UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

February 22, 2022

VIA EMAIL
Mr. Itai Grinberg
Deputy Assistant Secretary (Multilateral Negotiations)
U.S. Department of the Treasury, Office of Tax Policy
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Dear Deputy Assistant Secretary Grinberg,

USCIB has followed the work of the OECD/G20 Inclusive Framework, and appreciates the time, attention, and resources the US Treasury Department has invested in the process. We understand that you, your colleagues, and your Inclusive Framework (IF) counterparts are considering the many moving pieces of the two-Pillar project. USCIB wishes to be helpful to the process and provide support and input as you work through the many important issues over the next several months.

We write today to convey our recommendations on measures we see as necessary for stabilizing the international tax system, an essential goal of the Pillar One project. We have focused, in particular, on the design of the proposed marketing and distribution safe harbor ("MDSH"), which should also anticipate the ultimate design of Amount B. There is risk of a disconnect between the MDSH design and the Amount B design, given that the latter is on a later 2022 timeline than the former. The MDSH design work has particular urgency if the Inclusive Framework members cannot agree on an Amount B mechanism at this initial stage.

Importance of a Principled Agreement to Preserve the Arm's Length Principle

As you are undoubtedly aware, over the past few years, we have seen the introduction of novel taxes and tax theories that effectively subject certain companies and industries to taxation in market jurisdictions beyond the arms-length standard. Such measures are largely state reactions to the digitalization of the global economy and new business models. However, these unilateral measures also subject companies to substantial uncertainty, double taxation, disproportionate compliance costs, and barriers to free and fair trade.

These unilateral measures uniformly depart from the arm's length principle. They impose tax on profits arising beyond those attributable to assets, functions, and risks located in the taxing state. In most if not all cases, the purpose and effect of such measures is to create a market state tax nexus for residual (intangible) profit economically created (and taxed) outside the market jurisdiction. These taxes thus conflict with longstanding norms that taxable income attributable to a particular jurisdiction should align with the economic value resulting from functions performed, assets held, and risks borne in that jurisdiction. These international norms have generally resulted in the majority of profits (and start up or new business investment losses) being recognized, for income tax purposes, in the country of production or development, rather than in the market jurisdiction. In contrast, market jurisdictions have typically captured the value attributable to a customer base in their jurisdictions through indirect taxes.

We believe a principled and coherent agreement amongst the OECD/G20 Inclusive Framework members covering an administrable MDSH and Amount B is necessary to stabilize the international tax framework. The MDSH and Amount B will contribute to stabilizing the international tax framework only if they are firmly based on the fundamentals of the arm's length principle.

Path Forward for the Marketing and Distribution Safe Harbor and Amount B

We understand that the design of the MDSH is still very much uncertain. This state of affairs is concerning to USCIB, which believes that the MDSH is a necessary foundation for preserving the centrality of the arm's length principle within the broader Pillar One project. Establishing a principled, well-functioning MDSH as part of the initial implementation of Pillar One will provide greater certainty to the in-scope companies. Further, we believe that an agreement on an MDSH as part of the initial implementation of Pillar One can provide useful direction to the development of the Amount B parameters as this is developed later this year.

USCIB strongly recommends that the separate yet interrelated roles of Amount A, the MDSH, and Amount B be clearly defined in order to stabilize the international tax system and to reduce double taxation, given the risk of overlap among these three features. We see the three distinct roles as follows.

1. Amount A should be the sole mechanism for allocating residual profit on a basis other than the presence of actual assets, functions, and risks in the market jurisdiction. Amount A should be the only element of the Pillar One agreement that departs from the arm's length principle.
2. Amount B should be firmly based on the arm's length principle. A key purpose is to reduce the administrative burden on taxpayers and tax administrations caused by transfer pricing disputes regarding profits attributable to routine marketing and distribution operations. We also support a broader application of Amount B to all market country functions, as long as its design remains anchored in the arm's length principle. This is a particular focus for countries with less capacity to audit transfer pricing issues.
3. The role of the MDSH is to avoid double taxation of residual profits in the market jurisdiction. When a multinational enterprise ("MNE") group is already compensating its actual market jurisdiction subsidiary or branch for all in-country activities that directly or indirectly support locally sourced sales that are taxed in that jurisdiction, or is paying local withholding taxes, Amount A must be reduced to minimize double market jurisdiction taxation on the group's residual profit.

Clearly delineating among these three essential features of Pillar One also clarifies and expresses the tradeoff inherent in the political agreement that underlies Pillar One. Residence or production jurisdictions ceding taxing rights to an agreed amount of residual profit under Amount A should be able to insist that market jurisdictions adhere to the arm's length principle for routine activities. The withdrawal of unilateral measures that tax residual profits also is an essential component of the underlying political agreement. Withdrawing those unilateral measures affirms the primacy of the arm's length principle in all cases except where a new taxing right is created under Amount A.

Design, Mechanics of the Marketing and Distribution Safe Harbor

Because the precise mechanics of the MDSH and its relationship to Amount B have not yet been determined, USCIB would like to provide initial thoughts as to the design of those provisions. We acknowledge that there are multiple options for the MDSH and Amount B. We will describe those options and our recommended approach below.

Under any of these options, withholding taxes imposed by source countries should be taken into account when calculating Amount A. Specifically, any withholding tax paid by an Amount A taxpayer in the market jurisdiction should decrease the Amount A allocation to that taxing jurisdiction by the amount necessary to avoid double taxation of the taxpayer's residual profit. Since Amount A is designed to be an allocation of residual profit earned from functions, assets, and risks located outside the market jurisdiction, and because withholding taxes impose tax on profits arising from those functions, assets, and risks, withholding taxes should be deemed to be imposed on residual profits.

Option 1: MDSH as no more than a 2.5% Return on Sales

Our preferred option is to establish an MDSH which reduces an Amount A allocation if locally reported profits on marketing and distribution activities[1] exceed a 2.5% Return on Sales (ROS) in that market jurisdiction. Any amounts reported in the market state with respect to marketing and distribution functions in excess of the 2.5% ROS would reduce a notional Amount A allocation under the MDSH concept. This simple approach does not require an agreement on Amount B to implement the MDSH. Given existing data and analysis, the specified return on sales for the MDSH should not exceed 2.5%.[2] Establishing an MDSH based on a fixed return on sales creates a simple and certain rule that is broadly tied to the arm's length principle.[3]

We acknowledge that this approach may sacrifice some precision for simplicity and certainty, because transfer pricing analysis always is a facts and circumstances exercise. However, we believe that many MNE groups with higher consolidated operating profit margins likely already allocate some residual profit to the marketing and distribution functions of their entities operating in market jurisdictions. Thus, an amount no higher than a 2.5% ROS on MDSH factor would help identify that existing allocation of residual profit and make a corresponding reduction in Amount A.

This kind of formulaic, yet data-driven compromise is not unprecedented. For instance, the United States and Mexico recently renewed their Qualified Maquiladora Approach Agreement (QMA), which includes fixed transfer pricing margins. Similarly, US and other Competent Authorities have agreed to standard mark-ups for defined classes of services.

An early agreement on Amount B could, in theory, reach the same result as Option 1, assuming that the MDSH is the simple sum of Amount B and Amount A. However, according to the current Pillar One timeline, an agreement on Amount B likely will lag behind Amount A. Accordingly, our recommended approach provides a broadly accurate result based on the arm's length principle that allows IF members time to develop Amount B. If this Option 1 MDSH is agreed, the fixed return threshold over which amount A would be reduced should reflect the median return for value-added distributors. For many companies, setting the MDSH fixed return at 2.5% already includes an element of residual profit. Setting the MDSH fixed return at 2.5% ROS implies an MDSH cap as a percentage of global system profit of 25.0% (across all levels of profitability), which already is a robust share of systems profit for the market jurisdiction. Since the Amount B details will not be known at the time, an unduly high MDSH threshold may also create an implication that the eventual Amount B should not be lower than the MDSH threshold. It also raises the possibility of double allocation of residual profit, which as stated, violates the objectives of the framework.

Option 2: Amount B Instead of Fixed Margin as Benchmark

Option 2 would be to resolve the issue of establishing a routine return to marketing and distribution activities through Amount B as proposed in the October Statement. In that case, the MDSH would be the sum of Amount B and Amount A for that taxpayer. This option provides the opportunity to craft a version of Amount B that is based on the arm's length principle and provides greater precision over an MDSH-

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[1] The definition of "marketing and distribution" activities should be sufficiently broad to ensure the profits of activities for which a MNEs remunerates a market jurisdiction are considered for MDSH purposes (e.g., a MNE may perform activities to promote the buying or selling of a product or services which are not specifically labeled as "marketing").

[2] We believe that an amount no higher than 2.5% return on sales would be an accurate return for routine marketing and distribution activities across business sectors and across geographies and is supported by existing data and analysis. *See, e.g.*, KPMG, Transfer Pricing Analysis of Arm's Length Return to Sales, Marketing & Distribution Activities (Feb. 2020), available at https://www.wu.ac.at/fileadmin/wu/d/i/taxlaw/institute/WU_Global_Tax_Policy_Center/KPMG_-_Amount_B_Econ_Analysis_-_full_report.pdf.

[3] Some members with lower overall total operating profit believe that the MDSH should be proportionately lower than 2.5% ROS to avoid over allocation of their overall systems profits.

only option. A developed Amount B, as opposed to a fixed safe harbor as described in our Option 1, provides the opportunity to develop formulas for a wider range of circumstances that can be supported through data derived from large sets of comparables. The processes and approaches (including data collection and arm's length analyses) developed for the Qualified Maquiladora Approach Agreement (QMA) also provide some precedent on how this effort could proceed.

We acknowledge that Option 2 would be more complex, due to the necessity of agreeing to the Amount B mechanics. Developing a tailored, precise, and effective Amount B, anchored in arm's length principles, would require time, substantial data, business input and alignment, as well as the development of clear guidelines distinguishing routine from nonroutine distribution activities. Thus, we strongly believe that the OECD/G20 Inclusive Framework should be realistic about the time commitment involved and take the appropriate time to achieve these goals for Amount B. As such, we recommend Option 1, until these goals can be effectively accomplished.

Option 3: Overall Formula for Amount A and Amount B Allocations

Option 3 would be to establish an overall formula for the Amount A and Amount B allocations, based on operating margin and other financial factors, such as marketing expenses. As with the version of Amount B discussed in Option 2, this overall formula should produce results consistent with the arm's length principle and would be developed and supported through the use of data derived from sets of comparables. This broader formulaic option would present the benefits of greater certainty and administrability for taxpayers and tax administrations.

Option 3 would, however, effectively combine residual and routine profit into a single calculation, making it less in line with the arm's length principle. As a result, this would be a less precise option than others that retain separate allocations for routine returns and residual profit. Further, we assume it would be politically untenable to introduce such a fundamental change to Pillar One at this stage of the negotiations.

Option 4: MDSH Based on Percentage of System Profits

Option 4 would be to establish a MDSH that is tied to a percentage of system profits. This option is a variant of Option 3, but with a different allocation key. Thus, Option 4 would provide similar benefits: formulaic, provides certainty, and increases administrability.

Basing the MDSH on a percentage of system profits, however, would be a significant departure from the arm's length standard. Thus, the allocation of value amongst jurisdictions would be based almost entirely on a political agreement on the applicable percentage, rather than a comparison of functions, assets, and risks deployed in routine distribution activity in the market state. Any approach that requires a political agreement at odds with arm's length principles may well pose greater challenges to achieving consensus support for the amount and would depart from a principled application of the arm's length principle.

Option 5: MDSH Based on Return on Tangible Assets and Payroll

Option 5 would be a variation of the fixed MDSH threshold based on a different allocation key. Under Option 5, the MDSH threshold would be based on a return on tangible assets and payroll expenses in the market state. As with the other formulaic MDSH options, this option could provide certainty, provided that there are well-defined rules regarding the cost base and agreed mark-ups related to tangible assets and payroll expenses. Similar to other options outlined, however, this approach is too disconnected from arm's length principles. Different assets and workforces would produce very different returns, especially given that this approach does not account for the impact of intangible assets, so it would not be an effective approach for limiting double taxation of residual profits.[4] We, therefore, conclude that it is not a viable option for the MDSH.

Recommended Approach

Based on our analysis above, we strongly recommend Option 1, particularly since a comprehensive, well-developed, arm's-length-anchored Amount B (as described in Option 2) is unlikely to be agreed in the near term.

Some of our members, as well as many other members of the business community, would be willing and able to volunteer the data and comp sets necessary to support the recommended MDSH and/or design an effective Amount B, anchored in arm's length principles. We would look forward to working with U.S. Treasury and the OECD to develop reasonable, clear guidelines, and establish appropriate, arm's length returns for both the MDSH and the eventual Amount B measures. Additionally, some members have recommended that, as a backstop, total returns in a market jurisdiction properly allocable to marketing and distribution activities, including Amount A and Amount B, do not exceed a specified proportion (e.g., 25%) of the operating margin of the in-scope MNE or segment thereof.

Again, we greatly appreciate Treasury's efforts with respect to these issues and your willingness to field suggestions. Please let us know if you would like to discuss the recommendations set forth in this letter.

Sincerely,

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

Rick Minor
Vice President & International Tax Counsel
United States Council for International Business
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[4] In theory, we agree that there are transfer pricing approaches (e.g., Berry ratio) that could be developed, based on comparables collected from operations that do not include intangibles, to better achieve a ratio of gross profit to operating expenses that would apply to routine market functions, but we also conclude that these are harder to apply across different industries and would be politically much less feasible than the Option 1 approach. Thus, we do not believe it would ultimately solve the failings of Option 5, and still strongly prefer Option 1.