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VIEWPOINT

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In this article, the authors examine the potential impact of the OECD's two-pillar approach on transfer pricing.

Transfer pricing has been an important feature of the international tax system for about a century, but it has taken on an increasingly central role in recent times. The global expansion of multinationals, increased complexity of supply chains, and sustained divergence in countries' tax rates have meant that questions about where groups should pay tax have become increasingly important and contentious.

Transfer pricing is in some respects an inherently subjective exercise, requiring that transactions between the different entities that make up a multinational group are priced at arm's length. In recent years transfer pricing has become increasingly challenging as more countries have adopted transfer pricing rules, which now apply in almost every country, and as countries have adopted different approaches to applying the same arm's-length standard. Perhaps the most creative approaches to transfer pricing have been pioneered by China and India, which have used "market premium" and "location saving" arguments to claim very high returns for seemingly routine activities. These creative approaches have become increasingly common, in part because of the changes to the guidance provided in the OECD transfer pricing guidelines on control of risk and intangibles.[1]

For transfer pricing practitioners globally, it has become difficult to navigate an ever-more-uncertain world. In the United States, recent changes to the foreign tax credit regulations make identifying creditable taxes more difficult, while recent court cases show the IRS discarding transfer pricing settlements made in prior years,

[1]*See* Richard S. Collier and Ian F. Dykes, "On the Apparent Widespread Misapplication of the OECD Transfer Pricing Guidelines: Risk and Post-BEPS Problems for the Arm's Length Principle," 76(1) *Bull. Int'l Tax'n* 20 (2022); and Collier and Dykes, "The Virus in the ALP: Critique of the Transfer Pricing Guidance on Risk and Capital in the Light of the COVID-19 Pandemic," 74(12) *Bull. Int'l Tax'n* 702 (2020).

despite taxpayers' reliance and settled expectations.

The first base erosion and profit-shifting project — BEPS 1.0 — has already radically reshaped transfer pricing, and it may continue to do so as more countries interpret and implement its principles. It has placed more emphasis on functionality than contractual terms, the control rather than contractual allocation of risk, and the development rather than ownership of intangibles. The OECD's current work program — BEPS 2.0 — has the potential to bring about even greater change. The two-pillar solution to address the tax challenges arising from the digitalization of the economy represents a paradigm shift.[2] Pillar 1, and specifically amount A, is designed to allocate taxing rights to market jurisdictions in a formulaic manner beyond that which they would be allocated under the arm's-length standard. Pillar 2 will introduce minimum effective tax rules that give countries the right to tax low-taxed profits irrespective of where these profits are. Moreover, recent consultations by the OECD on the future of article 9 (associated enterprises) of the OECD model tax convention[3] and dispute resolution mechanisms[4] may lead to further changes in how the arm's-length standard is applied and administered.

This article — which is split into two parts — explores the potential impact of the OECD's current work program on how we approach transfer pricing. In the first part, we focus on the impact of BEPS 2.0. In the second, we consider the threats and opportunities created by the OECD's ongoing work on article 9 of the model tax convention and potential improvements to dispute resolution mechanisms.

Pillar 1

Before exploring the impact of pillar 1 on transfer pricing and the arm's-length standard, it is important to understand the basics of its two core components, amount A and amount B.

The OECD has always been explicit that amount A will create a new taxing right for market jurisdictions that goes beyond that prescribed by the arm's-length standard.[5] It does this by allocating taxing rights over a portion of a group's residual profits, calculated using a formula, between countries, using a revenue-based allocation key. The differences from the current transfer pricing system are that these rules: (1) apply to a multinational group, not to separate legal entities; (2) allocate taxing rights to a country where a group is deemed to generate revenue, irrespective of whether it has a taxable presence (in the form of an entity or permanent establishment) in that country; and (3) allocate a portion of a group's residual, or non-routine, profits to market jurisdictions where a group may perform only routine activities (or no activities at all).

In contrast to amount A, amount B is intended to simplify and streamline the application of the arm's-length standard to baseline marketing and distribution activities.[6] The basic idea is that the present application of transfer pricing rules to baseline (or routine) marketing and distribution activities is unnecessarily complex and gives rise to disputes, and amount B presents an opportunity for simplification by establishing standardized returns.[7]

Amount A

For some, amount A represents an existential threat to the arm's-length standard and transfer pricing as we know it today. It is true that amount A adopts a different philosophical approach to the allocation of taxing rights from the arm's-length standard, promoting a destination-based approach to taxation that allocates taxing rights to where goods or services are sold to customers, rather than where they are produced.[8] It is also

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

[3] OECD, "Public Consultation Document: Proposed Changes to Commentaries in the OECD Model Tax Convention on Article 9 and on Related Articles" (2021).

[4] OECD, "Public Consultation Document: BEPS Action 14: Making Dispute Resolution Mechanisms More Effective — 2020 Review" (2020).

[5] OECD, "Addressing the Tax Challenges of the Digitalisation of the Economy — Policy Note," at 2 (2019).

[6] OECD two-pillar statement, *supra* note 2.

[7] For an in-depth discussion of amount B, see Alistair Pepper, Thomas D. Bettge, and Jessie Coleman, "Amount B: The Forgotten Piece of the Pillar 1 Jigsaw," *Tax Notes Int'l*, July 11, 2022, p. 143.

[8] The destination-based approach adopted by amount A is similar to a tax reform initiative proposed by House Republicans in 2016 in a policy paper. *See* Better.gop, "A Better Way: Our Vision for a Confident America" (June 24, 2016).

true that amount A represents a formulaic approach to allocating taxing rights comparable to formulary apportionment.

However, the discussions on amount A also provide clear evidence of why moving away from the arm's-length standard is so difficult. Fundamentally, if implemented, amount A would alter the way profits, and hence tax revenue, are allocated between countries, likely benefiting large market jurisdictions at the expense of countries where multinationals are headquartered or have regional hubs. The countries that would lose out from amount A are understandably reluctant to sign up, and without changes to existing bilateral tax treaties it is difficult to foresee how other countries could effectively implement amount A.[9] This is one of the reasons why the scope of amount A is relatively narrow, limited to approximately 100 companies with revenues over €20 billion and profit margins above 10 percent,[10] and even for these groups limited to 25 percent of their residual profits, defined as profits over a 10 percent profit margin.

Amount A will apply as an overlay to the existing profit allocation system, and thus in-scope groups will still need to apply existing transfer pricing (potentially modified by amount B, as discussed later).[11] This means that for in-scope groups, transfer pricing will become more important because it will determine where the profits reallocated under amount A come from. It also means that if these groups are subject to transfer pricing adjustments this has potential spillover effects on amount A, because it will change where a group's profits are realized, and hence potentially which countries should be responsible for relieving the double taxation arising from amount A.

For example, imagine in years 1 through 4, a group is subject to amount A and determines that the residual profits that are being reallocated are being realized in Country 1. In year 5, Country 2 makes a transfer pricing adjustment arguing that the group's residual profits have been incorrectly allocated to Country 1 and should have been allocated to Country 2. The question arises that if Country 1 accepts this adjustment, should Country 2 then be required to relieve the double taxation arising from amount A, and if so, how would this change be implemented?

The fact that changes to a group's transfer pricing might affect the calculation of amount A is one reason why the inclusive framework agreed that dispute prevention and resolution should be extended to "all issues related to Amount A (e.g., transfer pricing and business profits disputes), in a mandatory and binding manner."[12] Though there is disagreement within the inclusive framework concerning the appropriate scope of dispute prevention and resolution for these related issues,[13] for the reason outlined above it is clear that amount A can only feasibly be applied to groups where the initial allocation of profits determined under the arm's-length standard is relatively stable.

In summary, amount A does not appear to be an existential threat to the arm's-length standard or a slippery slope to formulary apportionment. The fact that amount A applies as an overlay to the existing profit allocation is an implicit endorsement of the arm's-length standard and a recognition that an attempt to move to full formulary apportionment will likely end in disaster.[14]

Amount B

Amount B, which unlike amount A is not limited to large, highly profitable multinationals, is an attempt make transfer pricing easier to apply to baseline marketing and distribution activities, while remaining aligned with the arm's-length standard. In this regard, it seeks to build on previous, largely unsuccessful, efforts by the

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

[10] OECD two-pillar statement, *supra* note 2.

[11] OECD, "Tax Challenges Arising From Digitalisation — Report on Pillar One Blueprint: Inclusive Framework on BEPS," at 135 (2020).

[12] OECD two-pillar statement, *supra* note 2, at 2.

[13] *See* OECD, "Pillar One — Tax Certainty for Issues Related to Amount A," at 7 (2022).

[14] For a further explanation of the challenges of formulary apportionment, see Pepper, Coleman, and Bettge, "Why It's Still Not Time for Global Formulary Apportionment," *Tax Notes Int'l*, Aug. 22, 2022, p. 911.

OECD and other international organizations to simplify transfer pricing.[15]

For purists, the attempt to standardize returns for baseline marketing and distribution activities will lead inevitably to outcomes that are inconsistent with the arm's-length standard, because such an approach necessarily fails to account for the specific facts and circumstances of particular marketing and distribution activities. For a number of reasons, this criticism of amount B seems overstated, but it represents a risk that cannot be ignored.

First, the inclusive framework has not released any details on the design of amount B, and the inclusion of some features could address the concern that amount B is conceptually incompatible with the arm's-length standard. We agree that if the inclusive framework were to establish a single fixed return for all marketing and distribution activities, this would result in non-arm's-length outcomes, at least for some taxpayers. To use a simple example, the arm's-length return for the distribution of pharmaceuticals by a full-risk distributor is unlikely to be the same as the return for the distribution of cars by a low-risk distributor.

But if the scope of amount B were limited to specific industries and specific marketing and distribution activities, it would be possible to agree on a return for baseline marketing and distribution activities that is consistent with the arm's-length standard, at least in most cases. To address the concern that there may be instances when amount B is not arm's length, amount B could be rebuttable by the taxpayer or tax administrations. The problem with making amount B a rebuttable presumption is that it reduces the certainty benefits that amount B is designed to provide. If it proves too difficult for the inclusive framework to reach any agreement on fixed returns, it may be that it chooses to publish standardized benchmarking sets to indicate a reasonable range of returns for baseline marketing and distribution activities. The publication of these types of benchmarking sets would clearly not be inconsistent with the arm's-length standard and could reduce the compliance costs taxpayers incur from completing their own benchmarking searches, as well as the resources that tax administrations need to invest in determining taxpayers' transfer pricing compliance.

Second, amount B builds on earlier efforts to simplify the application of the arm's-length standard. The most recent of these is the fixed return for low-value-adding intragroup services developed by the OECD as part of BEPS 1.0.[16] This kind of approach may not always be perfectly aligned with the arm's-length standard but should deliver a reasonable outcome in the majority of cases.[17] The main limitation of these initiatives is that they were optional. This meant that, in the case of the low-value-adding intragroup services simplification, tax administrations that were already satisfied that a 5 percent markup of cost was appropriate adopted the simplification, but those that were not satisfied did not and hence taxpayers saw little benefit. This is a limitation that the design of amount B needs to address.

Third, sensible simplifications of the arm's-length standard have the potential to make transfer pricing more sustainable and administrable in the long run. The globalization of supply chains and adoption of transfer pricing legislation in more and more countries has made the current system increasingly difficult to apply. It has left tax administrations in low-capacity countries struggling to understand rules that are subjective and require practical experience to apply correctly, and taxpayers needing to complete and file ever more documentation and manage ever more disputes. Some countries have started to question whether the arm's-length standard is the best way to allocate taxing rights between countries, both because they do not like

[15] The OECD's 2022 transfer pricing guidelines include proposed simplification rules for low-value-adding intragroup services and sample memoranda of understanding for competent authorities to establish bilateral safe harbors. The limited adoption of both frameworks meant that neither has led to meaningful simplification of transfer pricing rules. Similarly, the Platform for Collaboration on Tax's 2017 "Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses" explored the benefits of transfer pricing safe harbors; however, there was limited adoption of such measures.

[16] OECD, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022," at 326-336 (2022).

[17] It is also worth noting that other safe harbors are in widespread use. For example, in the United States, reg. section 1.482-9 allows taxpayers to charge cost only with no markup component for some intercompany services using the services cost method.

the outcomes it delivers and because it is so complex. Sensible, targeted reform, which amount B could be, would make transfer pricing easier for everyone, and enable greater focus to be given to complex, high-value transactions where simplification is not possible.

Chaos

The OECD's primary argument for pillar 1 is that the alternative is not a return to the status quo, but chaos. In the past three years, the discussions on pillar 1 have helped to slow the proliferation of digital services taxes, which seek to sidestep, rather than override, the constraints on countries' taxing rights imposed by the arm's-length standard. We have also witnessed countries stretch the arm's-length standard through so-called antiabuse rules, such as the diverted profits tax or the offshore receipts in respect of intangible property measure in the United Kingdom, or the multinational antiavoidance law in Australia. We have also seen tax administrations simply make aggressive or excessive transfer pricing adjustments.

The OECD's work on pillar 1 is evidence that international consensus on the arm's-length standard is in decline. But it has also contributed to this decline, by recognizing the legitimacy of countries' claims that the allocation of taxing rights delivered by the arm's-length standard is unfair, and seeking to develop an alternative. In the absence of an inclusive framework agreement to restabilize the international tax system, there is a significant risk that the failure of pillar 1 would result not only in the proliferation of DSTs, but also the adoption of other measures and practices that are fundamentally inconsistent with the arm's-length standard.

Pillar 2

Pillar 2, unlike pillar 1, has no direct impact on the arm's-length standard or transfer pricing. The global anti-base-erosion (GLOBE) rules — the core part of the pillar 2 minimum tax rules — will not change where the profits of a multinational are allocated; however, they will change where those profits are taxed if they are taxed below the minimum rate.

The GLOBE rules, consisting of the IIR and UTPR, will create a floor on tax competition among jurisdictions and result in multinationals facing a minimum level of taxation of 15 percent on their GLOBE income. Countries also have the option of introducing their own qualifying domestic minimum top-up tax (QDMTT) to bring the tax rate on domestic profits of in-scope multinationals up to the minimum rate.

There are questions about what the GLOBE rules mean for the future of tax planning. From our perspective, it seems that many aggressive tax planning strategies have already been significantly curtailed by BEPS 1.0 and the related tax reform initiatives. Moreover, increasing corporate focus on environmental, social, and corporate governance considerations means that aggressive tax planning is, perhaps, no longer in vogue. However, it seems unlikely that tax planning will disappear with the implementation of a minimum tax; while the GLOBE rules put a floor on corporate tax rates, there will still be material differences in profits taxed at a 15 percent rate and those taxed at the U.S. rate of 21 percent, or higher in many other countries. This means that for groups there will still be an incentive to expand their operations in countries where tax rates will be set at 15 percent. There has also been a suggestion that where a QDMTT applies, the jurisdictional top-up amount must be reduced (potentially to zero) before the IIR and UTPR apply. This may create an incentive for countries to restructure their tax systems, reducing the rate of their regular corporate tax regime (potentially to zero) and implementing a QDMTT as an alternative.[18] This type of systemic change may result in new planning opportunities.

It seems unlikely that the minimum tax will fundamentally change the current proliferation in transfer pricing audit activities and related controversies, because tax administrations will continue to challenge the application of the arm's-length standard by companies. Fundamentally, transfer pricing is about how taxing rights over corporate profits — the pie — are split among different countries, and every tax administration wants to make sure it is getting its slice. One key outstanding issue is that it is unclear how GLOBE

[18] Michael P. Devereux, John Vella, and Heydon Wardell-Burrus, "Pillar 2: Rule Order, Incentives, and Tax Competition," Oxford University Centre for Business Taxation Policy Brief (Jan. 14, 2022).

rules will deal with disagreements between jurisdictions on transfer pricing when there is an adjustment for future tax years by one jurisdiction. This is one of the many issues that the OECD intends to cover in the proposed implementation framework.[19]

In some ways, the GLOBE rules increase the importance of transfer pricing. The model rules require that transactions between related parties located in different countries are priced in accordance with the arm's-length standard (and at the same price), to ensure that the mispricing of transactions cannot be used to shift income from one country to another.[20] This means there is the potential that a third country might want, for GLOBE purposes, to review the pricing of a transaction between entities resident in two other countries.[21] This requirement may even extend the application of the arm's-length standard to transactions between countries with no treaties and no domestic transfer pricing rules. In other words, pillar 2 may actually extend the applicability of transfer pricing rules. A critical question, yet to be answered, is how tax administrations will monitor companies' compliance with this requirement.

In terms of increasing the importance of transfer pricing, the GLOBE rules also extend the arm's-length standard requirement not only to transactions between related parties located in different countries, but also to same-country transactions between minority-owned constituent entities and constituent entities if the sale or other asset transfer would produce a loss included in the GLOBE calculation.[22]

As companies are starting to come to grips with the GLOBE model rules, most are struggling with the myriad adjustments needed to perform GLOBE modeling to even understand where they may be subject to top-up tax. Many companies that have performed the detailed modeling have found that there can be some odd results. For a variety of reasons (such as the treatment of nonrefundable research and development tax credits, the cap on deferred tax liabilities to the 15 percent minimum rate, or the treatment of losses) groups are finding that under the GLOBE rules they can have low-taxed profits for GLOBE purposes in countries where the headline rate is well above 15 percent — such as the United States. As countries start to implement the GLOBE rules, groups may want to think about how to restructure their intragroup transactions to avoid being inadvertently subject to top-up tax. This will need to be a dynamic exercise, as it remains unclear which countries will implement the GLOBE rules and what a steady state future post-GLOBE adoption might look like.

Conclusion

Pillar 1 and pillar 2, if implemented, will have implications for how groups apply transfer pricing rules.[23] Though some aspects of both pillars suggest a reduced importance for arm's-length standard-based transfer pricing rules, in other ways the design of these new rules actually increases the importance of the arm's-length standard.

The formulaic, destination-based approach adopted by amount A means it can be portrayed as an existential threat to the arm's-length standard. But its limited scope and the fact that the rules will apply as an overlay, not a replacement to, the current system, emphasizes how difficult moving away from the arm's-length standard has proved. Likewise, amount B is an affirmation of the continuing relevance of the arm's-length standard, as well as a recognition that transfer pricing rules should be simplified where possible. The GLOBE rules will change how groups approach transfer pricing but will not address the fact that tax administrations care where groups pay tax, not just that they are taxed at a minimum rate. Tax administrations will likely see it as cold comfort to know that a group is

[19] OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)," at 63, para. 105 (2022).

[20] OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two)," at article 3.2.3 (2021).

[21] Historically, adjustments by one country regarding transfer pricing between entities in two other countries have been rare, but they do occur from time to time because of how the foreign-to-foreign transactions affect a taxpayer's tax liability in the adjusting country. *See, e.g.*, *Procter & Gamble Co. v. Commissioner*, 961 F.2d 1255 (6th Cir. 1992). *See also* Rev. Rul. 78-83, 1978-1 C.B. 79.

[22] OECD commentary to pillar 2, *supra* note 19, at 63, paras. 108-109.

[23] Herrington et al., *supra* note 9.

paying its "fair share" of tax if those payments are being made to other countries.

The most interesting question, and the one most difficult to predict, is what will happen to the arm's-length standard and transfer pricing, if BEPS 2.0 (or at least pillar 1) fails. At least in the short term, it seems almost inevitable that the work the OECD has done to date will fuel existing dissatisfaction with the arm's-length standard-based status quo, leading to the adoption of more measures or practices that are incompatible with the arm's-length standard and more double taxation. In short, a bad outcome for everyone.[24] ■

[24] 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 author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

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