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In this article, the authors examine the OECD's pillar 1 amount B proposal, explaining its possible effects and implementation challenges and how businesses should be preparing.

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In October 2021 the OECD/G-20 inclusive framework on base erosion and profit shifting released a statement outlining the contours of a two-pillar international tax reform.[1] One hundred and thirty-seven members of the inclusive framework, including every major global economy, have signed on to that deal, which if implemented, would amount to the most radical reform of the international corporate tax system since its foundations were established by the League of Nations in the 1920s.

To date, most businesses have understandably been focused on pillar 2 — a complex toolbox of minimum effective tax rules that countries can implement starting in 2023,[2] and which will apply to multinational businesses with more than €750 million in annual revenue. In contrast, there has been less focus on pillar 1, in large part because it is difficult to foresee the U.S. Congress ratifying the deal and impossible to see how pillar 1 could be implemented without the United States.[3] The pillar 1 technical work is significantly behind that of pillar 2; the OECD is still in the midst of releasing discussion drafts for public consultation as of the publication date of this article. In addition, the core part of pillar 1 — amount A — would apply only to businesses with more than €20 billion in revenue and a profit margin of 10 percent, a select group of approximately 100 companies globally. What is often missed is that pillar 1 is itself a two-part deal, and although amount A is limited to 100 companies, there are no similar limits on amount B. Amount B is a crucial part of the two-pillar reform but has been largely absent from public attention in recent months amid a flurry of activity on pillar 2 and amount A.

This article will explain: (1) what amount B is; (2) who is likely to be affected; (3) how amount B could work; (4) the challenges that could prevent

[1] OECD, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy" (Oct. 8, 2021).

[2] A number of jurisdictions — and notably the EU and the United Kingdom — have indicated that they will delay the implementation of the pillar 2 rules until the end of 2023 at the earliest.

[3] *See* Matthew Herrington et al., "The Diverging Paths of Pillars 1 and 2," *Tax Notes Int'l*, July 4, 2022, p. 29.



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amount B from being implemented; and (5) what groups should be thinking about today.

### What Is Amount B?

In reference to amount B, the October statement states that "the application of the arm's length principle to in-country baseline marketing and distribution activities will be simplified and streamlined, with a particular focus on the needs of low-capacity countries. This work will be completed by the end of 2022."[4]

In simple terms, this slightly cryptic language means the inclusive framework recognizes that:

- transfer pricing is often unnecessarily complex;
- taxpayers and tax administrations expend significant resources benchmarking and then arguing over the returns because of routine marketing and distribution activities;[5]
- benchmarking returns for routine distribution activities is particularly difficult in low-capacity jurisdictions, which lack the necessary expertise, access to databases, or both, without which effective transfer pricing enforcement becomes impossible; and
- transfer pricing would be simpler if tax administrations agreed on a common framework to identify and benchmark returns due for baseline marketing and distribution activities and committed to working on such a framework.

Amount B can in many ways be understood as a continuation of past, largely unsuccessful, OECD and other multilateral development organizations' efforts to simplify transfer pricing, whether through safe harbors or special rules for low-value-adding intragroup services.[6]

### Who Will Be Affected?

Unlike amount A, there is no suggestion that amount B would be limited to businesses based on a revenue or profitability threshold, and hence in principle it could apply to any group with baseline marketing and distribution activities. Any multinational business with baseline marketing and distribution activities — whether that be pharma, consumer goods, asset management, or automobiles — could be affected. Moreover, businesses with marketing and distribution activities that do not match the (yet to be determined) definition of baseline could also be affected by the need to demonstrate that they are outside the scope of amount B.

### How Would It Work?

Amount B has two core components: (1) a definition of baseline marketing and distribution activities that will be eligible for amount B; and (2) a framework to set a return (or more likely returns) for these activities.

The inclusive framework could adopt different approaches to defining baseline marketing and distribution activities, although the fundamentals of any definition are likely to be similar. It seems necessary to start with some kind of qualitative definition of the types of activities an entity could and could not perform. For example, an in-scope entity could: purchase goods for resale within the market, process customer orders, execute a centrally approved marketing plan, maintain local customer relationships, carry out invoicing, or perform warehousing and logistics. Such an entity could not perform: research and development, manufacturing, procurement, or activities related to the development, enhancement, maintenance, and exploitation of key intangibles.

The challenge with a qualitative definition is threefold. First, the kind of activities that constitute baseline marketing and distribution can vary significantly across industries. For example, the activities that go into marketing shampoo, pharmaceuticals, and financial products are very different. This means it will be difficult to develop a one-size-fits-all definition of baseline marketing and distribution. Second, the line between routine and nonroutine marketing and distribution activities can be blurry. For

[4] OECD, *supra* note 1, at 3.

[5] The term "baseline marketing and distribution" has been adopted by the OECD in an attempt to sidestep the language of "routine or low risk distribution," which many countries perceive to be a loaded term. This article uses these terms interchangeably.

[6] The Platform for Collaboration on Tax, "A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses," at 69 (2017).



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example, what is the line between localizing a centrally approved marketing plan and using central marketing materials to develop a unique local plan? Third, a qualitative definition is necessarily subjective and open to interpretation (including in some cases some very creative interpretations), which could result in tax administrations denying eligible entities access to amount B, limiting its potential benefits.

Although squaring this circle will not be easy, it is not impossible. As a first step, it would seem sensible to limit the scope of amount B to industries in which disputes over returns for routine distribution activities are most frequent, such as pharmaceuticals or consumer goods, and tailoring the amount B qualitative definition to these specific industries. Second, one approach that has been floated is to establish a standardized intragroup contract, which businesses with baseline marketing and distribution activities could adopt, thereby establishing their eligibility for amount B. The idea behind such a contract is to reduce, to the greatest extent possible, disputes over whether an entity is covered by amount B. If this approach were agreed upon and implemented, a taxpayer would be able to apply amount B to any entities that had a standardized contract, providing the activities performed by the entity were consistent with the terms of that contract. The success of this approach would depend on the way tax administrations confirm that entities are performing functions consistent with the contract. Whether and how tax administrations could apply amount B to functionally in-scope activities in cases in which the business had not adopted the standardized contract is a more difficult issue.

An additional way to limit the number of entities eligible for amount B would be to rely on quantitative filters, or thresholds. For example, an entity should have no or minimal R&D expenses in its profit and loss statement and no or minimal intangibles on its balance sheet, and so forth. These quantitative filters would provide a backstop preventing entities with expenses or assets that indicate they do more than baseline marketing and distribution activities from benefiting from amount B. Other quantitative filters, such as a low ratio of operating expenses to sales, can indicate one of two things: Either the distributor is extremely successful and able to generate significant sales with few costs (in which case it could exceed the amount B baseline), or it has very limited functions and thus incurs fewer costs relative to its sales than an ordinary distributor (indicating it may fall below the baseline). In either case, there is uncertainty over whether the entity should be covered by amount B, and hence it may be reasonable to require it to undertake a more rigorous transfer pricing analysis.

The second component of amount B is the fixed returns that will be allocated to baseline marketing and distribution activities. Although there were discussions about trying to reach agreement on a single, fixed return, that now seems unlikely, because inclusive framework members have come to recognize that routine returns for marketing and distribution activities vary significantly across industries. In addition, operationalizing a single, fixed point (versus a range) may be difficult for many taxpayers. Therefore, it seems most likely that the inclusive framework will seek to reach agreement on a standardized approach to benchmarking distribution returns — that is, a common benchmarking strategy. There also remains a strongly held view among developing countries that high interest rates and high levels of risk mean that their returns for marketing and distribution activities should be higher and that the returns need to account for differences in geographic locations. It remains to be seen what conclusion the inclusive framework may reach on this issue.

## The Challenges

If inclusive framework members are able to agree on amount B, it has the potential to be a big win for taxpayers, enabling them to streamline and simplify their current approach to benchmarking returns for routine marketing and distribution activities. But there remain three significant obstacles that may prevent the inclusive framework from reaching a meaningful agreement on amount B.

First, countries have very different views on what constitutes a routine return for marketing and distribution: Some would point to a return set at 1 to 2 percent of sales, whereas others would



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argue for a return on sales closer to 10 percent. Although there are some principles behind these arguments, some countries' concerns are more pragmatic. If a country is primarily a market jurisdiction, it can maximize its revenues by arguing for higher returns for routine marketing and distribution activities; if it is a jurisdiction where companies are headquartered, its revenues may be maximized by a lower return.

Second, to conclude previous discussions on transfer pricing simplifications, the OECD has given countries the option to adopt the relevant simplification measure. This has generally meant that countries that support a particular simplification measure adopt it, and countries that oppose it do not. This provides little additional benefit for taxpayers, because countries that support a simplification measure are unlikely to challenge transactions priced on this basis with or without a specific simplification measure. For example, the fact that Ireland, Singapore, and the United Kingdom have adopted the OECD's simplified approach to pricing low-value-adding intragroup services is of limited benefit because tax administrations from these jurisdictions rarely challenge the pricing of these type of services. This is why reaching a truly global agreement on simplification measures is so important.

Third, amount B is inextricably tied to the broader discussion on pillar 1. Many commentators see a conceptual connection between amounts A and B, through the marketing and distribution profits safe harbor, which is designed to cap amount A where a market jurisdiction already has taxing rights over a group's residual profits (that is, more than a routine return). The fact that the inclusive framework has agreed to proceed with amount A on a shorter timeline than amount B and has entrusted responsibility for these two workstreams to different working groups suggests that this is a view that is not shared at the OECD. Nevertheless, there is clearly a political connection between amounts A and B. It is difficult to see there being sufficient political momentum for the inclusive framework to agree on the simplification of transfer pricing rules without an agreement on amount A, which most countries continue to see as the primary response to the tax challenges arising from digitalization — the original objective of the two-pillar project. The path for agreement on and the implementation of amount A remains treacherous, leaving significant uncertainty about the future of amount B.

## Thinking Ahead

The simplification of transfer pricing for baseline marketing and distribution activities is something that principally benefits taxpayers and developing countries, who will have greater certainty over the pricing of these activities. Although tax administrations in developed countries should also benefit from amount B, they can already achieve many of the benefits by simply not challenging the pricing of these types of transactions when they fall within a reasonable range. For this reason, it is essential that businesses that see benefits from amount B continue to emphasize its centrality to pillar 1.

It is also important for businesses to think about and provide feedback to the inclusive framework on how the benefits of amount B can be maximized. For example, in the original BEPS project, action 14 focused on dispute resolution rather than dispute prevention; yet for many businesses it is dispute prevention that is more important, because this enables them to lower their tax reserves (a figure that is important for investors and CFOs). This could lead businesses to conclude that benefits from amount B would be maximized if it included the option to enter into a commonly designed short-form advanced pricing agreement with relevant tax administrations. This is only one example of ideas that businesses may bring to the table about how amount B could be improved.

For businesses that have atypical approaches to pricing routine marketing and distribution activities, and particularly those that rely on the Berry ratio, it will be important to remind policymakers that the design of amount B should take the specific fact pattern into account. In industries with high volumes and low margins, such as cars and chemicals, setting amount B as a return on sales could result in the vast majority of a group's profit being allocated to distributors that have very limited functions. The inclusive framework has been clear that amount B should



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be aligned with the arm's-length principle, so it is clearly not the intention that amount B results in significant additional non-arm's-length profits being allocated to distribution activities, but there is always the risk that this outcome can happen unintentionally, and that risk will be higher if the business community does not proactively engage with policymakers on amount B. Businesses may want to support amount B as a rebuttable presumption — allowing companies to rebut the application of amount B by demonstrating that a different transfer pricing method would be more appropriate.

Moreover, although the focus of amount B has been on simplifying and streamlining the benchmarking of baseline marketing and distribution activities, the project could provide an opportunity for the introduction of valuable administrative simplifications. For example, simplified transfer pricing documentation requirements could be designed for activities covered by amount B. Policymakers may be thinking of amount B primarily from a revenue perspective, and business input would likely be needed to make the case for any such administrative simplifications.

## Conclusion

Although amount B has largely stayed outside the limelight in recent months, it is progressing, and it has the potential to be a major benefit to business. To maximize those benefits and minimize the downsides, it is worth thinking seriously about amount B at this stage in the process. As experience with the rest of the two-pillar project has shown, business input is crucial in efforts to achieve workable outcomes.[7] ■

[7]The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

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