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Subject: Comments on Public Consultation Document Pillar One – Amount B

BDO is one of the largest full-service audit, tax and advisory organisations in the world. We employ over 97,000 people in over 1,700 offices in 167 countries and territories. Our global organisation focuses on supporting entrepreneurially spirited, ambitious businesses.

We appreciate the opportunity to submit our comments on the public consultation document **"Pillar One – Amount B"** that was released by the OECD on 8 December 2022 and to provide our input on the OECD's ongoing work on this important tax policy matter.

Our comments on the public consultation document focus on several key points:

- For Amount B to meet its goals of reduced taxpayer compliance costs and enhanced tax certainty, the IF should broaden the scope of activities that constitute acceptable baseline marketing and distribution activities.
- The two pricing methodologies currently under discussion require much additional work to avoid imposing excessive administrative burdens for MNEs.
- The arm's length range of results has been the standard for evaluating intercompany transactions since the 1990s, and requiring multinational entities to achieve a specific profitability margin (or one within a narrow range) undermines this standard.

Overall, we continue to believe that easing, rather than increasing, the compliance burden and uncertainty for taxpayers is of paramount importance as tax authorities across the globe address issues related to the digitalization of the economy. These overarching principles should be reflected in the design and implementation of the Amount B rules.

Our comments, developed by a BDO global working party, are set out in detail below. We hope they will be of assistance to the OECD and the Inclusive Framework on Base Erosion and Profit Shifting. If you have any questions or would like any further detail, please do not hesitate to contact us. We look forward to working with you and supporting you as you continue your work in this area.

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COMMENTS ON OECD CONSULTATION DOCUMENT
PILLAR ONE – AMOUNT B

I. Introduction

The goal of the OECD's Inclusive Framework's (IF's) two-pillar solution is to address the tax challenges arising from the digitalization of the economy. More specifically, Amount A of Pillar One aims to ensure a simplified and fairer distribution of taxing rights for the digital economy. In its current form, Amount A would apply only to the largest, most profitable multinational enterprises (MNEs), that is, those with over EUR 20 billion in revenue and over 10% profit margins. Amount B of Pillar One, in contrast, is intended as a simplified methodology for determining arm's length returns for baseline distribution functions for MNEs of any size that meet the scoping criteria. The focus of Amount B is on enhancing tax certainty, reducing resource-intensive disputes between MNEs and tax authorities and addressing the needs of low-capacity jurisdictions (LCJs).

On December 8, 2020, the IF released "Public Consultation Document, Pillar One – Amount B," which presents the current status of the development of an approach to implement Amount B. The consultation document covers three areas: scope, methodology and certainty. In all areas, the document reflects the unresolved tension between a system being designed for the greatest possible accuracy and one focused on administrability.

For example, the document proposes an alternative to benchmarking for in-scope distributors (and potentially commissionaires or agents). There are numerous proposed criteria for identifying these distributors. Taken together, applying these criteria could result in an overly restrictive approach that would likely result in relatively few MNEs being in scope of Amount B.

The pricing methodologies presented in the consultation document also raise questions. It is unclear why Amount B would need to disallow the use of a potentially more appropriate method, especially the comparable uncontrolled price (CUP) method, that might be appropriate in certain situations. There are also questions related to the selection of the net profit indicator (NPI) and the proposal for in-scope distributors to achieve a specific profitability point (or fall into a narrow range). In addition, the two pricing mechanisms currently under discussion -- a pricing matrix and a mechanical pricing tool – are in the early stages of development and many questions remain unanswered. The answers to those questions will determine whether the tool meets the goals of reliability and administrability for both MNEs and tax authorities.

II. Scope of Amount B

A. Overview of Proposed Rules

Section 3 of the consultation document sets out proposed rules to determine which entities are within the scope of Amount B. Broadly, Amount B would apply to two types of intragroup transactions -- buy-sell arrangements where the distributor purchases goods from associated enterprises resident in other jurisdictions for wholesale distribution to unrelated parties, primarily in its local market, and sales agency and commissionaire arrangements where the entity

contributes to the wholesale distribution of goods for a related party (although the IF is seeking comment on whether sales agency and commissionaire arrangements should be included within the scope of Amount B).

If a transaction falls within one of these two categories, MNEs or tax administrations would review the Amount B scoping criteria, which set out the economically relevant characteristics that an in-scope transaction would need to exhibit, to determine whether the transaction is within the scope of Amount B. The proposed scoping criteria include both qualitative elements (for example, whether the distributor performs any other economic activity for which it is (or should be) remunerated, including manufacturing, research and development, procurement, and financing activities) and quantitative components, such as the ratio of research and development expenses to net sales.

B. BDO Comments

Our comments regarding the scope of Amount B center on three aspects of the proposed rules: the scoping criteria themselves, the functions, assets and risks analysis, and the exclusions from the rules.

1. Scoping Criteria

As stated in the consultation document, Amount B is intended to be a simplification and streamlining measure in applying the arm's length principle based on the guidance provided in the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines). To that end, Amount B defines what the consultation document describes as "a streamlined and simplified approach to appropriately reflect the accurate delineation of in-scope transactions … through the application of the scoping criteria listed in Section 3."

In their current form, the scoping criteria seem overly restrictive for MNEs and may add, rather than reduce, complexity for tax authorities. For example, the scoping criteria require MNEs to analyze numerous quantitative thresholds and qualitative criteria (e.g., risk control functions, performance of non-distribution functions, creating or obtaining the rights to distribute in the distributor's market, strategic sales and marketing activities, and activities that lead to economically significant risks) to determine whether an intercompany distribution transaction is in scope for Amount B.

The risk criteria outlined in paragraph 18(j)(i-iv) would restrict distributors from bearing risks above a limited level; therefore, Amount B would apply only to limited-risk distributors. The applicability of Amount B is likely to be narrowed further when the various quantitative screens that have yet to be defined are applied.

The consultation document does not state whether an MNE must meet *all* the scoping criteria to be in scope for Amount B, or whether an evaluation of all the scoping criteria together would determine if a transaction is in scope. This clarification will be important for determining whether Amount B has broader applicability or becomes a niche methodology.

One of the enumerated scoping criteria provides that "[T]he distributor should not perform technical or specialised services that support the sale of the product or are essential to the

customer relationship in the market…" The policy reasons for excluding distributors that perform such support services from the scope of Amount B are not clear. Distributors, even if limited risk, often will provide some ancillary services (such as sales customer services) to its customer base.

In another example, African LCJs tend to operate in highly regulated markets. Many MNE groups operate with a centralized regulatory support service provider (whose specific services can vary by industry), but these centralized providers are not equipped to address local LCJ-related regulatory issues. Therefore, entities in LCJs tend to perform this service function, which would render them out of scope from Amount B. This would undermine the IF's goal of creating a simplified and streamlined approach to apply the arm's length principle, especially for LCJs.

Another of the proposed scoping criteria provides that:

> (j) In line with the limitation on activities that lead to the assumption of economically significant risks with respect to the controlled distribution transaction, the distributor would be expected to not assume economically significant risks above what may be defined to be a limited level, including:
>
> > (v.) Limited foreign exchange risk relevant to costs of purchases or performance of activities, where those are different to the functional currency in which revenues are generated by the distribution in its market.

This criterion fails to consider that many distributors in LJCs – in Africa particularly – commonly incur foreign exchange risk as part of their distribution arrangements. Adoption of this criterion could therefore result in the exclusion of those distributors from Amount B. This too seems to be in conflict with the stated goal of focusing on the specific needs of LCJs in administering the application of the arm's length principle.

Paragraphs 14 and 18(b) refer to "buy-sell" arrangements where the tested party purchases goods from one or more associated enterprises resident in other jurisdictions for wholesale distribution to unrelated parties primarily in its local market. In LCJ regions, such as Africa, local country markets are often not large enough for a distributor to operate successfully on an individual-country basis, so distributors operate across a region rather than in one country. Therefore, excluding distributors operating on a regional basis would result in more distributors falling out of scope for Amount B, again particularly affecting LCJs.

2. Functions, Assets, and Risk Analysis

Paragraph 1.51 of the OECD Guidelines provides that in accurately delineating controlled transactions, the functional analysis will provide key information to understand the functions performed, risks assumed, and assets used by the parties to the transaction.

The consultation document embraces the functional analysis concept and provides that "as it would be unfeasible to establish an exhaustive list of the functions that the distributor should undertake, the application of Amount B should be guided by the general principle that the distributor may not perform any significant function that is not typical for independent distributors."

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The consultation document relies heavily on a functions, assets, and risk (FAR) analysis to determine whether a transaction is in scope of Amount B. Such reliance may add to the complexity of the determination and augment the degree of uncertainty involved in the scope determination. From the taxpayer's perspective, heavy reliance on a FAR analysis may not cause a heavier compliance burden, given that MNEs already conduct a FAR analysis in the course of their transfer pricing compliance, but the same may not be true for many LCJ tax authorities, which may not have the necessary resources to evaluate MNEs' FAR analyses. Additional work regarding the extent to which the FAR analysis might be simplified in the context of Amount B is warranted.

3. Exclusions

The consultation document proposes two product-based exclusions and one activity-based exclusion for determining whether a distribution transaction would be in scope for Amount B. The product-based exclusions would apply to non-tangible goods and commodities; the activity-based exclusion would exclude value-added activities.

a. Non-Tangible Goods

Paragraph 37 of the consultation document states that "Amount B applies to tangible property … and does not capture the distribution and marketing of services or digital property." The document justifies this decision by noting that "The activities required to distribute tangible property compared to services or digital property can entail significant differences in the functions performed, assets used, and risks assumed by the parties." In the case of tangible products, by contrast, there is "broad consistency in the overall supply chain and functional analysis," according to the consultation document.

In an attempt to provide some additional context for the exclusion of non-tangible goods, the consultation document states:

> One reason for this exemption is predicated on the basis that **the distribution of non-tangible goods such as software or digital goods occurs under materially different economically relevant circumstances to those that apply to tangible goods**, such that accurately delineated "baseline" distribution transactions for non-tangible goods would fall out of the Amount B scoping criteria or that non-baseline activity would potentially fall within the scoping criteria. [Emphasis added]

The proposal to exclude digital property from the purview of Amount B seems particularly ironic, given that the original impetus for Pillar One was the perceived need to address the tax issues arising from the digital economy. The question as to why non-tangible goods are excluded from Amount B is more puzzling when considering that sales agents and commissionaires, which may have similar FAR profiles as software/digital good "distributors," are being considered for inclusion.

We agree that the economic circumstances of an MNE selling a non-tangible (digital) product can vary from those of a tangible-goods distributor, depending on the product and the market. Distributors of non-tangible goods do not warehouse, "break bulk," or manage logistics in the way

that a distributor of tangible products might. But the value-added distribution functions of marketing, identifying and supporting customers, processing orders, and managing billing and collecting are similar for both tangible and non-tangible goods. In addition, in today's economy, tangible-goods distributors are leveraging digital technology to create, deliver, and sustain new and impactful customer experiences. To stay competitive, companies are incorporating new technologies (such as e-commerce, drones, 3-D printing, smart vending machines, customer-facing apps, etc.) into their business strategies. The use of new technology has already begun to blur the distinction between distribution functions of tangible and non-tangible goods distributors, and this trend will continue. To exclude distributors of non-tangible goods from Amount B might therefore be creating a distinction that will become increasingly difficult to apply.

b. Commodities

The consultation document's second product-based exclusion of commodities is explained with the observation that, in practice, the arm's length price for the distribution of certain materials, goods or products in the commodities industry may be established through the CUP method, rather than the transactional net margin method (TNMM) relied upon for purposes of Amount B. However, the consultation document notes that the IF is considering allowing the CUP method for other purposes. If the CUP method is permitted under Amount B, then there is little reason to exclude distributors of commodities from Amount B.

Moreover, the distribution of commodities is often undertaken through centralized commodity marketing hubs outside the jurisdiction in which the commodity was extracted and outside the market jurisdiction in which the commodity is ultimately sold. The consultation document concludes that resource-rich countries have witnessed BEPS risks associated with these hubs and including them within the scope of Amount B "may not lead to the policy intent of simplifying and streamlining of in-country baseline marketing and distribution activities." In practice, these hubs usually earn modest margins and tax authorities generally view them as limited-risk entities, so we would expect commodity marketing hubs to fall in scope for Amount B. Therefore, the general scoping criteria of Amount B would seem to be applicable to the functions of a commodity marketing hub.

c. Value-Added Activities

Differentiation among distributors in an industry is important to enable companies to remain competitive in challenging markets. Value-added activities such as customization of products, assembly, packaging, and customer inventory optimization are commonly used to promote sales. With the advent of digital technologies, this trend is growing, including in traditional tangible-goods industries. For these reasons, the performance of ancillary value-added activities as described in paragraph 30 of the consultation document should not be included in the Amount B scoping criteria, and should not be a factor in removing distributors from the scope of Amount B.

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III. Pricing Methodology

A. Overview of Proposed Rules

The Amount B pricing methodology seeks to provide an effective means to address the challenges that commonly arise in pricing baseline marketing and distribution activities. The overarching goal is to develop a methodology that allows MNEs to price their in-scope transactions and to simplify administration for tax authorities. To do so, the consultation document proposes the use of a single global comparables set for all in-scope distributors. The IF analyzed the global comparables to identify correlations between certain economic factors and profitability. From this, two different approaches for pricing in-scope intercompany distribution transactions were developed -- a pricing matrix approach and a pricing tool.

B. BDO Comments

The consultation document presents several open questions regarding the proposed pricing methodologies. Among them are:

- Whether in-scope distributors should be allowed to use the CUP method instead of the TNMM;
- What NPI or NPIs should be used;
- Whether a single-point return (or narrow range) rather than an interquartile range of returns should be specified;
- What benchmarking criteria should be applied to develop a global set of comparables; and
- Which of the two proposed "output options" is more appropriate.

1. CUP vs TNMM

The IF is evaluating whether the transfer pricing methodology for Amount B should be limited to the TNMM, or whether it should allow the use of an alternative method if the facts and circumstances of the intercompany transaction warrant it. One view is that the TNMM should be used as the transfer pricing methodology on the basis that Amount B represents a permissible administrative simplification to the most appropriate method principle. But limiting an MNE to the TNMM may result in a level of profit that is not arm's length if there is an alternative method (such as the CUP) that is more appropriate given the facts and circumstances of the transaction.

We believe in-scope distributors should be allowed to use other transfer pricing methods instead of the TNMM when appropriate. Chapter 2 of the OECD Guidelines states that no one method is suitable in every possible situation, and that the CUP method is preferred when both another method and the CUP may be applied in a reliable manner. Moreover, we believe that alternative transfer pricing methodologies -- particularly the CUP method -- should be considered for Amount B when that method can be applied in a reliable manner.

As the consultation document explains, an exemption from applying the Amount B pricing methodology could apply when another transfer pricing method is the "most appropriate method." The consultation document goes on to explain that an alternative method to the TNMM

could be used on a “rebuttable presumption” basis, so that either MNEs or tax administrations could rebut the application of the Amount B pricing methodology on the grounds that another transfer pricing method would be more appropriate.

For these reasons, the Amount B pricing methodology should contain an exception when another transfer pricing method, in particular the CUP method, is the most appropriate method.

2. **Selection of the NPI**

The consultation document notes that the IF is considering alternative NPIs other than the operating margin, including Berry ratio, operating margin with a cap-and-collar Berry ratio, return on assets, or a combination of NPIs. The most complex of these options are the cap-and-collar Berry ratio and the combination NPIs, which we understand would provide guardrails to adjust an in-scope distributor to an appropriate point within a range.

Implementing, monitoring, and adjusting one NPI for a taxpayer can be difficult; adding a secondary NPI makes the process far more unwieldy. Further, the facts and circumstances of the intercompany transaction should drive the selection of the NPI, not a quantitative test. Therefore, the IF should consider allowing any NPI that results in a reliable result rather than introducing the cap-and-collar Berry ratio or a combination of NPIs that MNEs would be required to operationalize, manage, and test annually.

3. **Point versus Range of Results**

The consultation document proposes that in-scope distribution activities be required to achieve a specific Amount B profit level (point) or a very narrow range of results (smaller than the interquartile range), rather than a profit level within an arm’s length (interquartile) range. However, the consultation document acknowledges that further consideration is needed to understand the practical implications for both MNEs and tax administrations of targeting a specific arm’s length result for Amount B pricing purposes.

Amount B is intended as a simplification and streamlining measure in applying the arm’s length principle; therefore, the application of Amount B should be consistent with the OECD Guidelines, specifically, Chapter III, paragraphs 3.55 to 3.63, which discuss the use of the arm’s length range. Moving away from the concept of an arm’s length range negates the reasons the range concept was adopted. The OECD Guidelines cited several reasons, including the fact that in general, transfer pricing is not an exact science. In addition, often the application of the most appropriate method produces a range of results, all of which are relatively equally reliable. Such a range embodies the notion that independent MNEs may not earn the same profits for a given transaction.

Adopting a policy that the Amount B pricing methodology should yield a specific arm’s length result (or narrow range) rather than a range of results would suggest that the OECD and many tax authorities, including the U.S. Internal Revenue Service, have been wrong about the concept of the arm’s length range for more than 20 years. The arm’s length range has been the standard for evaluating intercompany transactions since the 1990s, and requiring MNEs to achieve a specific profitability margin undermines this standard.

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From a practical perspective, requiring in-scope distributors to achieve a specific operating margin each year would be onerous. MNEs can budget expenses and project sales, but they have little control over variations in the timing of sales, and operating costs are subject to numerous variances. Unlike a cost-plus arrangement (commonly used by contract manufacturers and service providers), in which transfer prices are based on current costs incurred, transfer pricing for distributors is often based on sales. However, implementing the transfer pricing is achieved through intercompany transfers of product for resale (cost of goods sold). As a result, profit margins cannot be directly controlled in real time through transfer prices. Worse, retroactive adjustments to costs of goods sold could trigger customs and duties adjustments for which the taxpayer would need to perform an analysis and submit a claim for a refund or make additional customs payments through the customs authorities. In some countries, this cannot be done, because once the transaction value is confirmed and duties are paid, the taxpayer is unable to amend the customs value and claim a refund.

The consultation document makes no mention of the use of multiple years of data in the global benchmarking set. As the OECD Guidelines note, the use of multiple-year data is often appropriate. We believe that using multiple years of data would improve reliability by reducing the effect of short-term fluctuations impacting individual-year results.

4. Benchmarking Search Criteria

Annex A in the consultation document lists the search criteria proposed for the global benchmarking analysis, and we note the use of specific keywords to eliminate companies from the set.

The use of keywords in practice creates the potential for inappropriately excluding comparable companies. In our experience using Bureau van Dijk's Orbis database (and other databases), using keywords in the business descriptions in the databases to exclude companies as potential comparables can cause the rejection of a company for spurious reasons.

We have reviewed wholesale distribution sets used in our documentation reports and identified examples where keyword screens would have caused the rejection of comparable companies based on the keywords in Annex A of the consultation document. We understand the desire to quickly screen large numbers of potential comparables, but we have always been wary of using keywords in this way and continue to believe that it can cause unintended results. Below are two excerpts from the business descriptions of distributors that would have been rejected using the keywords presented in Annex A.

- Company X "supplies parts used in the ***manufacture*** of products to a range of industries, including aerospace, circuit board, communication, computer, fabrication, instrumentation, industrial equipment, and marine."
- Company Y "provides custom display solutions, such as touch screens, protective panels, all-in-one computers, custom enclosures, specialized cabinet finishes, application specific software packages, and certification services to corporate enterprise, ***financ***ial, healthcare, industrial, and medical original equipment manufacturer markets."

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In addition, Orbis and other databases base their company business descriptions on annual reports, government filings when available, company websites, and other available information. By necessity, the business descriptions in the databases are condensed versions of the full company descriptions, and often do not include all the ancillary activities performed and markets served by the company. Ironically, companies selected for the global set of comparables for Amount B in some cases may not meet the scoping criteria of Amount B. To derive a set of true distribution comparables similar in FAR to an in-scope distributor, the potential comparables should be subject to a far more rigorous review than a mere examination of database business descriptions.

5. Pricing Matrix versus Mechanical Pricing Tool

The consultation document presents both a pricing matrix and a mechanical pricing tool as possible “output options” for calculating the target distribution return for in-scope distributors. The document notes that the design and form of the pricing tool is still under consideration, and technical challenges remain. Both options are based on technical (econometric) analysis being conducted by the IF.

We have concerns regarding the overall approach, in particular, given the statement in the consultation document that “the current econometric modelling to date has been able to account for a small portion of the variation in operating margin” (paragraph 56). In our view, if this econometric modelling underlies both output tools, the reliability and accuracy of both may be limited. Note that this further calls into question the proposal that the target margin for in-scope distributors will be specified as a point or very narrow range instead of a broader (interquartile) range. With the admission that the econometric analysis underlying the tools has limited explanatory power, both pricing tools will yield inexact results at best; therefore, the use of a range seems necessary to ensure reliability.

Recognizing the preliminary status of the analysis and output tools, we offer one suggestion related to the pricing matrix output. The consultation document notes the potential “cliff effect” problem, wherein a small variation in a distributor’s determining factor could cause a significant change in the required profit margin. We believe that moving from a single arm’s length point to a range would address this issue. We propose using overlapping ranges in the pricing matrix; this would improve the reliability of the output tool, and it would address the cliff effect problem.

IV. Tax Certainty

A. Overview

The consultation document recognizes that adoption of Amount B will not preclude transfer pricing disputes for in-scope transactions, and that tax authorities and MNEs may disagree as to whether a transaction is in scope or not. The consultation document proposes no new dispute prevention or resolution mechanisms, but rather relies on currently available advance pricing agreement and mutual agreement procedures.

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B. BDO Comments

The proposals described in the consultation document would introduce a new level of complexity around the determination whether a transaction is in scope for Amount B. While the proposal would also eliminate the task of choosing comparables in the benchmarking process, the overall effect does not move the simplification goal forward significantly in the context of determining and documenting transfer pricing for limited-risk marketing and distribution entities.

Notwithstanding that fact, and recognizing that disputes regarding whether Amount B applies in a particular situation will occur, we agree that current dispute prevention and resolution procedures should be available.

The IF should also consider the mandatory or elective nature of Amount B. The options range from designing Amount B as a safe harbor to prescribing Amount B as the interpretation of how the arm’s length principle applies to baseline marketing and distribution activities.

Amount B, as currently described in the consultation document, contains many of the attributes of a tax safe harbour, which generally include the following:

- Clear and unambiguous rules for determining eligibility;
- A reasonable expectation of compliance;
- A reasonable level of certainty that the taxpayer will not be subject to additional taxes or penalties;
- A reasonable level of protection from audit or litigation; and
- A reasonable level of protection from retroactive changes in the law.

The consultation document discusses these requirements directly or indirectly. Based on the above characteristics, Amount B has the attributes of a safe harbor, and the IF should consider implementing it as one. Doing so would address some of the concerns already discussed, including the use of CUPs and local comparables. If an MNE believes that a CUP or local comparables would provide a more reliable result than Amount B, then it could proceed pricing its transactions on that basis. If it prefers the Amount B approach, it would in return receive some certainty that its return is consistent with the arm’s length principle.

V. Conclusion

We appreciate the opportunity to weigh in on the main design elements of Amount B, as proposed by the IF in the consultation document. We are cognizant of the arduous task they have undertaken, and hope our comments contribute to a successful outcome for taxpayers and tax authorities alike.

We believe that for Amount B to meet its goals of reduced taxpayer compliance costs and enhanced tax certainty, the IF should broaden the scope of activities that constitute acceptable baseline marketing and distribution activities. Moreover, the two pricing methodologies currently under discussion require much additional work to avoid imposing excessive administrative burdens for MNEs and tax authorities.