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Pillar One – Amount B

Final report issued by OECD / Inclusive Framework

21 February 2024

Summary

The Organisation for Economic Co-operation and Development (OECD) / G20 Inclusive Framework (IF) issued the report on simplified and streamlined approach, earlier referred to as Amount B, on 19 February 2024. This report, which was an outcome of the two Pillar solution, will now form part of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TP Guidelines) – Chapter IV.

The report is largely on the lines of the public consultation document issued in July 2023 and includes additional guidance for operation of the simplified and streamlined approach ('the approach'). It is optional for Jurisdictions to consider this approach. When adopted in their respective tax regime, it can either be elective – in the nature of a Safe Harbour or prescriptive – mandatory for taxpayers and tax authority to follow the approach for in scope transactions. The approach cannot be considered as the basis to interpret the application of the remainder of the TP Guidelines.

Election of the approach by a jurisdiction cannot be binding on counterparty jurisdiction where the approach has not been adopted. The IF members commit to respect the outcome where the approach has been adopted by a Low-capacity jurisdiction (LCJ) and relieve potential double taxation arising due to adoption of the approach. IF explicitly caveats that the arm's length consideration under this approach does not represent a 'floor' or 'ceiling' for the distribution activities in other cases. IF is working on an additional optional qualitative scope to apply as an additional step to identify baseline distribution activities, which it expects to conclude by March 2024. The IF will agree on the list of LCJ by March 2024. Jurisdictions can apply / implement the approach for fiscal years commencing on or after Jan 2025.

India has made reservations in areas pending finalization such as inclusion of definition of LCJ, political commitment on the approach. India has also made critical reservations to support the approach in the absence of additional qualitative criterion being incorporated in the scoping criteria.

This alert discusses in detail the report on the approach in the ensuing sections.

Qualifying and In Scope Transactions

The Approach is applicable to wholesale distributors, sales agents, and commissionaires involved in the sale of goods, excluding distribution of digital goods, commodities and digital services. Where distributors undertake both wholesale and retail distribution, retail sales should not exceed 20% of the total annual net sales.

Distributors (tested parties) that meet qualifying transactions definition and scoping criteria are eligible under the approach.

Qualifying Transactions

The qualifying transactions under the approach are as follows:

Buy-sell marketing & distribution transactions	Purchasing goods from AE(s) for wholesale distribution to unrelated parties
Sales agency, commissionaire transactions	Contributing to wholesale distribution of goods from AE(s) to unrelated parties

Scoping Criteria

In-Scope

Qualifying transactions will be 'In-scope' if:

1. They can be reliably priced using one-sided transfer pricing method, with the distributors, sales agents or commissionaire being the tested party and the most reliable method for pricing distribution activity should be Transactional Net Margin (TNMM). Exception being where there is availability of reliable internal comparables for the in-scope transactions and comparable uncontrolled price (CUP) method can be adopted as the most appropriate method.

2. Annual operating expenses/Net sales of the tested party is not lower than 3% or greater than the band between 20% to 30%. Jurisdictions can select any point between 20% to 30% while applying the approach in their tax laws. The three-year weighted average ratio is considered while computing the said ratio. The ratio for Year 'y' would be computed based on three-year data prior to the year under consideration:

$$\frac{\Sigma\,(Operating\ Expenses)_{y-3,\ \ y-2\ and\ y-1}}{\Sigma\,(Net\ Sales)_{y-3,\ \ y-2\ and\ y-1}}$$

Out of Scope

Qualifying transactions will be 'Out-scope' if:

1. They are involved in distribution of non-tangible goods, services or commodities.

Commodities may be – renewable / non-renewable physical products primarily derived from earth's crust, land or water (Examples include hydrocarbon, mineral, mineraloid and agricultural product), renewable or non-renewable physical product that has undergone qualifying processing.

2. Tested party undertakes non-distribution activities in addition to qualifying transactions and where either the non-distribution activities and qualifying transactions cannot be evaluated on a separate basis or cannot be reliably priced separately.

   Non-distribution activities include manufacturing, R&D, procurement, financing or retail distribution. The guidance in TP Guidelines are to be referred for allocation of income, expenses and assets and liabilities between distribution and non-distribution segment – Chapter II (TP methods) and VII (intragroup services).

Arm's length consideration

Arm's length price under the approach is captured through 'Pricing Matrix'. The arm's length price ranges in the pricing matrix will be updated once in 5 years, unless in case of significant change in market conditions, where interim updates will be provided. In addition, operating expenses cross-check guardrail and net risk adjustment will have to be factored in for the qualifying jurisdictions.

Pricing Matrix

Pricing Matrix is a translation of arm's length results which is determined from global datasets in a matrix form. Segments of this matrix are Operating asset to sales intensity (OAS), operating expense to sales intensity (OES) and industry. Factory intensity i.e., OAS and OES should be computed using three-year weighted average viz., three years prior to the year under consideration. Industry grouping is as follows:

- Group 1: - Perishable foods, Grocery, household consumables, construction materials and supplies, plumbing supplies and metal.
- Group 2 –IT hardware and components, electrical components and consumables, animal feeds, agricultural supplies, alcohol and tobacco, pet foods, clothing and apparel, textiles, hides, furs, jewellery, plastics and chemicals, consumer electronics and ***products and components not listed in group 1 and 3.***
- Group 3 - medical machinery, industrial machinery including industrial and agricultural vehicles, industrial tools, industrial components miscellaneous supplies.

In determining the arm's length return for the tested party involved in qualifying in-scope transactions a three-step process will have to be followed.

- Firstly, determine the industry grouping. Where more than one industry group exists the weighted average return for the 2 or 3 groupings should be considered. If one of the grouping has greater than 80% sales into a single group, then this industry group should be considered for the entire distribution activities.
- Secondly, determine relevant factor intensity classification of the tested party. There are 5 classifications provided viz., A,B,C,D and E. Accounts payable guardrail will have to be considered

i.e., the accounts payable will have to restated to 90 days credit period, for the purpose of this approach, where the payable days is greater than 90 days.

- Thirdly, identify the arm's length price viz., return on sales %, that corresponds to the intersection of relevant parameters

The pricing matrix derived from the global dataset, as per the document, is as follows:

Industry Grouping / Factor Intensity	Industry Grouping 1	Industry Grouping 2	Industry Grouping 3
[A] High OAS (>45%) and any OES	3.50% +/- 0.5%	5.00% +/- 0.5%	5.50% +/- 0.5%
[B] Med to High OAS (30%-44.99%) and any OES	3.00% +/- 0.5%	3.75% +/- 0.5%	4.50% +/- 0.5%
[C] Med to low OAS (15% - 29.99%) and any OES	2.50% +/- 0.5%	3.00% +/- 0.5%	4.50% +/- 0.5%
[D] Low OAS (<15%) and non-low OES (10% or higher)	1.75% +/- 0.5%	2.00% +/- 0.5%	3.00% +/- 0.5%
[E] Low OAS (<15%) and Low OES (<10%)	1.50% +/- 0.5%	1.75% +/- 0.5%	2.25% +/- 0.5%

Net operating assets for this purpose is tangible assets (property, plant, and equipment net of accumulated depreciation, land and net capital leases) and intangible fixed assets (include all intangible fixed assets, net of accumulated amortisation, but excluding goodwill) plus working capital (stock plus debtors less creditors).

Net expenses are total costs excluding cost of goods sold, pass-through costs and costs related to financing, investment activities or income taxes. It should not include any exceptional items that are unrelated to recurring business. Expenses should be quantified as per the applicable accounting standards (i.e., accounting standards permitted in the tested party's jurisdiction).

For net operating assets and operating expenses, the three-year average i.e., three years prior to relevant year, has to be considered for this computation.

In determining whether the qualifying in-scope transactions are at arm's length, the tested party margins should be within the range. If the tested party margins are outside the range, adjustment would be made to bring it to the range.

Operating expense cross-check

A guardrail in the form of operating expenses cross-check, through a cap-and-collar, has been included. For qualifying jurisdictions, the guardrail has been extended. Subsequent to arriving at arm's length consideration as per pricing matrix, the return on operating expense is computed for the tested party. This return is mapped with the prescribed operating expense cap-and-collar range:

Factor Intensity	Default cap rates	Alternative cap rates for qualifying jurisdictions	Collar Rate
High OAS [A]	70%	80%	10%
Med to High OAS **[B], [C]**	60%	70%	
Low OAS **[D], [E]**	40%	45%	

Where the tested party's return on operating expense is outside the range, the return on sales will have to be adjusted until the above return on operating expense reaches cap or collar, as the case maybe.

Country Risk adjustment

Certain jurisdictions have been observed to not have sufficient or to have no data points in the global dataset. For these qualifying jurisdictions, a net risk adjustment is to be applied after the application of the aforementioned steps. Adjusted return on sales is arrived by:

$ROS^{TP} + (NRA^{J} * OAS^{TP})$ where ROS^{TP} is the return on sales of tested party computed after pricing matrix and operating expenses cap-and-collar, NRA^{J} is the net risk adjustment percentage with reference to the sovereign credit rating of the jurisdiction of the tested party and OAS^{TP} is the operating asset to sales intensity of the tested party for the relevant period and should not exceed 85% for computing the adjusted return on sales.

The list of qualifying jurisdictions for operating expenses cap-an-collar and country risk adjustment will be published on the OECD website and periodically updated.

Other Aspects

- **Documentation**: Local file of the distributor opting under the approach should include accurate delineation and detailed functional analysis of the qualified in-scope transactions, calculations and workings to align with pricing approach, etc. Taxpayers and tax administration can also leverage information in Master File to support their position. Once the taxpayer decides to opt under the approach for the first time, it needs to notify the local tax authorities and may need to continue to apply the approach for minimum three years.
- **Transitional Issues**: MNEs may restructure the entities either to opt-in or opt-out from the approach, evaluating its pros and cons. When doing so, the tax authorities have the right to analyse such reorganization in light of OECD guidelines (Chapter IX – Restructuring).
- **Tax certainty**: Taxpayer invoking MAP (mutual agreement procedure) cases should rely on rest of the OECD Guidelines where the relevant jurisdiction has not adopted the approach. Where primary adjustment is on the premise of application of pricing approach by one of the jurisdiction and the counterparty jurisdiction has not adopted the approach, the issue should be resolved by the competent

authorities in light of the guidance in the rest of the OECD Guidelines and request for corresponding adjustment also should be evaluated. Instances where APA or MAP cases have already been settled prior to the adoption of the pricing approach, the agreed terms and conditions to prevail for the covered years. This will ensure uncertainty is not created owing to pricing approach, which is against the premise of the approach.

India

Several reservations were made by India in the report on the simplified and streamlined approach.

- **Qualitative criterion**: India opined that a critical aspect to determine baseline activities is having qualitative criteria. Since the existing report did not include these criteria, India conveyed its inability to support the approach if the same was not included.
- **LCJ**: As LCJ was not defined / listed, India expressed its reservation in any political commitment unless the definition of LCJ is agreed by the IF.
- **Pricing Methodology**: In connection with pricing of baseline activities, reservations by India included exclusion of goodwill from the definition of intangible fixed assets, no requirement of variation band of +/-0/5% to the operating margin in the pricing matrix, use of single commercial database and hence the dataset not being geographically representative, appropriateness of filtering criteria and factor used in the matrix and their categorisation.
- **Operating expenses cross-check**: India is of the view that value created by a distributor is more of a function of sales generated than the operating expenses incurred, and therefore made its reservation. This can be viewed parallel to stand of India to factor in demand side rather than just the supply side. Further, considering that low-income countries would having lower operating costs, as compared to high income countries and hence India argued operating expenses cross-check would not principally meet its objective.
- **Qualifying Jurisdiction**: India made its objection to non-inclusion of definition of qualifying jurisdiction w.r.t. operating expenses cross-check and country risk adjustment.
- **Framework development**: IF is to gather information on practical application of the approach after a period of time. India made a reservation as no details w.r.t. framework has been provided, and the exercise being resource intensive and in light of capacity constrained jurisdictions.

In light of the reservations / objections made, the adoption of the simplified and streamlined approach in the Indian tax laws will have to be awaited. Further points for consideration with regard to adoption of the approach in India Tax laws include current stance of Indian tax authorities to treatment of incurring of 'excessive' AMP/marketing intangible and its preference on use of local database / selection of local comparable companies.

Conclusion and Key Takeaways

The publication of the final report on the simplified and streamlined approach is itself a milestone considering complexity and multi-dimensionality of the topic. Incorporating the approach in the OECD guidelines, post the demerger from the two-pillar approach (referred as 'erstwhile Amount B') is in

alignment with its spirit of effecting administrative procedures aimed to minimize transfer pricing dispute. The approach will become an elective safe harbor w.r.t. the OECD Guidelines, similar to low value adding activities, and thereby providing jurisdictions to decide implementation in their respective tax / transfer pricing regime.

The approach provides a right tool to MNE facing protracted litigation on baseline distribution activities and in applicable cases businesses can be expected to reorganize their structure (including demerger / hive-off) to insulate on transfer pricing disputes. Reorganization should be undertaken optimally as the provisions on restructuring (OECD TP Guidelines - Chapter IX) will be carefully analyzed by the tax authorities.

Considering the quantitative thresholds for applicability adopts data of the previous three years - instead of the relevant / current year, MNEs can be well prepared whether they would be in scope for the relevant year, upfront contemporaneously

One needs to be aware of that no economic adjustments will be available for the tested party distributor while opting for the approach. Further to the returns in the pricing matrix, the other adjustments such as operating expenses cap-and-collar, accounts payable guardrail and country risk adjustment will have an impact on the expected returns

The continuum of the success of the simplified and streamlined approach will depend on the wide adoption of this ‘safe harbour’ by the jurisdictions. Though the quantitative benefits accruing to tax administrations have largely not been arrived at, unlike the two-pillar solution, jurisdictions can be expected to implement the approach as the report issued is post the consensus of the Inclusive framework(exception of India). This may find favour with jurisdictions having marked ‘limited capacity’ with high litigation on baseline distribution activities for implementation in their local tax / transfer pricing laws. Jurisdictions with emerging tax reforms / introduction of tax regime may also consider adoption of the approach.

About us

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Our offering spans the end-to-end Transfer Pricing value chain, including design of intercompany policy and drafting of Interco agreement, ensuring effective implementation of the Transfer Pricing policy, year-end documentation and certification, BEPS related compliances (including advisory, Masterfile, Country by Country report), Global Documentation, safe harbour filing, audit defense before all forums and dispute prevention mechanisms such as Advance Pricing agreement.

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