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PILLAR ONE – AMOUNT B – PUBLIC CONSULTATION DOCUMENT

Comments on Pillar One – Amount B

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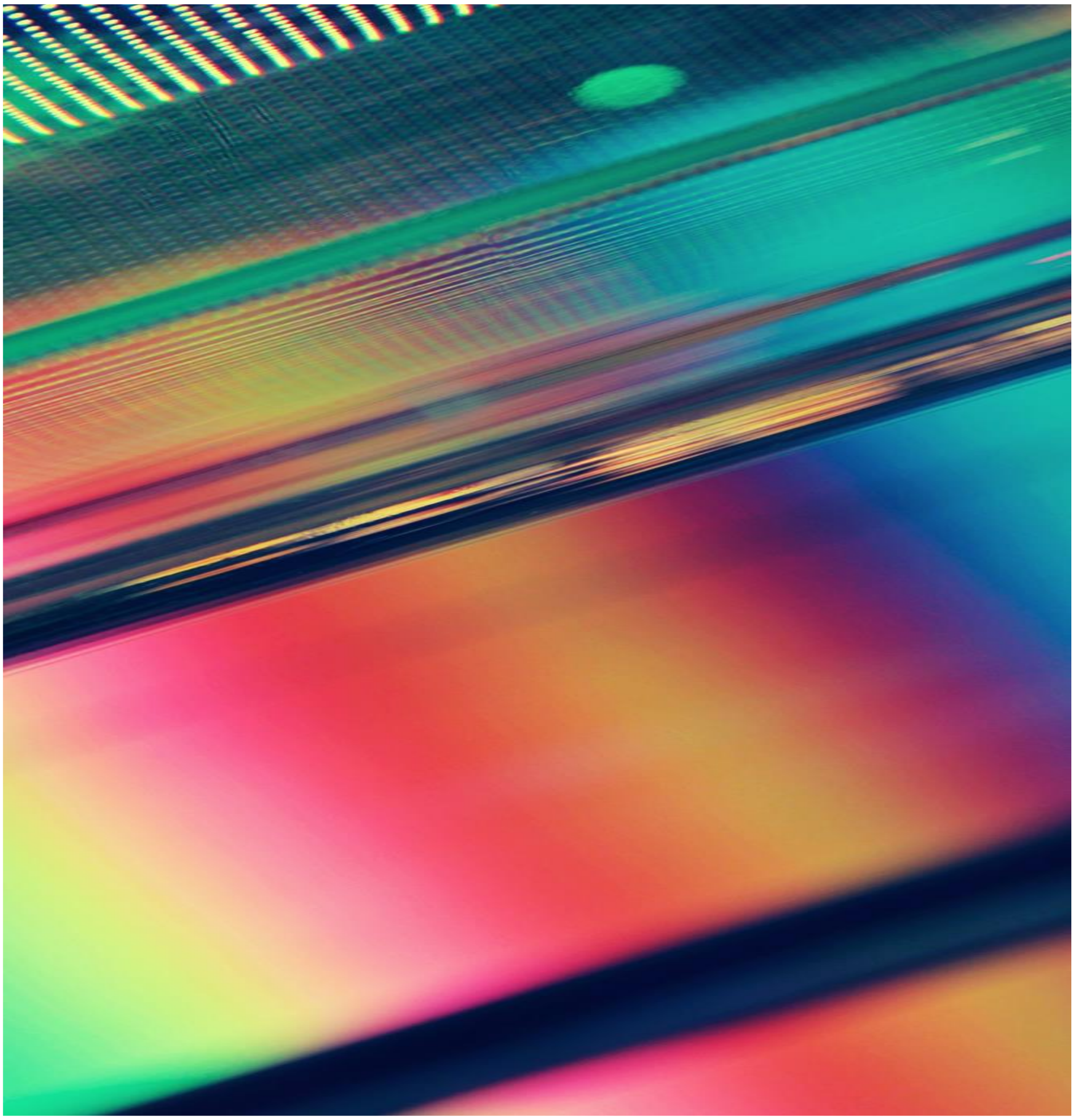

Introduction

Scope of the document

On October 14th, 2020, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (IF) released the report "Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint". The Blueprint stated that Amount B was intended to streamline the process for pricing baseline marketing and distribution activities in accordance with the arm's length principle (ALP), thereby aiming at enhancing tax certainty and reducing resource-intensive disputes between taxpayers and tax administrations. The Blueprint additionally noted that Amount B should address the needs of low-capacity jurisdictions (LCJs).

On October 8th, 2021 the IF agreed a two-pillar solution to address the tax challenges arising from the digitalisation of the economy. The IF Statement described Amount B as one of the components of Pillar One, and mandated Working Party No. 6 and the FTA MAP Forum to undertake the technical work to design Amount B.

Members of the Inclusive Framework have invited input from stakeholders on the elements identified on the Public Consultation Document of July 17th, 2023 (Document), including on the relevant aspects of the design of the scope and pricing methodology, through September 1st, 2023 with the work on those elements to be completed by year end.

General comments

According to the Document, there are two controlled transactions considered qualifying transactions for the simplified and streamlined approach:

1. Buy-sell marketing and distribution transactions where the distributor purchases goods from one or more associated enterprises for wholesale distribution to unrelated parties; and

2. Sales agency and commissionaire transactions where the sales agent or commissionaire contributes to one or more associated enterprises' wholesale distribution of goods to unrelated parties.

Comments on the exclusion of digital goods

According to note number 3, the distribution of digital goods might be an in-scope transaction, while the distribution of digital services is out of the scope (along with other services). In this respect, it would be beneficial to define what means "wholesale distribution" in the digital sector and, in particular, provide a definition of digital goods and digital services. For this purpose, definitions can be derived by referring to the ones provided by EU Directive 2019/770, where digital service has been defined as *"(a) a service that allows the consumer to create, process, store or access data in digital form; or (b) a service that allows the sharing of or any other interaction with data in digital form uploaded or created by the consumer or other users of that service*" while a digital content has been defined as "*data which are produced and supplied in digital form*".

That said, digital business companies may be puzzled by the apparent exclusion from the scope of Amount B or by their partial inclusion.

We believe that the best option would be to extend the scope of the simplified and streamlined approach to encompass the distribution of digital goods. We support this conclusion, by highlighting the fact that the functions performed (and generally the main characteristics) by companies involved in the distribution of digital goods are in principle not significantly different from traditional businesses, as they are of the same routine nature and both are easily benchmarked. Differences may be found for instance in (i) inventory levels (so that certain adjustments would inevitably be required in order to take into account differences in inventory assets and the related risk) and (ii) sales functions (where, for instance, in the sale of digital goods, the final customer usually interact using its device rather than receiving support from a physical person).

However, these differences should not be sufficient to exclude *in toto* the distribution activities of digital goods from the scope of Amount B. Moreover, based on our experience, a benchmarking analysis for the distribution of tangible goods has more similarities with an analysis of the distribution of digital goods (potentially not included in the Amount B) than it does with sales agency or commissionaire arrangements (which fall within the scope of Amount B).

Thus, we believe that the simplified and streamlined approach should be extended also to the distribution of digital goods, as this activity can be just as routine in nature and somehow benchmarked as the equivalent of physical goods.

Differences may be more pronounced in the case of digital services and therefore, we believe that in the case of inclusion of digital services within the scope of Amount B, a specific pricing matrix must be considered. We believe that it could be a next step in the scope of Amount B including the distribution of digital services. We feel that a compromise to include them in a near future would be coherent with the OECD Two Pillars approach of tackling the tax complexities arising from the digitalization of the economy.

Comments on the exclusion of retail distributors

In addition to the above, from the review of the different documents published by the IF and submitted for public consultation, we have noticed that the controlled operations carried out by retail distributors are outside the scope of Amount B.

In our experience, it is very common finding retail distributors that only perform this kind of activity, with very limited risk, and normally apply the methodology proposed in this Simplified Approach (the TNMM). In general terms, Tax Administrations tend to accept this methodology as the tested company (the retail distributor) does not have any intangibles or other activities that could impact on the final result. The main discussion is focused on the benchmark and final margin the distributor should be obtaining. This situation also normally ends up in a MAP and/or APA.

As these are simple businesses, we do see a benefit in the inclusion of these distributors in the scope of the document.

The value chain in this case is even more simple than the ones covered in the document as in the cases we consider it would be a manufacturer (entrepreneur) in one country and retail distributors in another jurisdiction. These distributors could act through a store or group of stores.

We consider that a short value chain such as the one mentioned above should benefit from this Simplified Approach, as it is not a complex or sophisticated business where intangibles or different activities could be affected.

Finally, the document should clarify that taxpayers are allowed not to adopt Amount B and use the conventional Transfer Pricing principles based on the ALP.

Comments on Box 2.1 – Alternative A and B

We appreciate that the scoping criteria of Amount B have been broadened (compared to the initial proposal outlined in Paragraph 18, section 3.1 of the previous public consultation document released in December 2022) and at the same time, the amount of information to be collected by the companies has been significantly reduced. The streamlined approach reduces the burden on companies, making it more feasible and encouraging for them to adopt Amount B.

The key open issue regarding scope is whether a separate qualitative scoping criterion is required to identify distributors that make non-baseline contributions which cannot be reliably priced under the pricing methodology.

There are two alternatives for consideration: the first, Alternative A, in the absence of a separate qualitative criterion; the second, Alternative B, in the presence of a separate qualitative criterion.

Below we incorporate our comments with the reasons that lead us to conclude that Alternative A is more appropriate to analyze the controlled operations of wholesale distributors, sales agents, and commission agents.

Comments in favour of Alternative A

We are in favour of the use of objective, quantitative and easily calculable indicators to determine Amount B for the scoping criteria. This approach will minimize disputes as to whether a transaction qualifies as an in-scope transaction, thereby increasing certainty and clarity in the process. Moreover, this will foster a greater sense of fairness and predictability in determining Amount B, benefiting both taxpayers and tax authorities alike.

Considering the above, we believe that the best approach is Alternative A, as it aligns with the objective of simplification, certainty and transparency.

In this respect, we understand that without a qualitative criterion, the number of criteria to identify the in-scope transaction would be extremely reduced and therefore the streamlined approach may lead to a wide pool of transactions, potentially undermining the application of the arm's length principle.

However, it’s important to bear in mind that the introduction of Amount B was intended to simplify transfer pricing procedures for baseline distribution activities. This simplification should reduce complexity, and in doing so, it unavoidably introduces the possibility of distortions that may arise from the broad spectrum of transactions included in the analysis.

Amount B Approach has been defined with strict criteria that try to cover most of the scope of these activities, as it has been performed based on experience. In past years, many MAP’s and APA’s have been devoted to this kind of business, and a lot of time and resources have been spent in these processes; in most of the cases the discussions were very similar and so the final agreements. Amount B intends to avoid these situations and simplify or eliminate these procedures.

Adding a qualitative requirement as proposed by some countries would eliminate most of the advantages Amount B was initially created for and there would not be a substantial difference with the situation we are facing today.

From our perspective, the distortions introduced by the simplified and streamlined approach are minor compared to the potential burdens and uncertainty of introducing a qualitative threshold.

Comments regarding Alternative B

The main comment when analysing Alternative B is that it incorporates all the complexity that already exist in the Transfer Pricing Guidelines for the distribution business; it does not add any value in terms of simplification.

As some countries have mentioned, quantitative analysis and the exclusions incorporated in the document should minimize the potential risks. Although this might not be an exhaustive analysis, adding a qualitative analysis would not imply a perfect solution either and it would miss the main object of this document.

Another comment made by the Tax Administrations in favour of Alternative B mentions that the number of APA and MAP would not be higher. Our experience is just the opposite. Most of the MAP in many countries refer to distribution activities so any simplification in this respect would be welcomed. If the Alternative B was implemented, the same discussions we witness today would continue in the future as they would focus on the nature of certain functions and ending up in a MAP.

Finally, there are many comments regarding the potential tax planning opportunities and base erosion. Given the limitations included in the scope, the exclusions agreed, and the pricing matrix, the profits attributed to the distribution activity would be very similar to the situation today. The only advantage of this simplified approach would be avoiding disputes with Tax Authorities, but no changes in the usual transfer pricing policies of international Groups.

The simplified and streamlined pricing approach recognises that operating margins for baseline distributors can vary based on certain factors, and appropriately adjusts returns for differences in operating assets, operating expenses, industry, country, among others. Further, this approach can ensure that a tested party's ratio of operating expenses to sales is broadly within the central tendencies of the global dataset, so that the global dataset may be a reliable basis on which to price the tested party; a similar quantitative criterion could be applied for the tested party's ratio of operating assets to sales.

Further requirements that aim to exclude from scope distributors making "non-baseline" or "above-baseline" contributions are not needed to achieve arm's length pricing and could inappropriately imply that the simplified and streamlined pricing approach establishes a "floor" on all controlled distributor returns.

Comments on Alternative B as an "opting-out solution"

The quantitative criterion, by setting a standard interval ratio between annual operating expenses and annual net sales, intends to exclude from the application of the simplified and streamlined pricing approach tested parties that have unusual operating margins and, consequently, should be subject to a more complex two-sided transfer pricing mechanism.

However, critics from Alternative A argue that the quantitative criterion is not enough to ensure that non-baseline contributions are excluded from scope of the simplified and streamlined pricing approach. In other words, there can be situations where, even though the quantitative criterion is verified, the tested party makes non-baseline contributions to the transaction under analysis and, as such, a more complex two-sided transfer pricing mechanism would be more accurately to determine the price of the transaction in accordance with the arm's length principle.

In this sense, we believe that, in addition to the criteria of Alternative A, the use of the qualitative criterion proposed in Alternative B as opting-out mechanism for tested parties would help to mitigate one of the flaws pointed to the scoping criteria of

Alternative A, without jeopardising the main objectives of Pillar 1, Amount B (simplify the existing transfer pricing rules, increase tax certainty, reduce compliance and administrative costs and assist low-capacity jurisdictions that often suffer from the absence of local market comparables).

In a scenario where this solution would be implemented, tested parties that fall within the quantitative criterion but are still non-baseline distributors would be able to exclude themselves from the simplified and streamlined approach by demonstrating - based on the qualitative criteria foreseen in Alternative B – that they make non-baseline contributions to the transaction under analysis (carrying the relevant burden of prove). In such cases, tested parties would be able to apply two-sided pricing mechanisms that, although complex, would represent more realistically the value added to the chain that they are contributing to.

By transferring the burden of proof to the tested parties, the opting-out mechanism ensures a simple, yet more reliable, scoping strategy without imposing excessive additional compliance and administrative costs to tax administrations.

Hence, in our view, the opting-out solution guarantees a balanced trade-off between reliability and administrability inherent in the arm's length principle, which is in line with the objectives of Pillar 1, Amount B.

Comments on Scoping criteria

With reference to the criteria mentioned in para. 8 let. b) which provides that the tested party's yearly operational costs should not fall below 3% and should not exceed [50%] [30%] of its annual net sales for the qualifying transaction, we propose the inclusion of a specific provision for new market entrants or companies in their initial operating phase (*i.e.,* start-up period).

This provision would recognize that such entities, even though they perform routine functions, may have a higher cost/net sales ratio in light of their start-up nature. Therefore, we would suggest including an ad hoc exemption for such entities.

Comments on Box 2.3 – Administrative simplification

In relation to administrative simplification, which seeks to eliminate from the scope of application transactions in which the distributor's cost base is significantly influenced by the indirect allocation keys and affect its net profit margin, we consider it that, in order to be applied correctly, the following must be taken into consideration:

1. The nature of the costs assumed by the distributor. As indicated in the Transfer Pricing Guidelines, all direct and indirect elements (costs, in this case) related to the controlled party under analysis must be taken into account for the purpose of calculating the net market profit margin, excluding those that affect comparability with uncontrolled transactions.

   Therefore, in the first place, we consider that the simplified administrative approach will only be possible to apply as long as a wholesale distributor, a commission agent or a sales agent is capable of segmenting their financial statements.

   Thus, to calculate the net profit margin in the qualified controlled operation, you must take into account only those elements that are related (directly or indirectly) to your distribution activity.

   Secondly, it should be determined the nature of the cost to consider that it is related to the distribution activity. However, it can be complex for wholesale distributors that perform ancillary functions (for example, the provision of services).

   When we refer to indirect costs related to a related transaction, examples appear such as rents, supplies, personnel expenses, among others. Separating the proportional part of these expenses and allocating it between distribution activities and non-distribution activities can create difficulties for taxpayers. Beyond the fact that reasonable cost allocation criteria should be used (in line with the Transfer Pricing Guidelines), it might be appropriate for the final Amount B document to include some guidelines and examples of what are considered own (direct) costs and indirect of the distribution activity, allocation criteria and (perhaps) attributable quantitative limits.

2. Limit of 30% of indirectly allocated operating costs. Instead of establishing a fixed amount already determined (30% limit), we consider that it would be necessary to assess this percentage limit according to the different types of industry proposed in the Document by the IF.

   Several quantitative limits could be established depending on the industrial profile of the wholesale distributor, sales agent or commission agent, which would be in line with the application of the proposed transfer pricing methodology and even with the points of the range of values of net profit margins and the arm's length principle.

   In relation to the above, in case there are differences between the types of industries mentioned in the Document and, consequently, the operating cost cap would be different, further explanatory detail should be provided and included on these differences and their impact on the cap.

In short, beyond questioning the cost allocation keys, it might be appropriate to analyze their nature and their relationship with distribution operations through a correct segmentation of financial statements based on a functional analysis of the taxpayer.

Comments on Box 4.1 – Determining the arm´s length return under the simplified and streamlined approach

We welcome the proposed simplified and streamlined approach and we consider the approach being proposed achieves its aim of being "simplified" and "streamlined" by providing a pragmatic pricing matrix that addresses economic factors such as geographical differences and lack of data availability. However, we consider certain aspects of the guidance to be vague and we would welcome further clarity on such aspects. Providing such clarity will ensure that the OECD is able to achieve its objective of enhancing tax certainty and reducing resource-intensive disputes between taxpayers and tax administrations. We consider that further clarity is required with respect to the following aspects of the guidance:

1. We consider the definitions of operating asset to sales intensity (OAS) and operating expense to sales intensity (OES) to be broad. We recommend that a more prescribed definition is provided for OAS and OES in order to ensure that the calculation of OAS and OES are not open to the application of significant judgement by a taxpayer and/or tax authority. Additionally, it would be helpful if the OECD could provide comprehensive examples with respect to how OAS and OES should be calculated in practice and what factors should (or should not) be taken into account when calculating OAS and OES.

2. Figure 4.1 and Figure 4.2 consist of "+/- 0.5%" adjustments being applied to the return on sales percentages. The current draft guidance is not clear as to how an adjustment of "+/- 0.5%" should be applied when applying the pricing matrix.

3. The current draft guidance contains a modified pricing matrix for qualifying jurisdictions in section 4.2.1. Paragraphs 60 and 61 seem to suggest that the modified pricing matrix will take into account geographic differences that have been identified in qualifying jurisdictions but the guidance is unclear as to which jurisdictions will fall into section 4.2.1 of the guidance and the materiality of the pricing variance between section 4.2.1 and section 4.1. Furthermore, it is unclear as to whether the guidance in section 4.2.1 and section 4.2.3 is trying to address the same issue with respect to geographical differences or whether section 4.2.1 and section 4.2.3 of the guidance are trying to provide simplified solutions to different issues. We consider that further clarity is required on the distinguishing factors associated with section 4.2.1 and section 4.2.3 of the guidance.

4. The OECD Transfer Pricing definition of Berry ratio is highly subjective where it is defined as *"ratios of gross profit to operating expenses. Interest and extraneous income are generally excluded from gross profit determination; depreciation and amortisation may or may not be included in the operating expenses, depending in particular on the possible uncertainties they create in relation to valuation and comparability"*. Given the very broad nature of the definition, we consider that a more prescribed definition should be provided to ensure that the Berry ratio is computed in a more objective manner that enhances tax certainty and reduces resource intensive disputes between taxpayers and tax administrators in the context of applying the simplified and streamlined approach. Furthermore, comprehensive examples that illustrate the application of Berry ratios will be helpful.

With respect to paragraph 58, we do not share the position taken whereby the tax administration should make reference to the midpoint.

More in detail, we believe that when the margin reported by the taxpayer falls outside the arm's length range resulting from the application of the simplified and streamlined approach, the tax administration should make reference to the nearest edge of the aforementioned range to adjust the margin of the controlled transaction, since any point in the range satisfies the arm's length principle, as provided by the OECD itself in its transfer pricing guidelines (such provision has been also endorsed by certain local tax administrations in local public guidelines such as in Italy).

[4.3] - Corroborative mechanism to address low and high functionality (p.30)

Enhancing Amount B by including a corroborative mechanism is crucial, especially for distributors with low functional activity where the ROS may not be the most appropriate Profit Level Indicator (PLI) able to align transactions value with the arm's length value.

This is the case for sales agents and commissionaires, where they do not take the title of the inventories and do not account for third-party revenues, and therefore the Berry ratio may be a viable alternative. For this reason, we welcome the introduction of the corroborative mechanism based on the Berry ratio.

[4.4] - Periodic updates (p.31)

We believe that the analysis to support the determination of the arm's length range should be updated no more than every three years (instead of every five years).

Indeed, one critical aspect of data analysis is its periodic updating to ensure that the information used remains relevant and reliable. Updating analyses every five years may not be sufficient and may lead to misleading conclusions, especially in those specific sectors that are strongly affected by wide fluctuation of the economic circumstances (e.g. resulting in relevant price volatility).

On the other hand, more frequent updates, such as a three-year reassessment (or less), can help to minimize the impact of outdated data.

Critics may argue that conducting analyses every three years (or less) could be resource-intensive and time-consuming. However, we strongly believe that the benefits outweigh the costs.

In conclusion, we believe that updating data analysis every five years may not be sufficient in a rapidly changing business world.