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A Simplified Method for Taxing Multinationals for Developing Countries: Building on the 'Amount B' Proposal to Repair the Transactional Net Margin Method

Summary of ICTD Working Paper 108 by Michael C. Durst

The context

The OECD's Inclusive Framework is currently considering two substantial tax reform plans, Pillar One and Pillar Two. These are intended to develop a global consensus on methods for taxing the digitalised economy, but in their current form would have broad implications for international tax architecture in general, and particularly for the control of base erosion and profit-shifting (BEPS).

This brief focuses on one component of Pillar One: Amount B. This would modify the OECD's transfer pricing Transactional Net Margin Method (TNMM), as applied to 'routine' marketing functions of distribution companies. The TNMM, since its inception in 1995, has become central to tax administration in many countries. This is because multinational enterprises (MNEs) commonly establish 'limited risk' subsidiaries in countries where they operate, to perform not only distribution functions, but also manufacturing and service-provider functions. MNEs argue that because subsidiaries incur only limited business risks and perform only 'routine' functions, they should be permitted under the arm's-length standard to earn relatively low profit margins in-country, and to transfer the remainder of their profits, in the form of management fees and other intragroup payments, to affiliates in other countries. The result has been high levels of BEPS.

Tax administrations are supposed to use the TNMM to limit profit-shifting from limited risk subsidiaries, including subsidiaries engaged in distribution, manufacturing and service provision. The tax authority must (i) perform a detailed, case-by-case 'functional analysis' of the controlled subsidiary, and (ii) using information from commercially available financial databases, carry out 'comparables studies' on entities performing similar functions to the controlled subsidiary, ideally in the same country. It must then use statistical analysis to compute an 'arm's-length range' of permissible profit levels, proposing adjustments if reported taxable income falls below the bottom of the range.

How the TNMM has performed in practice

When introduced, the TNMM was intended as a relatively efficient means by which tax administrations could benchmark the incomes of MNE subsidiaries operating in their jurisdictions. In practice, however, the requirement to perform functional analyses has imposed very large personnel burdens on tax administrations, and in many developing countries has been infeasible. Similarly, access to financial databases has proven prohibitively expensive to many developing countries. Even where databases are available, (i) the expertise required to use them may not be available, and (ii) the volume of data available

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is generally insufficient to generate statistically useful estimates of 'arm's length range'. In addition, for technical reasons the TNMM is not capable of controlling taxpayers' intragroup interest expenses, a major source of profit-shifting. The TNMM is therefore often an unsatisfactory tool for transfer pricing compliance even in wealthy countries, and in many developing countries fails in its mission to constrain outbound transfers of income in connection with taxpayers' profit-shifting arrangements.

The Amount B proposal

This would simplify the TNMM as it applies to 'routine' distribution operations of MNE groups, primarily by allowing tax administrations to specify 'fixed returns' for the distribution function. They would therefore not be required to perform detailed comparables searches. The working paper on which this policy brief is based expressed overall support for the Amount B proposal, but also addressed several unanswered questions raised by the proposal. (After publication of the working paper, the OECD released an updated version of its proposal, on which this brief is based.)

Key issues

1. **Who would be responsible for determining 'fixed returns'?** The current proposal would require tax authorities to determine 'fixed returns', presumably by reference to the analysis of comparables, for various categories of distributors, in different geographical locations. This politically sensitive and technically demanding function might be performed by national tax administrations, regional organisations, or global organisations. The question of who would determine fixed returns has not been addressed in detail in OECD discussions released to date.

2. **Might a 'formulary' approach to determining fixed returns greatly simplify the administration of Amount B?** Commenting on an early version of the proposal, two MNEs, Johnson & Johnson and Procter & Gamble, suggested that arm's-length fixed returns might be approximated, without the analysis of comparables, simply by multiplying some fraction of the local distribution company's sales by a fraction (e.g. 25 per cent) of the MNE's global return on sales. This would eliminate the need for a central tax authority to estimate fixed returns based on comparables searches. Despite their potential benefits, however, these proposals have not, at least publicly, been considered in depth by OECD. In view of their potential for greatly simplifying administration, while yielding results similar to those reached under the less-administrable comparables-based approach, the Inclusive Framework should give them serious consideration.

3. **Should the TNMM, as applied under the Amount B proposal, be modified to be effective in controlling related-party interest deductions?** Currently, the TNMM benchmarks a taxpayer's 'operating income', which generally is income *before* interest payments. It is therefore not effective in controlling profit-shifting through interest payments to related parties. This could be remedied if the TNMM were amended to benchmark 'earnings before tax' or a similar measure of income after interest payments. This would render the TNMM much more effective in controlling profit-shifting. The latest version of the Pillar One Blueprint leaves open whether fixed returns will be determined under a before- or after-interest basis; the latter would render Amount B much more useful.

4. **Should the Amount B approach be extended beyond distributors, to also encompass limited-risk manufacturing and service-providing companies?** The TNMM is defective not only in its application to distribution companies, but also manufacturing and service-provider companies. Strong arguments could therefore be made to reform TNMM as it applies to all categories of taxpayers. Against this, however, problems in applying the method to distributors seem especially troublesome to developing countries. Moreover, even applying the 'fixed return' approach only to distributors is likely to require a substantial analytical and rule-making effort. The current blueprint envisions changing TNMM only as it applies to distributors. This incremental approach seems prudent, so long as reforms are later made to TNMM as it is applied to other kinds of taxpayers.

Further reading

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Credits

Michael C. Durst is a long-time tax practitioner based in the USA, an author on international taxation and developing countries, a former government official and law professor, and a Senior Fellow at the International Centre for Tax and Development.

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