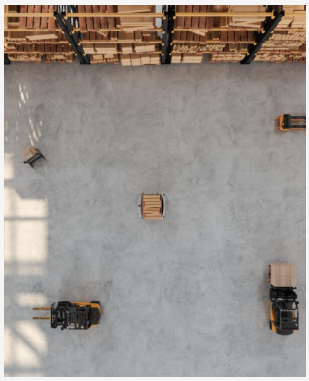
OSLER

OECD releases transfer pricing guidance on a simplified and streamlined approach (Amount B of Pillar One)



FEBRUARY 23, 2024 11 MIN READ

Related Expertise

- International Tax
- Tax
- Tax Advisory Services
- Tax Disputes
- Transfer Pricing

Authors: Patrick Marley, Amanda Heale, Peter Macdonald, Oleg Chayka

On February 19, 2024, the OECD/G20 Inclusive Framework on BEPS (Inclusive Framework) released a report on Amount B (Amount B Report) that provides guidance on the simplified and streamlined approach (SSA) for pricing certain routine, wholesale marketing and distribution transactions (including sales agency and commissionaire transactions). The guidance is incorporated into the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the OECD Transfer Pricing Guidelines) as an Annex to Chapter IV.

Pillar One is part of the OECD's two-pillar initiative and involves two key elements:

- Amount A – reallocation of taxing rights to market jurisdictions where customers are located, allowing these jurisdictions to tax a share of residual profits of in-scope multinational enterprises (MNEs) under a multilateral convention on Amount A (MLC on Amount A)
- Amount B – simplification of the transfer pricing of certain baseline wholesale marketing and distribution activities by providing fixed returns derived from a pricing matrix that is updated from time to time

On July 11, 2023, the Inclusive Framework released a statement (Outcome Statement) indicating its intention for the MLC on Amount A to be signed by the end of 2023. When it became evident that this deadline would not be met, the OECD released a brief statement on December 18, 2023, delaying the anticipated finalization of the MLC on Amount A to March 2024. There is a significant risk that the MLC on Amount A will not be finalized by that deadline, if at all. In particular, the United States has an effective veto over its ratification, and there has been significant political opposition to the proposals in that country.

Unlike Amount A, which requires a separate multilateral convention, Amount B can be implemented through amendments to the OECD transfer pricing guidelines. The Outcome Statement indicated the Inclusive Framework's intention to finalize a report on Amount B and to incorporate it into the OECD Transfer Pricing Guidelines by December 31, 2023. The released Amount B Report missed that deadline but fulfilled the objective.

Impact of the Amount B Report

The SSA is proposed to be optional for jurisdictions; countries can choose to apply it beginning January 1, 2025. Jurisdictions that decide to adopt the SSA may do so on either a mandatory or an elective basis for its taxpayers. That is, a country may implement the SSA as either a simplified transfer pricing method applicable to qualifying transactions or as an effective "safe harbour" for taxpayers that choose to employ the SSA to those transactions. It is possible that further changes could be made to the Amount B guidance. In particular, the U.S. Treasury continues to advocate for the SSA to be mandatory across all jurisdictions.

In its Transfer Pricing Consultation Paper released on June 6, 2023, the Canadian Department of Finance stated that "Canada remains an active participant in [work on Pillar One] and will consider the implementation of Amount B once the proposals are finalised." The draft legislative proposals included in the Transfer Pricing Consultation Paper (which did not address simplified methods) have not been introduced in a bill, and Finance has not yet indicated whether Canada will adopt Amount B on either an elective or mandatory basis.

Qualifying transactions

The following two types of transactions may be qualifying controlled transactions if they meet the scoping criteria:

- marketing and distribution trading transactions where a wholesale distributor purchases goods from related enterprise(s) and on-sells them on a wholesale basis to unrelated persons
- sales agency and commissionaire transactions where a sales agent or commissionaire is involved in a wholesale distribution of goods by one or more related enterprises to unrelated persons

To be eligible for the SSA, a qualifying transaction must also meet additional scoping criteria:

- The qualifying transaction must exhibit economically relevant characteristics so that it can be reliably priced using a one-sided transfer pricing method where the distributor, sales agent or commissionaire is the tested party.
- The tested party must not incur annual operating expenses lower than 3% or greater than an upper bound of between 20% and 30% of the tested party's annual net revenues.
- The tested party must not carry out non-distribution activities in addition to the qualifying transaction, unless the qualifying transaction can be adequately evaluated on a separate basis and can be reliably priced separately from the non-distribution activities.

Consistent with the approach taken in the OECD Transfer Pricing Guidelines to all controlled transactions, the functions performed, assets used and risks assumed by the parties are to be analyzed to determine whether a transaction is in scope, including, notably, whether the marketing and distribution function is sufficiently routine as to be reliably priced using a one-sided method.

Only wholesale marketing and distribution transactions may qualify for the SSA. If a distributor engages in both wholesale and retail distribution, it is deemed to carry out only wholesale distribution provided that the retail activities are *de minimis*, meaning that the three-year weighted average net retail revenues do not exceed 20% of the distributor's three-year weighted total average net revenues.

The distribution of intangible goods and services are specifically carved out from qualifying transactions, as are transactions involving commodities.

While the scope of Amount A is limited to large multinational enterprises with revenues in excess of €20 billion, the Amount B Report does not include any similar limitation. This absence is consistent with the fact that Amount B is a separate transfer pricing initiative that has no direct linkage to, and is not dependent on, Amount A. Amount B can be fully implemented regardless of whether or not an MLC on Amount A ever comes into force.

Method

Under the SSA, the guidance in the Amount B Report provides that the transactional net margin method (TNMM), with return on sales as the net profit indicator, is generally the most appropriate transfer pricing method. The comparable uncontrolled price (CUP) method can also be used in certain situations where it "can be reliably applied and the necessary information is readily available to tax administrations and taxpayers."

Pricing matrix and three-step process

The Amount B Report sets out a pricing matrix that is at the heart of the SSA. The matrix provides pricing outcomes for qualifying transactions, expressed as returns on sales ranging from 1.5% to 5.5%, depending on the "intensity" of certain operating factors and industry groupings.

The Amount B pricing outcomes were determined by analyzing a global dataset of financial information of selected (benchmarked) distributors that conduct relevant baseline marketing and distribution activities. The Amount B Report includes an appendix that describes the benchmarking search criteria. The returns featured in the pricing matrix are meant to approximate arm's length outcomes for qualifying distributors and, accordingly, to simplify and streamline their compliance with the arm's length principle.

The Amount B Report sets out a three-step process to determine the appropriate rate of return for a tested party involved in a qualifying transaction for the relevant year:

- Step 1 – Out of three industry groupings provided, identify the industry grouping(s) of the tested party. (If multiple groupings apply, determine the proportion of sales for each grouping, and use a weighted average if multiple groupings have 20% or more of sales.)
- Step 2 – Out of five "factor intensity" scenarios provided, determine which of the scenarios of the tested party applies based on the party's relative net operating asset intensity and operating expense intensity.
- Step 3 – Identify the range of return on sales provided in the matrix applicable to the intersection of the industry grouping(s) and the factor intensity classification of the tested party.

Placement of the qualifying transaction on the pricing matrix determines whether it falls within the arm's length range of plus or minus 0.5% of the applicable return on sales percentage.

The Amount B Report provides for adjustments to the return on sales determined by the pricing matrix in two circumstances. The first is an "operating expense cross-check," wherein an adjusted return on sales is required if the return on operating expenses of the tested

party falls outside the pre-defined "cap-and-collar" range of operating expenses. The second is a "data availability mechanism," applicable when a tested party is located in a "qualifying jurisdiction" for which no (or insufficient) data are available in the global dataset. In that case, an adjustment to the return on sales is made, in part by reference to the sovereign credit rating of the qualifying jurisdiction. The criteria for "qualifying jurisdictions" are to be set out in a subsequent update to the Amount B guidance.

The return on sales ranges, operating expense cap-and-collar range and "qualifying jurisdictions" will be updated every five years, unless (based on an annual review of the financial data in the global dataset) there is a significant change in market conditions that merits an earlier update. Other data points in the SSA (including those composing the data availability mechanism) will be reviewed and, where necessary, updated annually.

Compliance and documentation

A taxpayer contemplating applying the SSA for the first time must include in its local file (or other relevant documentation) a consent to apply the SSA for a minimum of three years, subject to some exceptions relating to the three-year requirement.

Taxpayers must have sufficient reliable information to enable the tax authorities to audit and assess their eligibility for and application of the SSA, including an explanation of the delineation of the qualifying transaction, relevant contracts, calculations supporting the determination of revenue, costs and assets allocated or attributed to the qualifying transaction, and information and allocation schedules demonstrating how the financial data used for the SSA tie to the annual financial statements.

Dispute prevention and resolution

The fact that jurisdictions may opt out of the SSA gives rise to uncertainties and an inherent risk of double taxation as the outcome under the SSA for a participating jurisdiction is not binding on a jurisdiction that has opted out. The Amount B Report therefore also includes guidance on how potential disputes should be managed and resolved, including through the mutual agreement procedure (MAP) under the relevant double tax treaties, and directs Working Party 1 to develop appropriate conforming text for the Commentary to the OECD Model Tax Convention.

The potential for double taxation and disputes is intended to be reduced for certain "low-capacity jurisdictions" that adopt the SSA. The introduction to the Amount B Report notes that for such jurisdictions, all members of the Inclusive Framework are expected to respect the resulting transfer pricing and relieve any double taxation even if they have not adopted the SSA themselves (subject to "domestic legislations and administrative practices"). No specific guidance or list of low-capacity jurisdictions is included in the Amount B Report; further updates are to be released later this year.

The Inclusive Framework will also consider additional measures to make sure that the outcomes determined under the SSA are respected and double taxation is relieved. The Amount B Report clarifies that any bilateral and multilateral advance pricing arrangement (APA), MAP or other agreement reached before the implementation of the SSA is valid with respect to qualifying transactions, even in jurisdictions where the SSA will be mandatory.

Conclusion

Released shortly after the missed deadline for finalizing guidance on Amount B, the Amount B Report leaves certain work (including the criteria for and lists of low-capacity jurisdictions and qualifying jurisdictions) incomplete, leading India in particular to make certain reservations.

Multinational enterprises with operations in Canada are likely to welcome the introduction of streamlined and simplified transfer pricing methodologies in general and Canada's adoption of the SSA, assuming the streamlined and simplified options are optional.

However, some caution is warranted. The Amount B Report limits the SSA to circumstances where a comparability analysis supports the use of a one-sided transfer pricing method. In practice, there is a risk that this intended simplification exercise will instead shift the emphasis of audit and enforcement activity (and the scope for debate and dispute) away from benchmarking studies and towards the functional analysis required to determine whether the marketing and distribution activities meet the criteria for qualifying transactions. Canada and the other members of the Inclusive Framework should be encouraged to continue all efforts to adopt streamlined and simplified approaches to transfer pricing and to seek to resolve more transfer pricing disputes in a timely and efficient manner.

Further reading

For further details on the OECD's two-pillar approach, progress with finalising Amount A and Amount B of Pillar One, Canada's commitment to Pillar One and recent transfer pricing developments in Canada, please see the Osler Updates on

- October 14, 2020 (blueprint reports on international tax Reform – Pillar One and Pillar Two)
- December 14, 2020 (Osler submission on the OECD Pillar One and Pillar Two blueprints)
- October 12, 2021 (statement on the Two-Pillar Solution)
- December 21, 2021 (draft DST legislation)
- March 28, 2023 (Budget 2023 update on Pillar One and Pillar Two)
- June 12, 2023 (release of consultation paper proposing amendments to Canada's transfer pricing rules)
- July 14, 2023 (subject-to-tax-rule and Canada's position on DST moratorium extension)
- July 31, 2023 (Osler submission on transfer pricing consultation paper)
- August 10, 2023 (draft *Global Minimum Tax Act* (Canada) and revised DST legislation)
- November 21, 2023 (update on the Canada's plans to introduce a digital services tax in Fall Economic Statement 2023)
- December 1, 2023 (Osler legal outlook on how transfer pricing proposals infuse Canada's tax laws with OECD concepts)
- December 4, 2023 (Bill C-59, which includes a revised version of the DST legislation and related regulations)
- December 21, 2023 (OECD releases third administrative guidance on Pillar Two and confirms delay of the Pillar One timeline)