of the underlying data will still be required. This analysis will be particularly detailed where Groups have 'mixed segments' that require specific categorisation of both revenue and expenses between in-scope and excluded activities.

Where existing accounting systems are not aligned with the Extractive Activities boundaries provided for in the rules, such analysis is likely to be complex and may require impacted groups to adjust the procedures applied in undertaking their operating segment accounting.

‘Rolling’ public consultations

This is the fourth in a series of public consultations on the Pillar One Amount A Model Rules that the OECD is expected to release over the coming months, with very short comment periods, as part of a 'rolling consultation.' The first release covered the [revenue sourcing and nexus rules](#), the second release covered the rules for [tax base determinations](#), and the third release covered the [general scope rules](#). The Extractives Exclusion is intended to exclude from the scope of Amount A the profits from 'Extractive Activities.' The consultation document notes that the rules covering the scope exclusion for regulated financial services and the application of Amount A to a disclosed segment will be released at a later date.

The takeaway

The approach envisaged in the explanation is likely to involve significant complexity for industry participants, particularly where parties are unable to rely on the disclosed segment approach or where they have 'mixed segments' that do not meet the predominance test. The approach outlined for the Extractive Exclusion highlights the need for an effective tax certainty mechanism for Amount A - particularly for Groups in scope of the Extractives Exclusion.

It also seems likely that the test outlined in these rules for identifying excluded versus in-scope profits using an Entity-level approach (for the purpose of then reapplying profit thresholds) will be equally applicable to the exclusion for Regulated Financial Services. Therefore, the draft rules for extractives should give the financial services sector a head start for assessing the potential impact.

Let's talk

For a deeper discussion of how the proposed approach to the Extractives Exclusion might affect your business, please contact:

Tax policy leadership

Stef van Weeghel, *Amsterdam*
+31 0 88 7926 763
stef.van.weeghel@pwc.com

Will Morris, *Washington*
+1 202 213 2372
william.h.morris@pwc.com

Edwin Visser, *Amsterdam*
+31 0 88 7923 611
edwin.visser@pwc.com

Regional tax policy leaders

James O'Reilly, *Australia*
+61 7 3257 8057
james.oreilly@pwc.com

Kartikeya Singh, *United States*
+1(202) 312 7968
kartikeya.singh@pwc.com

Stewart Brant, *United States*
+1 (415) 328 7455
stewart.brant@pwc.com

Tax policy editors

Phil Greenfield, *London*
+44 0 7973 414 521
philip.greenfield@pwc.com

Chloe O'Hara, *Dublin*
+353 87 7211 577
chloe.ohara@pwc.com

Giorgia Maffini, *London*
+44 0 7483 378124
giorgia.maffini@pwc.com

Annex 1. Flowchart of steps to determine Extractive Exclusion

