To	Tax Policy and Statistics Division, Centre for Tax Policy and Administration	Date	November 12, 2019
From	KPMG International	Ref	Secretariat Proposal for a 'Unified Approach' under Pillar One
Cc	Manal Corwin, KPMG LLP, United States Christopher Morgan, Head of Global Tax Policy, KPMGI		

Comments on the Secretariat Proposal for a 'Unified Approach' under Pillar One

Professionals in the member firms of KPMG International[1] ("KPMG") welcome the opportunity to comment on the OECD's public consultation document entitled "Secretariat Proposal for a 'Unified Approach' under Pillar One," released on 9 October 2019 (the "Consultation Document").

The Consultation Document contains a proposal by the OECD Secretariat for a "Unified Approach" intended to help expedite progress by the Task Force on the Digital Economy (the "Task Force") and the Inclusive Framework on BEPS (the "Inclusive Framework") toward a consensus on Pillar One of the two pillar approach being pursued with respect to the broader tax challenges arising from the digitalization of the economy.

KPMG's comments on the Consultation Document are presented below.

1) Introduction and Overview

As we have noted in prior comments,[2] tax issues related to the digitalized economy (including both the BEPS issues addressed in Pillar Two and the more fundamental allocation issues addressed by Pillar One) have been a source of enormous political pressure around the world. Previous work under the BEPS Project has not relieved this political pressure, which has led to a proliferation of uncoordinated unilateral measures being considered or enacted by some members of the Inclusive Framework. These measures often appear intended to fall outside the scope of existing tax treaties, creating the risk of double or multiple taxation without a clear obligation to provide relief. While many countries considering such measures have expressed a desire to forestall further uncoordinated unilateral measures pending a global solution, such a solution appears to be needed quickly if the consensus-based international tax system is to be preserved.

Thus, to the extent that it is not possible to prevent further proliferation of uncoordinated measures and allow time for implementation of the BEPS recommendations before taking further action, it is our belief that it will be critical to pursue a solution that: 1) can achieve the broadest possible consensus among members of the inclusive framework; 2) is clear and easy to administer; 3)

[1] KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 154 countries and territories and have 200,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

[2] KPMG International, Comments on OECD Public Consultation Document on Addressing the Tax Challenges of the Digitalized Economy, March 6, 2019(https://tax.kpmg.us/content/dam/tax/en/pdfs/2019/3-6-19-kpmgi-comment-letter-oecd-consultation-document-digital-economy.pdf)

KPMG International Cooperative ("KPMG International") is a Swiss entity. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services.

No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm.

preserves, to the extent possible, existing tax rules and standards, including the arm's length standard; 4) reconciles new rules with existing standards to prevent double taxation; 5) includes robust mechanisms and expectations for effective dispute resolution and prevention; and (6) is sustainable over time given changing business models. In addition, any solution arrived at by the Inclusive Framework must address the application of unilateral measures if it is to achieve the goal of addressing the tax challenges of the digitalized economy without creating the risk of double or multiple taxation. It is our belief that all jurisdictions taking part in this work should commit to repeal unilateral measures in favor of implementing the global solution that is reached through the current work. A peer review process should be considered to evaluate compliance with this commitment.

The Consultation Document sets out only a basic framework for discussion by the Inclusive Framework and the TFDE with the intent of arriving at a consensus solution. As a result, details as to the precise scope of taxpayers covered, the threshold for nexus in a country under Amount A, the quantum of profit to be allocated under the proposals, and the approach to relieving double taxation are all left open. While agreement on the quantum of profit that should be allocated to the market jurisdiction will require a political agreement, the methodology and mechanics for establishing nexus, allocating profit, and relieving double taxation are interdependent and fundamental to achieving certainty, administrability, and long-term stability. In this regard, we note that there may be multiple approaches to accomplish similar policy outcomes. As a general matter, we would support options that can accomplish the desired policy objective with the least possible disruption to the existing tax system, and that strike an appropriate balance between the desire for simple and administrable rules on the one hand, and accuracy on the other. In addition, we observe that long term stability is more likely to the extent that new rules are anchored in principles and can be reconciled with existing rules.

Our comments on the various elements of the Consultation Document reflect these guiding principles, and focus on key issues that we believe must be addressed in order to maximize the chance of reaching a global consensus solution that is clear and administrable, eliminates double taxation, promotes long term stability, and provides for effective dispute resolution.

2) Comments on Amount A

a) In General

The work on the tax challenges of the digitalized economy had its origins in the perception among some countries that the existing tax rules did not always take into account the role that market externalities play in creating value in a digitalized economy.[3] In connection with this, concerns were expressed about the ability of a highly profitable business to substantially interact with a market remotely while locating relevant business functions related to sales elsewhere, such that the market had no or only limited rights to tax the related profits. Amount A, as described in the Consultation Document, attempts to address this issue by reallocating to the market the right to tax a defined portion of the deemed residual profits of an MNE group (without regard to the application of the

[3] See, e.g., the BEPS Action Plan, which described the digital economy as characterized by "unparalleled reliance on intangibles, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs." OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD Publishing, Paris (2015), Paragraph 2 of Chapter 1 http://dx.doi.org/10.1787/9789264241046-en

arm's length standard), while allocating the remaining profit of the MNE group in accordance with the existing arm's length standard.

As discussed in greater detail below, we believe that while digitalization has raised challenges that have put pressure on some specific areas of the existing tax rules, in most cases the existing principle-based system built on application of the arm's length standard continues to function appropriately. We are concerned that a broad departure from these principles is unlikely to result in a stable consensus unless changes are principled and targeted carefully at relieving the pressure on the existing system from the specific concerns that have arisen in connection with digitalization. In this regard, we believe that targeted measures that minimize disruption to and can be reconciled with existing principle-based rules and standards, promote certainty, and have long term viability cannot be achieved by ring-fencing specific industries or business models.

Because the purpose of Pillar One is to reallocate a portion of taxing rights while still avoiding double taxation, an increase in one country's taxing rights will necessarily require a decrease in one or more other countries' taxing rights. Accordingly, a fundamental shift in the approach to allocation of taxing rights may also cause concerns among countries that would be giving up those taxing rights. As a result, we believe that reaching the broadest possible consensus will be more likely if the method for reallocation is firmly anchored in agreed principles, and/or the amount of profits to be reallocated under Amount A is set at a relatively modest level that takes into account both market country and residence country concerns.

The Consultation Document describes a number of different approaches that might be used to target the proposal to the specific concerns raised by digitalization. These approaches include setting minimum revenue thresholds before taxpayers will be subject to the proposal, carving out specific types of business, tailoring application of the proposal on a business line basis, and excluding a fixed amount of deemed routine return from application. We believe that some sort of narrowing of focus will likely be needed in order to achieve consensus, as broadly reallocating profits from a very large number of taxpayers in one country to another country may raise political concerns for the country being asked to surrender revenues.

An appropriate narrowing of focus could be done in a variety of ways, each of which is discussed in further detail below. A high gross revenue threshold for application of the new taxing right, for example, would target the proposal only to the larger companies that may be more likely to have the resources necessary to apply it. High thresholds for deemed routine profits and provisions for appropriate treatment of losses may similarly ensure that the proposal is appropriately focused on high-margin businesses. Carve-outs for specific types of business that are considered not to raise the concerns that the proposal is intended to address should also be considered, though care will need to be taken to make any such carve-outs clear, specific, and objective in order to minimize disputes. Care would also be needed to ensure that any such carve-outs do not result in taxing similarly situated businesses differently or ring-fencing one specific industry.

In order to achieve consensus on a Pillar One proposal, countries who will be required to surrender taxing rights to market jurisdictions ("surrender jurisdictions") with respect to Amount A will have to be persuaded that the approach to identifying surrender jurisdictions and determining the amount to be surrendered is fair. This is more likely if the approach to determining and apportioning Amount A and the corresponding approach to determining the surrender amounts is anchored in agreed principles that can adapt to changing business models and economic conditions. In this regard, recognizing that the solution produced by this work will need to be applied by a broad range of countries with varying levels of resources, any sustainable, effective solution will need to strike an appropriate balance between the desire for accuracy and the need for simplicity and

administrability. Any gains in theoretical accuracy should be carefully weighed against the possibility of increased cost and complexity of administration and the potential for disputes.

Either way, as discussed further below, an effective means of resolving those disputes is essential to the functioning of the new system.

b) Scope

As noted above, to avoid unnecessary disruption while accomplishing the purpose of the current work on the tax challenges of digitalization, Amount A should be targeted to the particular concerns that work is intended to address, including in particular the concern that a taxpayer may be able to interact significantly with consumers in a market without creating a taxable presence, or that such interaction even with a taxable presence should create taxing rights beyond those provided under the arm's length standard. The benefits to such targeting, however, must be balanced against the additional complexity that such an approach may bring, as well as the potential of efforts at targeting to create distortions among similarly situated businesses.

The Consultation Document notes that some sectors, including extractive industries and commodities, would be carved out, and that more broadly, the Unified Approach is intended to focus on large businesses that have significant consumer-facing elements. While there are good reasons to keep the proposal focused on taxpayers that particularly raise the concerns that the work is intended to address, any such carve-outs should be crafted carefully and described in objective terms, in order to avoid offsetting the benefit of such carve-outs with increased complexity and risk of disputes.

The Consultation Document suggests that the proposal will be aimed at consumer-facing businesses, broadly defined. The Consultation Document suggests that, for this purpose, a business that sells into consumer markets through non-related local distributors would be treated as "consumer-facing," as would a business with non-paying users who are individuals, and paying customers that are businesses. While we agree that pure B2B business models are less likely to raise the concerns that Amount A is intended to address, care will need to be taken in developing an appropriate carve-out for B2B businesses. In particular, if it is considered necessary to define "consumer-facing" businesses broadly, it will be important to develop a clear and objective definition that provides certainty about which businesses are intended to be carved out. In addition, careful consideration will need to be given to how to determine the location of sales for purposes of applying Amount A to businesses that do not sell directly to customers, recognizing that in some cases, information about the ultimate location of consumers may not be available to companies using unrelated distributors.

Some pressure could be taken off the issue of whether a particular group is entirely in or out of scope by doing an analysis on the basis of financial report segmentation; as discussed below, however, such an approach presents its own issues of complexity. As a result, we believe that if significant carve-outs from the scope of the proposal are pursued, it will be essential to provide for mandatory binding arbitration with respect to disputes as to whether a business is covered by the rules or eligible for a carve-out.

c) Considerations with respect to the Financial Services Industry

The Consultation Document indicates that whether and how Amount A should apply in the context of financial services businesses is still being studied. In this regard, it should be noted that a defining feature of financial services businesses is the centrality of capital at risk. While mobility of

capital has been identified as a concern in prior work, in the context of financial services businesses, capital is not highly mobile. To the contrary, high levels of non-tax regulations governing financial services sectors dictate minimum capital requirements in the jurisdictions where financial services companies do business, and as a practical matter require physical presence.

As a result of these considerations, "residual" profits for financial services are very often the result of risky returns to capital and can be volatile over both time and geography. In addition, financial services companies generally have many entrepreneurial entities, and few or no "low risk" customer-facing entities.

The work on Pillar One appears to be motivated by concerns that an MNE group may concentrate residual profits from remote interaction with market jurisdictions in entities located offshore, and for the reasons stated above financial services businesses do not generally present those characteristics. Such businesses do, however, pose substantial challenges with respect to implementation of Amount A including accounting for volatile profits over time, determination of appropriate surrender jurisdictions for Amount A and associated allocations, and determination of appropriate allocation factors for Amount A across market jurisdictions. Implementation of Amount A in a way that results in a re-allocation of statutory profits among jurisdictions may trigger significant regulatory scrutiny. It will therefore be important, in light of the unique characteristics of the financial services industry, to balance the impact of tax and non-tax regulations in order to avoid putting the industry at a disadvantage.

d) Nexus

The threshold for creating nexus should be made as simple and administrable as possible. It appears that a determination based on the amount of sales in a market jurisdiction is under consideration. If such an approach is followed, we recognize that differences in the size and level of development of a country may be relevant in determining where the threshold should be set, and that such a threshold may as a result need to vary by country. To the extent the proposal ends up applying very broadly as a result of a relatively low threshold for nexus, it will be important to consider ways to simplify administration of the proposal.

e) Determining the Profit Subject to Amount A

The Consultation Document notes that the starting point for the determination of Amount A with respect to an MNE group would be the identification of the MNE group's profits, which could be derived from the MNE group's consolidated financial statements. The Consultation Document notes, however, that the starting point could instead be group profits calculated on a business-line-by-business-line basis, in order to address, e.g., a situation in which a group may have one highly profitable line of business and one lossmaking business. As discussed in greater detail below, we believe that determining group profit on the basis of a group's consolidated financial statements would be a significantly more administrable approach, and would avoid complexity that could lead to disputes. Recognizing, however, that there may be a desire for more detailed information, permitting taxpayers to report profit based on financial reporting segments appears vastly superior to attempting to craft tax-based definitions of business lines or regional groupings.

i) Appropriate metric for group profit

Recognizing that layering Amount A onto an existing system will inevitably introduce new complexity, a priority should be placed on simplicity and administrability wherever possible.

Against that backdrop, relying on consolidated financial statements as the starting point would be by far the most administrable approach to determining group profit. While this may result in significant departures from the way income is determined for tax principles, it should be noted that any relatively simple and formulaic approach will necessarily create the potential for distortions. The impact of those distortions, however, will be reduced to the extent that Amount A is designed to provide a relatively modest reallocation to market jurisdictions. If Amount A is intended to more significantly reallocate taxing rights, there may be more pressure on how to determine the group profit figure that forms the tax base for the proposal.

Assuming that a consensus is reached on a relatively modest reallocation under Amount A we believe that "Income from Continuing Operations Before Tax" would be the most appropriate starting point for calculation of Amount A. This measure would focus on the core of a group's operating income, while appropriately excluding less relevant items such as Income Tax Expense, Equity in Earnings of Unconsolidated Entities, Discontinued Operations, and Cumulative Effects of Changes in Accounting Principle.

ii) Adjustments to Group profit to adjust for different accounting standards

The Consultation Document asks whether standardized adjustments to financial statement profit may be needed to reflect differences in accounting standards. We would not recommend such an approach.

Attempting to reconcile the differences between GAAP and IFRS in the context of the Unified Approach would be ambitious even in the absence of political forces that constrain the amount of time available. In this regard, it should be noted that years of work have gone into adapting US GAAP and IFRS to converge in treatment, and that despite that substantial effort, many differences in these two standards remain. Attempting to resolve the remaining differences within the time frame of the work on the Unified Approach (whether to arrive at a new tax-based hybrid standard or to conform one standard to the other) appears close to impossible, and in any case appears likely to increase complexity and the risk of tax controversy.

In addition, the potential benefits of such an approach do not appear significant. Most differences between US GAAP and IFRS are differences in timing, rather than permanent differences. As long as Amount A appropriately allows for loss carryovers from year to year, any distortion created by those differences would be minimized over time. As a result, provided loss carryovers are appropriately permitted, we do not recommend making adjustments for divergence in accounting standards.

If any adjustments are made to reconcile GAAP and IFRS, however, they should be limited to material permanent or long-term temporary differences. These differences requiring adjustment should be specifically identified in the final guidance along with clear and thorough guidance as to how the adjustments should be made. Examples of long-term temporary differences might include:

- LIFO as an impermissible inventory method (IAS 2)
- Reversal of impairment losses for assets other than goodwill (IAS 36)
- Capitalization of self-developed assets (IAS 38)
- Contingent liabilities recognized in business combinations (IAS 37)
- Employee pension gains and losses recognized as a component of OCI (IAS 19)

iii) Segmentation

The Consultation Document notes that profitability of a multinational business may vary across business lines, regions, or markets. The document suggests there may be a need to measure profits on a business line and/or regional/market basis, to prevent potentially distortive blending. The Consultation Document notes the potential complexity that such an approach may raise, but suggests that requirements under financial accounting reporting standards to disclose certain financial information based on operating segments could help.

We recognize that the intent behind requiring segmentation would be to allow jurisdictions to more accurately determine the revenue that should be subject to tax under Amount A. Such an approach may also permit more nuanced application of any carve-outs that are ultimately agreed upon. While such segmentation will inevitably introduce complexity, permitting taxpayers to elect to make use of financial reporting segments appears to be an improvement over prescribing custom definitions of business lines or markets/regions for tax purposes. As discussed in further detail below, an approach permitting the use of financial reporting segments would reduce the complexity and subjectivity inherent in departing from worldwide profits per the MNE group's consolidated financial statements, while allowing jurisdictions to disaggregate an MNE's global operations into different operational groups.

iv) Follow reporting segments for financial reporting purposes

If it is determined that segmentation is required, it should follow the reporting segments used by the MNE group for financial reporting purposes (under IFRS 8 and ASC 280)[4]. While such segments may not achieve the theoretical accuracy of business model carve-outs or presentation of geographically-differentiated profit margins, financial statement segmentation can reasonably be expected to accomplish some degree of business line and regionalized profit margin differentiation. Financial reporting segmentation also has the advantage of being driven by business rather than tax concerns, and of being subject to regulation and oversight. The IFRS/GAAP rules are prescriptive and are monitored by regulators. In addition, IFRS/GAAP require reporting entities to determine reportable segments based on how the entity manages its business. As a result, the possibility that a taxpayer would manipulate financial reporting segments to engineer a desired tax outcome appears quite limited.

If segmentation is required, rules will be needed to address a situation in which a financial reporting segment aggregates profit from both covered businesses and businesses that are subject to a carve-out. One option would be to establish a threshold (e.g. where sales from covered businesses account for more than 50 percent of the total sales within a segment) after which all profit from that segment would be treated as within the scope of the new taxing right. However, if this approach is adopted, consideration should be given to permitting taxpayers to establish the profit attributable to the included business model and applying the taxing right only with respect to the profit established as attributable to the covered business.

---

[4] It should be noted that while financial reporting segmentation is a substantial improvement over 'tax-only' reporting segments, it will still present complexity for taxpayers and tax administrations alike. For example, reporting entities occasionally change their reporting segments due to management restructuring, new business models, growth or shrinkage of business lines, etc. Where this is the case, it will be challenging to determine how losses generated in prior periods under old reporting segments should be carried forward to new reporting segments.

Requiring Groups to segment their business in any way other than financial reporting segments will impose substantial burden on both taxpayers and tax authorities. Such segments are also likely to be significantly less reliable and verifiable than financial reporting segmentation. Groups' financial information reporting systems generally do not track revenue and expense items in the way the Tax Department would need to organize new segment information. Thus, the Tax Department would be left to make assumptions, estimates, and judgement calls to comply with a segment reporting system that deviates from the way the Group manages its business and is reflected in its financial reporting. Such an exercise would be burdensome, costly and prone to significant controversy with taxing authorities. To be effective, the new taxing right should aim wherever possible to avoid creating additional areas of subjectivity and controversy.

v) Allocation of centralized costs

The measure of financial reporting segment profit (or loss) could differ from Group consolidated income as a result of the use of different accounting standards and unallocated centralized costs. These differences would have to be assigned to financial reporting segments so that the sum of profit or loss from all reporting segments equals Group consolidated income. Reporting entities must reconcile segment profit (loss) to GAAP profit (loss). It is our experience that reporting entities know the detail of these unreconciled items and would have the factual basis to accurately determine how these differences could reasonably be allocated to its various financial reporting segments.

Centralized costs and other unreconciled items should be allocated to segments to properly reflect the net economic position of the taxpayer within each segment. From a theoretical perspective, the factual relationship between the expenses and the segments would ideally govern how these centralized costs are allocated to reflect the economic positions of the business segments. The aforementioned approach would, however, lead to subjective determinations that could present a significant risk of dispute that could lead to double taxation. While clear and detailed guidance could help avoid some of these disputes, we believe that to ensure that the remaining disputes can be resolved mandatory binding arbitration would need to be adopted with regard to how group-wide costs are allocated to different financial reporting segments.

Alternatively, if mandatory arbitration for group-wide centralized and unreconciled cost allocation is not possible, in order to minimize disputes and complexity while increasing administrability these costs should be allocated to reporting segments on the basis of an objective metric such as relative sales or relative gross margin as set out in the financial reporting segment disclosures in the financial statements.

vi) Determination of deemed routine and residual profit under Amount A

A consensus will need to be reached as to the portion of Group profit that should be deemed routine, and the portion of the remaining deemed residual profit that should be apportioned among market jurisdictions. While this consensus will involve some degree of political agreement, we continue to believe that these percentages, while formulaic, should be informed by some principled analysis that reconciles the new amount with current rules and standards. To this end, we believe that the threshold after which profit will be considered "residual" should be set at a substantially higher level than what is typically thought of as "routine profit." Noting that the routine profits required to compensate all routine activities for a wide variety of industries business models are likely to vary significantly, a high percentage will be necessary to prevent the distortions associated with attribution of arm's length routine profit to deemed residual. Perhaps more importantly, a higher

KPMG

percentage aligns better with the underlying policy to create a new taxing right that targets above-normal returns of highly profitable companies benefiting from digitalization.

In addition, the share of deemed "residual profit" allocated to market countries (the "Final Step") should reflect a reasonable balance between the desire to reallocate a portion of overall profits to the location of the customer and the recognition of the continued need to provide proper remuneration for transfer pricing purposes of the entities that carry on significant DEMPE functions. To avoid double taxation, as discussed in more detail below, profits reallocated by the proposal will need to be surrendered from another jurisdiction in which DEMPE functions are carried out. We believe that limiting the amount reallocated under Amount A to a relatively a modest share of residual profit is appropriate, as the taxpayer's DEMPE activities should continue to play the principal role in determining where residual profits are recognized.

vii) Digital differentiation

The Consultation Document raises the possibility of changing the way in which Amount A (and potentially Amounts B and C) apply on the basis of some measure of "digital differentiation."[5] The paper suggests that this could be done through a weighting of the amount of profit that would be subject to the new taxing right or by adapting the approach to Amounts B and C. We do not see how such an approach can be reconciled with statements elsewhere in the Consultation Paper that it is not possible to ring-fence a digital economy, and that the proposals are intended to be broadly targeted and not targeted solely at highly digitalized businesses.

Applying different profit attribution rules differently to specific types of businesses on the basis of digital differentiation would risk including some businesses while excluding others that may have similar characteristics and deliver comparable services to customers. Such an approach has the potential to create market distortions. It also creates uncertainty as businesses evolve and adapt to changing business models. As a result, we believe that such "digital differentiation" should not be incorporated into the consensus solution.

viii) Treatment of losses

The Consultation Document notes the importance of ensuring that the new rules avoid creating distortions and apply equally well to both profits and losses. For this purpose, it is important to permit the carryover of losses to future years in order to avoid (1) disincentives for capital investment and risk taking by capital owners; (2) unduly positive or negative treatment of taxpayers due to timing of income relative to the close of a fiscal year; and (3) situations in which a business that experiences fluctuations in profitability due to volatility from year to year is taxed less favorably than a business experiencing steady profitability.

Developing a carryover mechanism will require a determination of how losses should be measured, how losses from periods before the enactment of the Unified Approach should be treated, and how loss carryforwards should be allocated under the proposal. With respect to the measurement of losses, one option would be to consider the actual loss as reported on an MNE Group's financial statement (either in the aggregate or by segment) as a loss. Another would be to treat as a "residual loss" the amount by which the Group's financial statement profit falls short of the "deemed routine" profit. While the first approach would result in fewer companies being treated as having losses, the latter approach appears more consistent with the goal of minimizing the impact of

[5] See Consultation Document, para. 33.

fluctuations in profitability over time and ensuring that the proposal principally impacts businesses with profitability in excess of the deemed routine amount under Amount A.

With respect to the treatment of pre-enactment losses, we would note that the rationale that supports carryovers of losses would support reaching back to taxable periods prior to the enactment of any new taxing rights. If a limit is to be placed on this for reasons of administrability, the look back period should be long enough to effectively acknowledge the role of capital investment and risk bearing activity on profit generation.

f) Collection of Amount A

The Consultation Document notes that consideration is being given to enforcement and collection of tax on Amount A, and that one issue being explored is whether a withholding tax would be an appropriate mechanism for that purpose. KPMG believes that because Amount A is not determined at a transactional level and thus the amount of tax owed by a taxpayer with respect to an outbound payment cannot be known at the time of payment, such an approach would be likely to result in substantial over-withholding for a significant number of taxpayers. In addition, withholding is best suited to address cross-border payments where enforcement of net basis taxation would present significant compliance and enforcement issues. Here, because the targets of the reallocation will generally be very large MNE Groups with substantial ongoing interaction with market jurisdictions, the risk of intentional non-compliance appears remote.

A mechanism that permits taxpayers subject to the tax to register to self-assess the taxes they owe under Amount A would be a substantial improvement. Such an approach has been used in the context of VAT and other indirect taxes. For this purpose, to improve administrability, it should be made possible for any member of an MNE group to register to pay tax on behalf of the group, and be freely reimbursed by the members of the group that bear the technical liability for the tax.

Comments on “Amount B” and “Amount C”

g) In general

KPMG supports the Consultation Document’s general policy statement that apart from Amount A, activities in market jurisdictions and elsewhere would remain taxable under existing rules, including transfer pricing under the arm’s length standard. KPMG further strongly supports the OECD’s goal of reducing the large number of tax disputes relating to distribution functions.

The terminology and discussion of Amounts B and C in the Consultation Document, however, appears to introduce more complexity than clarity. The OECD’s objectives with regard to compensation of sales and marketing functions could be accomplished in a more straightforward manner. Our suggestions are founded on the following understanding and assumptions:

1. MNEs should continue to determine transfer pricing under the arm’s length standard, as interpreted by the Transfer Pricing Guidelines (including possible revisions), to determine baseline entity taxable income prior to any determination and allocation of Amount A taxable income and surrender.
2. Currently, excessive tax authority and taxpayer resources are devoted to disputes regarding appropriate compensation of distribution functions, and therefore additional guidance including specific baseline margins would be beneficial to both tax authorities and taxpayers.
3. The facts and circumstances giving rise to these issues are not limited to the enterprises (e.g. large, consumer-facing business) that the OECD intends to be in scope for Amount A, and

therefore any additional guidance on compensation of distribution functions should not be limited to “in scope” MNEs.

4. Any specified baseline margins established should be framed as rebuttable presumptions, recognizing that a variety of circumstances may lead to arm’s length compensation in a market jurisdiction different from any standard return to baseline distribution activity. Such deviation may be proposed and supported by (i) the market jurisdiction tax authority, (ii) the tax authority in a counter-party jurisdiction, e.g., that of a related party manufacturer selling to the market jurisdiction distributor, or (iii) the MNE taxpayer itself. This approach would eliminate the need for a separate concept of “Amount C,” as discussed further below.

KPMG recommends that the OECD address these issues as a workstream of potential revisions to the Transfer Pricing Guidelines and related guidance. That workstream could proceed largely separately from the workstream considering Amount A, but for dispute resolution issues, as discussed in the next section. The workstream could consider issues including:

- Definition of routine distribution and marketing functions;
- Appropriate standard returns, including potential variations by industry and/or region;
- Application of such guidance where the market jurisdiction entity is not a “buy-sell” distributor but provides market jurisdiction support for sales into the market by an offshore entity, including interaction with the Authorized OECD Approach to profit attribution where the remote selling entity is determined to have a permanent establishment in the market jurisdiction;
- Guidance for jurisdictions that might wish to establish “safe harbor” regimes for eligible distributors based on the standard returns; and
- Standards for overcoming a rebuttable presumption that the appropriate standard return applies, both as determined by the taxpayer and supported in its transfer pricing documentation, and in the context of tax authority audit and dispute resolution proceedings.

h) Additional comments

i) Amount B

Treating Amount B as a fixed minimum return rather than as a rebuttable presumption will create significant and complex collateral issues, as well as inconsistencies with the arm’s length standard. KPMG would therefore strongly recommend against treating Amount B as a fixed or required return, rather than a rebuttable presumption.

ii) Amount C

The appropriate arm’s length return to a market jurisdiction could differ from Amount B (corresponding to the standard return in the discussion above) for a wide variety of reasons, including:

- Additional routine but high value-add functions relating to sales and marketing, such as high levels of customer service as with a value-added reseller;
- Performance of routine functions unrelated to sales and marketing, such as manufacturing or centralized service provision;
- Performance of DEMPE functions related to either marketing or non-marketing intangibles;

- Performance of important risk control functions leading to attribution of risk under Chapter I; and
- Substantial "local to local" business so that profits are not materially determined by related party transactions.

The Consultation Document is not clear on whether "Amount C" is intended to refer to all of these factors or only some of them. Further, while the possibility of negative amounts is clearly necessary to comply with the arm's length standard and resolve double tax disputes, the Consultation Document does not clearly contemplate that amount C could be negative. Finally, while the document seems to indicate that "Amount C" is applicable only to market jurisdictions, compensation of functions going beyond baseline distribution is required whether they take place in the market jurisdiction or elsewhere. KPMG believes that the use of special terminology to reference returns to such functions where they occur in market jurisdictions, and not when they take place elsewhere, is unnecessary and confusing.

Therefore, because the stated intent of the Unified Approach is that compensation of market jurisdictions (as well as non-market jurisdictions) should follow the arm's length standard except for the application of Amount A, and subject to additional guidance on compensation of baseline distribution functions, we do not think the concept of Amount C as a distinct concept is necessary or helpful.

iii) Double taxation and reconciliation of Amounts A, B and C

The arm's length standard historically has focused on transactions. Transactions between related parties are to be priced at arm's length, with profit allocation amongst constituent entities of an MNE following as a result of arm's length pricing. In fact, the Transfer Pricing Guidelines, especially prior to the 2010 revisions, were emphatic in the focus on transactions and preference for transactional methods. More recently, however, beginning to some extent with the DEMPE guidance on allocation of profits associated with intangibles, and more dramatically in the Public Consultation Document with the focus on determination of Amounts A, B and C, the OECD appears to be moving away from an emphasis on pricing of transactions to a focus directly on profit allocation. A large number of collateral issues are likely to result from this loss of focus on pricing of specific transactions, including the following:

- **Resolution of double taxation**: With a transactional focus, the counterparty jurisdiction to any dispute is automatically identified. A tax authority asserting an adjustment must frame that as an adjustment to a transaction price, and the jurisdiction at the other end of the transaction is clear and double tax disputes are almost always bilateral. In contrast, consider the case of a routine distributor who purchases from multiple related manufacturers. If that distributor must receive Amount B, and the tax authority of one manufacturing jurisdiction asserts an adjustment, resolution of the dispute necessarily requires involvement of the tax authority of the other manufacturing jurisdiction.
- **Withholding and other transaction-based taxes**: A direct focus on profit allocation without attention to transactional matters creates issues where any profit adjustment must be mapped to transactions in order for withholding and other transaction-based taxes to be properly computed.
- **Customs**: Customs rules generally require arm's length pricing of dutiable goods. Mandatory profit targets for distribution entities are likely to create conflicts over correct pricing of goods for customs purposes.

- **Coordination of local financial / tax statements**: Entities of an MNE often have differing tax years and / or accounting principles. With attention to proper pricing of transactions, these differences create relatively limited coordination issues because transactions are booked when they occur at an arm's length price. Where profit allocation among entities is mandated directly, substantial complexity is introduced by the need to reconcile differing tax years and accounting standards.

In order to reconcile Amounts A with existing transfer pricing rules (and amounts B and C) in a manner that avoids double taxation and reduces disputes KPMG suggests the following framework:

Step 1 An MNE determines its transfer pricing (and resulting baseline profit allocation) under the arm's length standard. If "Amount B" is implemented then the MNE sets pricing to target the appropriate standard return in market jurisdictions where it is applicable, where the arm's length standard requires a different amount in a market jurisdiction, the reasons for deviating from Amount B in that jurisdiction are covered in the MNE's local file for that jurisdiction.

Step 2. If an MNE is subject to Amount A, the MNE next determines Amount A and the allocation of Amount A among market jurisdictions. The MNE follows procedures to be developed by the OECD for the appropriate tax filing procedures in the associated jurisdictions as well as the procedures to be developed for eliminating double taxation.

Step 3. The MNE is permitted to reduce the taxable profits in jurisdictions identified as surrender jurisdictions relative to Amount A. To avoid double taxation, we would suggest a mechanism that would permit a group to deduct any amounts subject to tax under the new taxing right against income subject to traditional corporate income tax (the "Surrender Deduction"). It will be necessary for that purpose to identify which group entities will be required to surrender profits. One option would be to require the ultimate parent jurisdiction to surrender revenues. This approach, however, does not take into account that the ultimate parent entity may not be the entity that attracts the relevant residual profits under existing tax principles. It also will require residence jurisdictions to subsidize the allocation of profit to market jurisdictions without any principled justification. Another potential approach would be to require entities entitled to non-routine returns as determined under the arm's length standard to surrender a portion of those revenues. This approach, however, would be difficult to reconcile the formulaic approach used to arrive at the "deemed residual" amount allocated under Amount A.

Recognizing that Amount A relies on a pure formulaic determination of deemed profit, a third option would be to require MNE groups to identify group entities that earn profit in excess of the deemed routine profit used to calculate Amount A, and allocate the Surrender Deduction to those entities on the basis of their relative deemed residual profits. This approach appears to be in line with the policy behind the Unified Approach (i.e., reallocating only residual profits).

It should be noted that identifying Group entities that should be treated as Amount A taxpayers and allowed a Surrender Deduction becomes significantly more complicated if segmentation is required. The approach suggested above would require identifying segment costs on an entity-by-entity basis, which would be a substantial undertaking.

While a tax credit mechanism is an alternative approach to using deductions, KPMG believes that designing a tax credit mechanism as part of the Unified Approach and integrating that with existing tax treaty and domestic rules regarding tax crediting introduces additional layers of complexity that could threaten the proposed timeline, or ability to reach consensus. Moreover, foreign tax credit systems often require taxpayers to pursue practical and effective remedies as a prerequisite to

creditability. Thus, a tax credit system would not eliminate the need for disputes and effective dispute resolution mechanisms.

3) Dispute Resolution

As noted above, it will be important to have effective measures to resolve any disputes that may arise with respect to an MNE Group's tax filings.

These potential disputes would include, for example, disputes over:

- The amount allocated under Amount A
- Whether an MNE is in scope or out of scope for Amount A
- Whether an MNE has performed the baseline distribution activities described in Amount B
- Whether the conditions for asserting Amount C have been met
- Disputes over whether an adjustment is consistent with the arm's length standard
- Whether and in what quantum a jurisdiction should surrender income to be taxed elsewhere under Amount A
- If withholding is used as a collection tool, whether and to what extent amounts have been over-withheld

Effective dispute resolution will be needed to ensure that these cases can be resolved. Existing dispute resolution procedures will need to address a new normal paradigm in which an adjustment by one country will impact the taxing rights of a number of other countries. Mechanisms such as multilateral APAs will be effective in limited circumstances for avoiding disputes. A solution under Pillar One should thus ensure that APAs are made available to cover both Amount A allocations, as well as allocations for Amounts B and C. Because of the difficulties inherent in arriving at an agreement between a potentially large number of countries, however, mandatory binding arbitration will be needed as a backstop to traditional MAP and APA proceedings.

Even with effective dispute prevention, including advance agreement mechanisms, there will be a need for robust dispute resolution procedures. Given that the profit allocation rules are apparently meant to operate in a mechanical manner, a coordination rule will be needed where the outcome of the profit allocation conflicts with transfer pricing outcomes that are not only permitted, but required, under existing treaty provisions that apply the arm's length standard. While it appears that the OECD intends the mechanical profit allocation rules will trump the transfer pricing rules in these cases, this should be spelled out. In particular, it needs to be recognized that, while rules may be conceived of mechanically, in practice there will always be issues associated with determining an appropriate profit base and deciding which industry a taxpayer belongs to (and thus what set of fixed percentages may apply), and tax administrations' decisions on these and other points may need to be addressed in MAP or similar forums.

As noted above, identifying the surrender jurisdiction(s) with respect to Amount A allocations will pose difficulties, which the Consultation Document does not explore in detail.[6] Depending on the approach applied, there will often be several surrender jurisdictions. If the surrender jurisdictions are those that are entitled to residual profits under existing transfer pricing rules, determining the

[6] For instance, the illustration in section 3 of the Consultation Document contemplates a situation in which a single entity (the parent company) is entitled to all non-routine profit prior to application of Amount A.

jurisdictions in question and the quantum of profits to be surrendered by each would generally pose all the issues associated with a conventional transfer pricing dispute. A formulaic approach to determining surrender amounts based on the thresholds set for Amount A, as discussed above, should provide additional clarity, but would not eliminate all room for disputes (e.g., with respect to business line segmentation by jurisdiction).

Amount A disputes may therefore involve a large number of jurisdictions in two categories: surrender jurisdictions and recipient, or market, jurisdictions. The potentially large number of interested parties, as well as the conflict between the principles underlying Amount A and the arm's length standard, will in some cases make resolution within the framework of a MAP case unfeasible, and may increase resolution timeframes in cases that can be resolved in MAP. Note that, because there may be a disparity in the number of surrender jurisdictions and recipient jurisdictions, a majority-rule system for resolving disputes will not work. For instance, in a dispute over the quantum of Amount A, nine market jurisdictions could override a single surrender jurisdiction. KPMG considers that designing a system that produces fair outcomes and encourages confidence in dispute resolution mechanisms is of paramount importance.

KPMG accordingly believes that a workable dispute resolution system will depend upon the effective implementation of multilateral binding arbitration. The OECD should consider:

- Whether Amount A cases involving more than a specified number of jurisdictions should initially be brought as multilateral MAP cases, or whether such cases should go directly to mandatory arbitration;
- Whether it would be helpful to institute separate arbitration procedures for identifying the profits to be surrendered as Amount A, in which potential surrender jurisdictions could resolve which jurisdictions will surrender profits and in what amount; and
- The coordination of an Amount A case with subsequent transfer pricing disputes that could affect the agreed distribution of surrender amounts (e.g., if an Amount A case determines that jurisdictions X, Y, and Z are the appropriate surrender jurisdictions because they either earn deemed excess profits or perform DEMPE functions, and jurisdiction W subsequently asserts in a transfer pricing case that it should earn excess profits and/or that it performed DEMPE functions for the same years at issue).[7]

In addition, the OECD should consider what arbitration procedures are appropriate. Procedures for the selection of a panel of arbitrators, such as those in Article 20 of the MLI, generally appear to have been framed with bilateral disputes in mind, with each of two participants selecting a panelist and those two panelists then selecting the final panel member. Where there is an odd and/or large number of participants, these procedures appear unlikely to produce workable outcomes. As such, the OECD should consider the potential of an impartial advisory body to provide assistance with the mandatory arbitration process, and such a body could play a role in the recommendation and/or supply of qualified panelists.

In order to ensure that disputes in arbitration are resolved in a timely fashion, KPMG recommends that the OECD employ "baseball" style arbitration rather than reasoned decision arbitration. However, KPMG recognizes that the incentives inherent in a bilateral baseball arbitration case, in which each tax authority is encouraged to make a reasonable proposal lest the panel select its competitor's proposal, may not necessarily apply in multilateral cases, where no country's proposal

[7] In such a case, the parties to the Amount A case would presumably have a joint position, consistent with the Amount A case resolution.

may reflect a resolution that is reasonable with respect to all other countries. The OECD should consider modified baseball arbitration procedures with the aim of ensuring that the arbitration process is workable, efficient, and fair. Specifically, it may be helpful to adopt an iterative approach, in which the parties submit initial proposals for the panel to review; the panel identifies reasonable or valuable aspects of the proposals to be retained, while sending the proposals back for further work; and the parties submit revised proposals, until the panel eventually selects one of the proposals submitted. Such an approach, which resembles approaches commonly employed by judges to facilitate settlement, incorporates aspects of mediation while retaining an independent decision-maker, and thus could help to increase participants' confidence in the arbitration process.

As we have noted in previous comments, while we understand the reservations that some countries have expressed about arbitration, we believe effective dispute resolution to be critical to any solution that involves a substantial departure from existing tax principles, particularly to the extent that those existing tax principles are replaced with a more formulaic approach. Such an approach risks making negotiation between competent authorities more challenging, further highlighting the need for a dispute resolution process that is guaranteed to reach a binding resolution. To the extent it is not possible to achieve agreement on the use of mandatory arbitration by all members of the Inclusive Framework, the OECD should consider a fall back provision for cases that cannot be resolved in MAP and for which binding arbitration is not available. In such instances, the OECD should consider whether countries which refuse mandatory arbitration should be precluded from receiving an Amount A allocation.

We believe that participation of emerging and developing economies in the work to develop an arbitration approach will build confidence that the agreed mandatory binding arbitration procedures would result in balanced and fair outcomes. In addition, there should be a focus on providing emerging and developing economies with training, support, and resources to ensure that they have the capacity to participate in arbitration proceedings on an equal footing with developed countries. As noted above, the OECD should consider the creation of an OECD body to provide optional assistance to developing countries, including with respect to the development of position papers for arbitration proceedings.

KPMG Contacts	**Firm**	**E-mail**
Stephen Blough	KPMG in the US	sblough@kpmg.com
Manal Corwin	KPMG in the US	mcorwin@kpmg.com
Jesse Eggert	KPMG in the US	jeggert@kpmg.com
Mark R. Martin	KPMG in the US	mrmartin@kpmg.com
Brett Weaver	KPMG in the US	baweaver@kpmg.com
Gianni De Robertis	KPMG in Italy	gianniderobertis@kpmg.it
Matthew Herrington	KPMG in the UK	matthew.herrington@kpmg.co.uk
Christopher Morgan	KPMG in the UK	christopher.morgan@kpmg.co.uk

Robert van der Jagt	KPMG in the Netherlands	VanderJagt.Robert@kpmg.com
Grant Wardell-Johnson	KPMG in Australia	gwardelljohn@kpmg.com.au
Conrad Turley	KPMG in China	conrad.turley@kpmg.com

Privacy | Legal

© 2019 KPMG International Cooperative ("KPMG International"), a Swiss entity. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.