Tax Policy Bulletin

A closer look at the simplified and streamlined approach (Amount B)

14 March 2024

In brief

What happened?

The OECD/G20 Inclusive Framework on BEPS (IF), on 19 February 2024, released a report (Report) (and reader's guide) on Amount B of Pillar One, now referred to as the 'simplified and streamlined approach.' The Report introduces two elective options for the transfer pricing of certain baseline wholesale marketing and distribution activities. The Report follows the OECD's previous public consultations in July 2023 and December 2022 (July 2023 Consultation Document and December 2022 Consultation Document, respectively).

The content from the Report has been incorporated as an Annex to Chapter IV of the OECD Transfer Pricing Guidelines (TPG). The IF is developing additional guidance on Amount B with a view to concluding this work by 31 March 2024. Any additions (namely, an optional qualitative scoping criterion) will be incorporated into the TPG at that time. The list of jurisdictions that opt into Amount B within their jurisdictions will be made available on the OECD website.

We focus in particular in this Bulletin on changes from the July 2023 Consultation Document.

Why is it relevant?

Amidst increasing transfer pricing controversy, Amount B aims to promote stability and predictability within the international tax framework. The Amount B mechanism (fixed return) was designed with the goal of being consistent with the arm's length principle (ALP) for baseline marketing and distribution activities. Even if optional, when applied by a low-capacity jurisdiction, the counterparty jurisdiction will generally have to accept it subject, however, to some important caveats.

Under the optional methodology adopted by the IF for the simplified and streamlined approach, companies are unlikely to get the tax certainty that they would under a regime with more uniform adoption across countries. And the returns specified in the pricing matrix may end up serving as benchmarks – e.g., as unofficial floors – in the administration of the ALP even in countries that do not officially adopt the simplified and streamlined approach. It remains to be seen which countries will adopt Amount B. Notably, New Zealand and Australia have already signaled they will not adopt Amount B. What is more, New Zealand has also signaled that it will not respect transfer pricing outcomes under the simplified and streamlined approach implemented by counterparty jurisdictions unless supported by a full-blown analysis under the ALP. The list of concerns raised by India (in footnotes) also signals a certain level of disagreement still present among IF countries. Other design features appear to respond to at least some of the concerns raised during the consultation process. However, the approach still falls significantly short of addressing these in a way that can be expected to deliver on Amount B's primary objectives – administrative simplification and tax certainty.

Action to consider

Taxpayers with distributors that may fall within scope of the simplified and streamlined approach should start to work through these new rules and analyse how the outcome(s) under this approach compares with their historical policies implemented under a full-blown application of the ALP. Taxpayers will also need to contend with some challenges inherent in the approach – e.g., segmentation of balance sheet items, identification and treatment of ‘pass-through’ expenses, etc. – in order to be prepared as countries adopt these rules. The broad sweep of Amount B covers a large range of industries, including consumer goods, alcohol and tobacco, construction, vehicles, IT hardware, software and components, textiles, machinery and tools, and pharmaceuticals. Most taxpayers within these industries are likely to have related-party distributors that will be impacted.

In detail

Overview

After setting out options for the application of the simplified and streamlined approach, the Report defines qualifying transactions and other scoping criteria. A pricing framework whereby a three-step process determines a return on sales – the default net profit indicator (NPI) – for in-scope distributors is also provided. Finally, the Report provides guidance on documentation, transitional issues, and tax certainty considerations.

Options for application of the simplified and streamlined approach

The simplified and streamlined approach is optional for fiscal years commencing on or after 1 January 2025. If a country chooses to apply it, there are two options: (i) make it binding on all in-scope taxpayers, or (ii) make it a taxpayer-elected safe harbour available when the tested party meets the scoping criteria.

Observation: The optional adoption of Amount B by countries means that taxpayers may face *greater* complexity and uncertainty with respect to the transfer pricing of routine distributors than *before*. Under the current state, a taxpayer can use a uniform benchmarking and compliance approach that complies with the TPG to support its transfer pricing arrangements involving routine distributors around the world as long as those arrangements are governed by a consistent and uniform transfer pricing policy. Such an approach may not work for the taxpayer when dealing with jurisdictions, of which some adopt the simplified and streamlined approach while others do not (and some, like New Zealand, categorically reject it).

Transactions in scope and most appropriate method

The Report focuses on the following transactions which appear unchanged from the July 2023 Consultation Document: (i) buy-sell marketing and distribution transactions where the distributor purchases goods for wholesale resale; and (ii) sales agency and commissionaire transactions facilitating wholesale distribution (without holding title).

The scoping criteria (Section 3) for qualifying transactions follow the quantitative approach of 'Alternative A' instead of the qualitative approach of 'Alternative B' as set forth in the July 2023 Consultation Document. The Report retains relatively narrow scoping criteria similar to those in the July 2023 Consultation Document:

- The qualifying transaction is to be reliably priced using a one-sided method (e.g., in-scope distributors cannot assume certain economically significant risks or own unique and valuable intangibles), with the distributor/sales agent/commissionaire being the tested party; and
- To be in scope, the tested party is to incur a certain level of operating expenses relative to net revenues on a three-year weighted average basis (a band between 3% and 20-30% has now been established).

Certain activities may exclude a distributor from the scope, such as the distribution of non-tangible (digital) goods or commodities (in addition to all services, digital or otherwise). Non-distribution activities (e.g., manufacturing, research and development, procurement, financing, retail distribution) performed above the de minimis threshold would also exclude a distributor from the scope, unless those activities can be segmented and reliably priced on a separate basis under a general application of the TPG. The de minimis threshold is defined as 20% of net revenues on a three-year weighted average basis. The scope of the guidance is still limited to wholesale distribution of tangible goods and does not include services (including digital services).

While the scoping criteria specified in the Report align with Alternative A in the July 2023 Consultation Document, the Report states that the IF is working on an additional optional qualitative scoping criteria that jurisdictions may choose to apply as an additional step, with work to be completed by 31 March 2024.

As in the July 2023 Consultation Document, there is an exception to the scoping criteria, where the taxpayer (or a taxing authority) can assert the application of an internal comparable uncontrolled price (CUP) method as the appropriate method (under the applicable principles of the TPG) to exclude from the scope of Amount B a transaction that otherwise meets the above scoping criteria.

Observation: While the Report states that the IF is developing optional qualitative scoping criteria, it is unclear what the criteria will be. However, it is very likely that any additional qualitative criteria, which are subjective in nature, will make the approach more difficult to apply – for taxpayers and tax administrations (particularly in low-capacity jurisdictions). All of this is likely to further reduce the intended simplicity and tax certainty under Amount B.

Pricing matrix and adjustment

The pricing matrix (Table 5.1) which establishes the arm's length return for distributors, appears to be consistent with the July 2023 Consultation Document in terms of overall construct. As before, the return on sales is the default NPI mapped across two dimensions – industry grouping and factor intensity. The pricing matrix still has a total of 15 distinct target returns – and some have increased/decreased by a quarter of a percentage point – but the overall range of return on sales remains from 1.5% to 5.5%. In the latest update, industry classifications remain largely consistent with those in the July 2023 Consultation Document, with the exception that three industries (pharmaceuticals, health and wellbeing, and domestic vehicles) have been reclassified from Group 3 to Group 2.

A secondary check, the operating expense cross-check is intended to serve an analogous function to the 'guardrail' based on the Berry ratio discussed in the July 2023 Consultation Document. The cross-check applies a cap-and-collar range based on factor intensity. A tested party's return on operating expenses will first be derived from its return on sales. The operating expense cap-and-collar range will then be established based on Table 5.2 of the Report. If the equivalent return on operating expenses falls within this range, no adjustment is needed. However, if it falls outside the range, the return on sales is adjusted up or down to align with the established cap or collar.

While the current Report no longer includes any modified pricing matrices which would supersede the basic/default pricing matrix as previously proposed, an adjustment based on sovereign credit rating has been retained for ‘qualifying jurisdictions’ that are underrepresented in the global dataset used in the default pricing matrix. Those qualifying jurisdictions have not yet been specified. Specifically, the data availability mechanism adjusts the base return in data-scarce jurisdictions using a formula that includes a jurisdiction-specific risk adjustment based on the country’s sovereign risk rating and the tested-party distributor’s ratio of operating assets to sales.

The overall pricing methodology will undergo a systematic review every five years, with annual updates to the financial data and pricing matrix.

Observation: While the Report notes that the pricing matrix should not represent a ‘floor’ or a ‘ceiling’ for returns to out-of-scope taxpayers, there is a risk that some jurisdictions will view the pricing matrix as an inference that a lower return would not be appropriate. In jurisdictions with elevated credit risk, the potential for higher returns exists. This could imply a material surrender of the taxable base, for example from a principal located in a developed economy (which will generally have to accept Amount B) to a distributor in a low-capacity jurisdiction.

Documentation and transitional issues

As in the July 2023 Consultation Document, the current Report suggests that the local file should contain information to satisfy documentation requirements for the simplified and streamlined approach. This includes: functional analysis to explain the in-scope qualifying transaction delineation; written contracts; transaction-level calculations for revenue, costs, assets; and allocation schedules linking to annual financial statements. However, when the taxpayer seeks to apply the simplified and streamlined approach for the first time, the taxpayer should include in its documentation a consent to apply the approach for a minimum of three years. If a shorter term is needed, the taxpayer should provide an explanation.

The Report states that artificial arrangements aimed at exploiting the simplified and streamlined approach may be subject to increased scrutiny by tax administrations, and jurisdictions may implement specific measures to address these practices.

Observation: There will be an additional compliance burden created by Amount B, not only because of new information to be provided, but also because in-scope companies will need to source new data points for the calculations (e.g., operating assets) and possibly need to segment entity accounts.

Tax certainty and elimination of double taxation

A transfer pricing outcome under Amount B in an adopting jurisdiction will not be binding on a non-adopting counterparty jurisdiction. However, as an apparent benefit to low-capacity jurisdictions the Report describes a commitment from IF members to respect the outcome determined under Amount B when used by a to-be-determined specified list of countries. (Although, as noted below, this is subject to caveats.) This would include taking reasonable steps to relieve double taxation that may arise from the application of the approach by a low-capacity jurisdiction, where there is a bilateral tax treaty in effect. Some IF members may be able to extend this commitment to cases where no bilateral tax treaty exists. India has not agreed to be bound by this commitment because the list of low-capacity jurisdictions has not yet been defined. Once the list is agreed, it will be made available on the OECD website.

If the competent authorities of the relevant jurisdictions reach a mutual agreement procedure (MAP) or bilateral advance pricing agreement (APA) before Amount B is adopted, the MAP or APA will take priority for in-scope transactions. This is an important point to consider for companies in the process of negotiating bilateral APAs or with outstanding MAP disputes.

Observation: The IF has directed the OECD's Working Party 1 to develop appropriate commentaries to accompany the next update of the OECD Model Tax Convention. However, the limited treaty network that some countries have and lack of commitment from others could hamper the resolution of double taxation and the conclusion of competent authority agreements. Moreover, while the protection for low-capacity jurisdictions' choice to apply the rules initially sounds beneficial, that commitment is subject to countries' domestic legislations and administrative practices which may undercut its significance. Other jurisdictions could assert the presence of such legislation or administrative practices to avoid being bound, negating the intended benefit to low-capacity jurisdictions.

Let's talk

For a deeper discussion of how Amount B of Pillar One might affect your business, please contact:

Tax Policy Leadership

Will Morris
United States
+1 (202) 213 2372
william.h.morris@pwc.com

Edwin Visser
Netherlands
+31 (0) 88 7923 611
edwin.visser@pwc.com

Tax Policy Contributors

Kartikeya Singh
United States
+1 (202) 312 7968
kartikeya.singh@pwc.com

Giorgia Maffini
United Kingdom
+44 (0) 7483 378 124
giorgia.maffini@pwc.com

Stewart Brant
United States
+1 (415) 328 7455
stewart.brant@pwc.com