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In this article, Sicilian and Bettge explore how U.S. states might benefit from the work the OECD has done regarding base erosion and profit shifting and uniformity.

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As the "digital economy" is fast becoming simply "the economy," governments — both national and subnational — have been working to address perceived gaps in the ability of their tax structures to reach it. In the interest of uniformity, and with the hope of reducing multiple taxation, a significant portion of these efforts have been multijurisdictional. At the international level, the OECD/G-20 inclusive framework's (IF's) base erosion and profit-shifting 2.0 project is focusing the efforts of national governments on a new multilateral convention for international taxation of business income, specifically to broaden taxing authority for market jurisdictions.[1] At the same time, subnational governments of U.S. states are working through the Multistate Tax Commission to develop model laws that, if enacted by a state, would broaden the state's tax base for its indirect, transactional sales and use taxes.[2]

Not only are these national and subnational governments working amongst themselves, they are also, for better or worse, borrowing from each other. Any observer of international and U.S. state taxation will have spotted the cross-pollination around pillar 1. Pillar 1 contemplates two taxing rights: an amount A and an amount B. The proposed amount A regime would swap the current jurisdictional determinants based on physical presence (for example, permanent establishment and fixed place of business) for economic nexus. And it would, within its relatively narrow sphere, replace residency-based taxation with a formulary approach using market-based, single-sales-factor sourcing. The IF's amount A proposal clearly benefits from over a century of

[1] OECD, OECD/G20 Inclusive Framework on BEPS, Progress Report September 2021-September 2022 (2022).

[2] Multistate Tax Commission, Sales Tax on Digital Products.

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U.S. states' experience with economic nexus, formulary apportionment, and market-based sourcing.[3]

This article explores how U.S. states might likewise benefit from the work the OECD has done regarding amount B. We first discuss amount B and the state transfer pricing landscape and then consider the potential for state reforms similar to amount B.

Amount B

Amount A, a highly ambitious rethinking of the international allocation of taxing rights, is the most attention-grabbing piece of pillar 1. But amount A applies only to a small number of companies, at least initially, and its prospects for implementation are increasingly uncertain. Potentially more transformative for most taxpayers is amount B, a separate component of pillar 1 that until recently has kept a lower profile. Just as the OECD has been influenced by U.S. states regarding amount A, U.S. states and their taxpayers might find value in the OECD proposals for amount B.

Amount B aims to simplify the application of the arm's-length principle to "baseline" marketing and distribution activities, and one of its key purposes is to promote tax certainty by preventing disputes around routine transfer pricing issues. On December 8, 2022, the OECD released a consultation document outlining the core proposed design of amount B.[4] The inclusive framework aims to finalize amount B by mid-2023 (consistent with the timeline for amount A) and is working hard to complete the technical work needed to achieve that goal. Although the timeline may seem ambitious, it is clear that amount B is progressing and that even an amount B framework with narrow applicability could be a jumping-off point for broader reform in the future.

Amount B's pricing mechanism would be based on the transactional net margin method, the OECD equivalent to the comparable profits method under the U.S. federal transfer pricing regulations. While the consultation document contemplates that distribution returns could be determined using an operating margin (also known as return on sales) in many cases, it leaves open the possibility of using other profit-level indicators, including the Berry ratio (gross profit over operating expenses), which can be more appropriate for distributors with lower functionality. The OECD is carrying out a benchmarking analysis, supplemented by econometric analyses, to assess the relationships between distribution returns and various variables, but as of the date of the consultation document, this work had not progressed to a point where it was clear what returns distributors would earn and how different variables (for example, a distributor's ratio of operating expenses to sales, or its asset intensity) would affect those returns. Once its benchmarking work is complete, the OECD would produce either a pricing matrix or a mechanical pricing tool to determine distribution returns.

Numerous issues need to be worked through. As drafted, the consultation document contemplates a narrow scope for amount B focused on the wholesale distribution of tangible goods, subject to a number of entity-specific scoping criteria and potential exemptions. Many commentators expressed the need for a broader scope, and it is unclear how broadly amount B will apply. It also remains unclear exactly how amount B will be implemented (for example, through changes to the OECD transfer pricing guidelines or another mechanism) and whether it should operate as a safe harbor, a mandatory pricing mechanism, or a rebuttable presumption.

The devil is in the details with amount B, but the overarching concept — that simple intercompany transactions can be addressed through simplified transfer pricing rules — has

[3] An unfortunate example of cross-pollination is the willingness of some U.S. states to follow the lead of a number of nations in considering unilateral imposition of new gross receipts taxes targeted to digital products providers as a quick-fix alternative to working jointly on their existing tax structures. Between 2020 and 2022, at least 12 states considered legislative proposals for a gross receipts tax, or other new tax type, targeting a product of the digital economy, such as a digital advertising gross receipts tax. (*See, e.g.*, Maryland H.B. 732 (enacted); Connecticut H.B. 6187 and S.B. 821; New York S. 302, S. 1124, and A. 734; Montana H.B. 363; Massachusetts H. 3081, H. 2894, and H. 2928; Louisiana H.B. 612; Texas H.B. 4467; and West Virginia S.B. 605. *See also* taxes on personal data/information sharing (New York A. 946 and S. 3790; Oregon H.B. 2392; and Washington H.B. 1303) or social media provider taxes or fees (Arkansas S.B. 558; Connecticut H.B. 5645; and Indiana H.B. 1312 and H.B. 1572).)

[4] OECD, Pillar One — Amount B (2022).

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merit. This invites the question: If a workable simplification can ultimately be designed at the OECD level, what relevance does that have for U.S. states?

State Transfer Pricing

In fact, workable transfer pricing simplifications could be relevant for all U.S. states that impose a corporate income tax.[5] Of course, transfer pricing is most widely relevant in separate reporting states because in those states, the pricing of any transaction between the taxpayer and an affiliate — domestic or foreign — could affect the clear reflection of the taxpayer's income. In combined reporting states, transfer pricing is irrelevant for some transactions but relevant for others. Transfer pricing is generally irrelevant for transactions between affiliates that are part of the same unitary combined group since these transactions are eliminated or deferred for sales factor and tax base purposes. But when the transaction is with a non-group member that is nonetheless controlled by the same interests for transfer pricing purposes, the pricing has the same potential to affect the taxpayer's income as in separate reporting states. Such "non-group" transactions are not unusual. These could be transactions with non-unitary affiliates or with unitary affiliates that are excluded from the group for any reason — for example, because they are not subject to the state's corporate income tax (for example, an insurance company) or are domiciled beyond the water's edge (in cases in which the taxpayer has not elected to file on a worldwide basis or the state does not allow worldwide combination). Transfer pricing's increasing relevance in the state context is evidenced by the investments both separate and combined reporting states have been making to professionalize their transfer pricing capabilities, including audit and legal staff training and hiring third-party consultants for certain cases.[6]

With increasing audit attention, there is naturally a risk of increasing audit backlog and litigation, which presumably both states and taxpayers would like to avoid. Some increased litigation is likely inevitable, as some transfer pricing matters involve complex fact situations or establishing important legal principles, such as scope of agency authority to adjust prices,[7] applicability of federal section 482 regulations,[8] or the range of potential state remedies.[9] But there is also a fair amount of challenge around precisely the sort of routine pricing issues that the amount B proposal is asserting could be resolved more efficiently.

To be sure, some states have made dispute prevention efforts. However, most of these have been in the form of one-time amnesty programs rather than process improvements or streamlining.[10] A notable exception is Indiana's program for considering advanced pricing agreements, a first of its kind among states that is hampered by the lack of formal APA programs (and thus the availability of bilateral or multilateral state APAs) in other states.[11]

By considering the OECD's amount B proposals, it's possible state agencies and taxpayers may find an opportunity to do more. Benefits could include increased tax certainty, reduced consulting expenses, reduced risk of litigation, and freeing up resources to focus on more complex cases. There would also be some benefit to both state agencies and taxpayers in having the mechanism for updating fixed returns year over year determined in the more abstract context of enacting a statute or promulgating a regulation, outside the context of live litigation. This will be particularly true if

[5] Forty-six states and the District of Columbia impose a corporate income tax.

[6] *See* Amy Hamilton and Andrea Muse, "States Aggressively Contracting With Transfer Pricing Experts," *Tax Notes State*, Apr. 6, 2020. p. 95.

[7] *Maryland Comptroller of the Treasury v. Gannett Co. Inc.*, 356 Md. 699 (Md. Ct. App. 1999).

[8] *Utah State Tax Commission v. See's Candies Inc.*, 435 P.3d 147 (Utah 2018); and *Rent-A-Center East Inc. v. Indiana Department of State Revenue*, 42 N.E.3d 1043 (Ind. Tax Ct. 2015).

[9] *Columbia Sportswear USA Corp. v. Department of State Revenue*, 45 N.E.3d 888 (Ind. Tax Ct. 2015) (review denied, May 2016).

[10] *See, e.g.*, Louisiana Department of Revenue, RIB No. 21-029 Louisiana Transfer Pricing Managed Audit Program (now closed); New Jersey Division of Taxation, Transfer Pricing Initiative (now closed) and North Carolina DOR, Voluntary Corporate Transfer Pricing Resolution Initiative (now closed).

[11] Indiana DOR, Advanced Pricing Agreement Program.

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such fixed returns are coordinated on a multistate basis.

Coordination With Amount B

If the OECD's amount B project succeeds and is adopted internationally, including by the U.S. government, it may provide states with a ready-made model. States could presumably work through the MTC to adopt something similar to the OECD's amount B, including any adjustments to customize amount B for use in the specific context of U.S. states. A state could achieve some benefit even if it were to adopt a particular approach unilaterally, although the administrative efficiencies of uniformity would be lost.[12]

Even if amount B never gains the necessary political traction in the international space, the technical and conceptual work that has been done could still provide a springboard for a state initiative. Yet if the United States does not adopt amount B at the federal level, additional challenges may arise. States that otherwise conform to the federal section 482 regulations could enact statutes departing from that conformity for purposes of applying amount B. If amount B is consistent with the arm's-length principle — as it is intended to be — that departure from the federal approach to implementing transfer pricing would appear noncontroversial. However, if situations arise in which the amount B approach yields a non-arm's-length result, this would call into question the propriety of a state approach that diverges from the arm's-length principle. These difficulties could be mitigated by applying amount B on a safe harbor basis.

In any event, some changes to the design of amount B would be needed at the state level. For one thing, any allowance for variation in amount B returns between geographic markets (for example, Latin America vs. Western Europe) in the OECD project would not be needed in the context of state-to-state transfer pricing within the United States. For another, the consultation draft suggests that amount B may not apply if local comparables are available. In countries like the United States, which have enough public companies for which financial data are available, that exception would seem to swallow the rule, and thus meaningful implementation of an amount B solution on a state level would require application of amount B regardless of the existence of local comparables.

Other changes could be made at the state level to improve on the OECD's amount B. For instance, if the final design of amount B retains the narrow scoping laid out in the consultation document, states could decide to adopt a more broadly applicable approach that would provide certainty for a larger number of cases. States could consider covering other key areas, such as the distribution of digital goods and services.

Further-reaching changes could also be made. The OECD's amount B project is a foray into something new, a test case for simplifying the application of the arm's-length principle to routine cases. As a test case, it is confined in its scope. This makes sense. Disputes around routine marketing and distribution activities arise more frequently than they should, and amount B — if properly designed and implemented — can be impactful in the area set aside for it. But marketing and distribution cases are far from the only transfer pricing controversies generated by routine activities. Headquarters services, for instance, are frequent subjects of dispute as tax authorities question issues ranging from allocation to remuneration to substantiation. Not all those issues are susceptible of resolution in the style of amount B, but some are – and others could be resolved through other forms of multilateral agreement (for example, adoption of a uniform list of items that would be required to substantiate receipt of a beneficial service). If states have interest in simplifying the application of the arm's-length principle to routine cases, they may wish to go beyond the limited scope of amount B in doing so. Using safe harbors could help ensure that simplification measures continue to deliver arm's-length outcomes.

[12] There is no requirement that states coordinate adoption through a model, much less through agreement with other states. Indeed, there are certain interstate agreements that U.S. states could be prohibited from entering by the compact clause of the Constitution (U.S. Const. Art. I, sec. 10, cl. 3).

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Taxpayer Considerations

If appropriately scoped and delineated so that it delivers arm's-length outcomes for taxpayers in a more efficient manner while reducing compliance obligations, adoption of amount B or a similar regime by U.S. states should be welcome news for taxpayers. To the extent taxpayers have similar marketing and distribution activities in many or all states, a streamlined system for determining the returns attributable to those activities would relieve substantial uncertainty and, to the extent the system was uniformly adopted by the relevant states, would reduce the prospect of multiple taxation. Moreover, such a system would deliver states a ready-made pricing mechanism, eliminating the need to rely on outside consultants to create benchmarking ranges aimed at a specific controversy.

Amount B is not yet ready, but it is promising. To the extent that it works, U.S. states should be paying attention. Transfer pricing has become increasingly complex in recent years, and any simplification that can be achieved that is consistent with the arm's-length principle ought to be welcome news for tax administrations and taxpayers alike.[13] ■

[13] 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.

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