The Evolution of Transfer Pricing: Understanding the Impact of BEPS 2.0

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Topic 1

BEPS 2.0

- Digitalisation of the global economy has led to significant tax challenges, triggering concerns about fairness and transparency in the global tax architecture.
- It has become quite clear that these challenges could not have been addressed by unilateral measures undertaken by a tax jurisdiction. They have required a coordinated effort for more than 10 years, with G20 countries taking up the cause and tasking the OECD with crafting a package to:

✓ Improve the coherence of tax rules across borders;

✓ Reinforce substance requirements; and

✓ Enhance transparency and certainty.

- On 8 October 2021, nearly 140 countries from around the world rallied behind a historic overhaul of international corporate tax rules, marking a significant milestone in tax reform. The agreement reflects a collective effort to modernise taxation for the digital era and mitigate global tax competition through a 'two pillar' solution.

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BEPS 2.0

- The Organisation for Economic Co-operation and Development's (OECD) Inclusive Framework on Base Erosion Profit Shifting (BEPS) has been continuously evolving to develop an agreement on a two-pillar approach to help address tax avoidance, ensure coherence of international tax rules, and, ultimately, a more transparent tax environment. Today, BEPS 2.0 also looks to address the challenges arising from the taxation of the digital economy.
- The BEPS 2.0 proposals outline a new set of tax rules that are designed to address tax challenges arising from the digitalization of the economy. The proposals have two pillars and six sub-components.
- BEPS 2.0 has two elements:

✓ Pillar One on new nexus and profit allocation rules with the objective of assigning a greater share of taxing rights over global business income to market countries, and

✓ Pillar Two rules on new global minimum tax, approved in December 2021 by 141 jurisdictions participating in the BEPS 2.0 project.

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Pillar One

- Pillar One consists of two main elements, Amount A and Amount B.

- **Pillar 1A** is a new formulaic basis for allocating taxing rights on profits of the largest multinational enterprises. Most multinational enterprises will be outside of the scope of Pillar 1A because at the outset it will only apply to groups with more than Euro 20 billion of annual revenues and group profitability above 10% (the revenue threshold will reduce to Euro 10 billion over time).

- **Pillar 1B is** a new set of rules to standardise the profit margins earned by all group companies engaged in 'baseline marketing and distribution'.

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Pillar One – Amount A

Step 1. Scope determination

1.1. Group revenue and profitability test → 1.2. Limited exclusions

Step 2. Identification of Eligible Market Jurisdictions

2.1. Categorise group revenue and identify applicable source rule → 2.2. Apply the source rule using a 'reliable method' → 2.3. Determine nexus

Step 3. Calculation and Allocation of Profit

3.1. Determine the relevant group profit → 3.2. Allocate a portion of 'excess profit' → 3.3. Adjust for double counting

Step 4. Eliminate double taxation

4.1. Determine RODP for each jurisdiction → 4.2. Allocate relief obligations to jurisdictions → 4.3. Identify relief entities in each relieving jurisdiction

Step 5. Filing obligations, payment and claiming relief

5.1. Streamlined filing obligations → 5.2. Streamlined payment of tax → 5.3. Double Tax Relief process

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Pillar One – Amount B

- On February 19, 2024, the OECD/G20 Inclusive Framework published the report "Pillar One - Amount B" which will introduce a simplified approach to determining arm's length remuneration for transactions involving so-called "*baseline*" marketing and distribution activities.
- The report will be incorporated into the OECD Transfer Pricing Guidelines as an annex to Chapter IV ("Administrative approaches to avoiding and resolving transfer pricing disputes") and will grant jurisdictions the authority to introduce Amount B starting January 2025. A jurisdiction that intends to adopt Amount B may also choose whether to make this approach optional or mandatory for taxpayers.
- As clarified in the report, Amount B will apply to so-called limited risk distributors, agents, and brokers whose activities are of a basic nature and do not contribute "unique and valuable" elements. If retail distribution is also performed, it must be of a residual nature. The report specifies that this simplified approach will not apply to the marketing of intangibles, services, or commodities. Furthermore, the report identifies transactions that can be classified as in-scope, meaning they can be evaluated using a one-sided transfer pricing method (e.g., TNMM). In addition, the report outlines a series of qualitative and quantitative criteria that must be met to fall within the applicability of Amount B.

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Pillar One – Amount B

- From a qualitative perspective, it will be essential to accurately define the transaction to reduce the risk of disputes with tax authorities. Specifically, it requires an assessment of the transaction's characteristics to identify any non-baseline contributions, i.e., high value-added elements, that cannot be separated from the distributive transaction.
- Regarding the quantitative criterion, the tested party in the qualified transaction must not incur annual operating expenses lower than 3% or exceed an upper limit between 20% and 30% of net revenues generated. Entities with indicators outside this range are excluded from the simplified approach.
- After establishing the criteria for defining “qualified” transactions and confirming that the simplified approach can be applied, the report proposes a matrix (“Pricing matrix”) that lists arm's length operating margins.

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Pillar One – Amount B

Industry Grouping	Industry Grouping 1	Industry Grouping 2	Industry Grouping 3
Factor Intensity			
(A) OAS 45% or more, any level of OES	3,50%	5,00%	5,50%
(B) OAS 30% to 44,99%, any level of OES	3,00%	3,75%	4,50%
(C) OAS 15% to 29,99%, any level of OES	2,50%	3,00%	4,50%
(D) OAS less than 15%, OES 10% or more	1,75%	2,00%	3,00%
(E) OAS less than 15%, OES less than 10%	1,50%	1,75%	2,25%

- As evident from the table, a global set of independent comparable entities is proposed, along with the use of various parameters and profit indicators that allow the tested party to be positioned within the matrix.
- To determine the operating margins of the tested party involved in the examined transactions, the tax administration and the interested taxpayer will follow a three-phase process:

✓ The value ranges are divided into three industry sectors (Industry Grouping), specifically identifying three Groups.

✓ Once the Group to which the tested party belongs is identified, two intensity indicators are determined: operating assets/revenue ratio (OAS) and operating expenses/revenue ratio (OES). These classes form five horizontal rows in the matrix linked to the OAS level and the OES level. For classification in classes AC, a high OAS level (over 45%) is used, along with a medium/high level (between 30% and 44.99%) and a medium/low level (between 15% and 29.99%). For classification in classes D and E, a low OAS level (less than 15%) is applied. For classification in class D or E, a low OAS level is then combined with the OES level (if the OES level is low, i.e., below 10%, then class E; if the OES level is not low, i.e., 10% or higher, then class D). Once the values of the two indicators are identified, the corresponding range of the pricing matrix segment that intersects the industry grouping(s) and the classification factors of the tested party can be determined.

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Pillar One – Amount B

- The report proposes simplified solutions for so-called "qualifying jurisdictions."
- The data availability mechanism for qualified jurisdictions aims to enhance the returns of Amount B in jurisdictions with limited data to determine the pricing matrix for Amount B and with sovereign ratings below BBB-.The returns of tested parties operating in these jurisdictions will be increased based on the net risk adjustment percentage (NRA) for a jurisdiction, which ranges from 0.3% to 8.6%, multiplied by the OAS of the tested party (with a maximum cap of 85%).
- Regarding the information that the documentation must contain, it refers to the classic details related to functional analysis, an accurate delineation of the transaction, contracts or written agreements governing the transaction, calculations demonstrating the determination of revenues, costs, and relevant assets allocated or attributed to the transaction in question, and information and distribution schedules showing how the financial data used to assess the applicability of the simplified approach for the transfer pricing method relate to the annual financial statements.
- In conclusion, the report contains a section addressing issues of tax certainty. Firstly, there is a safeguard clause stating that bilateral APAs and MAPs concluded before the introduction of Amount B will remain in effect. Furthermore, it is specified that the result determined under the simplified approach by a jurisdiction that has chosen to adopt Amount B is not binding on the counterpart jurisdiction.
- **In summary, this approach aims to replace traditional benchmark analyses for testing the arm's length nature of "baseline" marketing and distribution transactions, which are characterized by high levels of subjectivity that can easily be contested by auditors. This initiative is intended to help multinational groups achieve greater certainty regarding the arm's length nature of the margins to be realized in the examined transactions.**

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Pillar Two

- Pillar 2 comprises four interlocking rules:

✓ The subject to tax rule (STTR). The STTR will apply a new tax on payments for interest, royalties and a defined set of other payments that are made to group companies that are taxed at a nominal corporate income tax rate applying to those payments of less than 9%. The STTR is only expected to be introduced by developing countries.

✓ The Income Inclusion Rule (IIR). Countries that adopt the Income Inclusion Rule will charge a top up tax on the profits of any direct or indirect subsidiary operations that are in jurisdictions where the group has an effective tax rate of less than a new 15% minimum tax rate (calculated using new rules defined by the OECD) (more details).

✓ Undertaxed Payments Rule ("UTPR"). Countries that adopt the Undertaxed Payments Rule will be able to tax the profits of foreign group companies (including companies domiciled in the ultimate parent location) that are still taxed at less than the new minimum tax rate of 15% (after the application of the STTR and the Income Inclusion Rule) (more details).

✓ Switch-over rule. The switch-over rule, where adopted, will mean that branches are treated in the same way as subsidiaries for countries that apply a branch exemption method (or would be required to do so based on an applicable double tax treaty).

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Pillar Two

- The top-up tax is essentially the difference between the taxes imposed on the group in a specific country and the minimum rate of 15%. The mechanisms for collecting the top-up tax are three:

✓ Qualified Domestic Minimum Top-up Tax (QDMTT): This is levied by a specific jurisdiction where the group's profits are subject to taxation below the minimum rate.

✓ Income Inclusion Rule (IIR): If a jurisdiction has not established a QDMTT, the top-up tax is levied on a group's ultimate parent entity located in that jurisdiction or, if that entity has not implemented an IIR, on the first intermediate entity in the chain that has done so.

✓ Undertaxed Payments Rule (UTPR): This rule applies in the absence of an IIR, distributing the tax burden among various jurisdictions based on substance indicators (like personnel costs and tangible assets).

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Pillar Two

- The priority rules are as follows:
  - If the low-tax jurisdiction has established a QDMTT, it has the primary authority to levy taxes on the low-taxed constituent entities located there.
  - If the jurisdiction has not established a QDMTT, the taxing power shifts to the jurisdiction of the ultimate parent entity (UPE) through the IIR, concerning its low-taxed subsidiaries.
  - If the UPE's jurisdiction has not enacted an IIR, the taxing power passes to the jurisdiction of the first intermediate parent entity (IPE) that has implemented an IIR.
  - Finally, if no jurisdictions have implemented an IIR, the taxing power goes to those jurisdictions that have established the UTPR (i.e. Italy has established its own QDMTT, referred to as the "national minimum tax“)

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Transitional CbCR safe harbour

- The use of the transitional safe harbor requires, as per OECD rules, the fulfillment of at least one of the tests provided therein, namely the transitional de minimis requirement (de minimis test), the simplified effective tax rate requirement (simplified ETR test), or the ordinary profit test (routine profit test).
- The de minimis test is satisfied if the multinational or national group has total revenues of less than €10 million and a pre-tax profit of less than €1 million, or a pre-tax loss (both revenue and profit parameters must be below their respective thresholds).
- The simplified ETR test is satisfied when the multinational or national group presents an effective group tax rate at least equal to the so-called "transitional tax rate" (15% for tax periods starting in 2023 or 2024;16% for tax periods starting in 2025;17% for tax periods starting in 2026)
- The routine profit test is considered passed if the group's pre-tax profit does not exceed the amount of the SBIE concerning entities located in a specific country. Similarly, the routine profit test is considered passed, without the need for calculations, if the group has a pre-tax loss. The rationale of the regulation is to provide specific benefits when there is no excess profit in the tested jurisdiction

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Transitional UTPR safe harbour

- "Transitional UTPR safe harbor," whereby, at the option of the group, the supplementary minimum tax determined with reference to the country of the ultimate parent entity is considered to be zero for 2025 (or 2025/2026), provided that this country has a nominal corporate tax rate of at least 20%.

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Transfer Pricing Implications

- The precise nature and extent of the interaction between Pillar One and Pillar Two, and other tax rules (such as transfer pricing rules and CFC rules), will probably only become clear over time.
- Both Pillar One and Pillar Two effectively prescribe mechanical rules for determining the amounts subject to tax rather than doing so by reference to the arm's length principle, the cornerstone of transfer pricing. So the question arises to what extent the traditional way of doing transfer pricing may be replaced, or at least eroded, by Pillar One and Pillar Two.
- From the OECD's perspective, Amount B is a simplification measure relying on the general principles of the OECD TPG, and not a revision of the principles. That is because, according to the OECD, the Amount B simplified approach approximates an arm's-length outcome that is consistent with general transfer pricing principles.
- Year-end TP adjustments under Pillar Two

- Additional Compliance Burden
- Risk of double taxation
- Monitoring TP and documentation

- Will Amount B eliminate many low-level distribution audits?

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Transfer Pricing Implications

- MNEs need to assess the impact of BEPS 2.0, which is not limited to calculating how much profit could be reallocated (for in-scope entities) under Pillar One to market jurisdictions and the increased liabilities due to the top-up taxes under Pillar Two. On the contrary, it may include considerations of further implications on a company's:

- ➢ corporate structure;
- ➢ value chain;
- ➢ transfer pricing models and reporting;
- ➢ statutory reporting;
- ➢ general tax forecasting and reporting;
- ➢ data systems.

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Strategies and actions for MNEs

- Reorganizing corporate structures and operational alignment: for example, MNEs may consider restructuring their entities to mitigate the exposure to top-up taxes under Pillar Two rules. This may include reviewing operations in low-tax jurisdictions and considering the potential tax burdens deriving from Pillar Two's global minimum tax. Moreover, MNEs in-scope for Pillar One may need to rethink their supply chains to ensure an operational and substantive alignment with new tax rules, especially in markets where they have a significant consumer base or digital operations.
- Transfer pricing strategies: TP models will undoubtedly become more and more complex as a result of BEPS 2.0, particularly with regard to IP and digital products (e.g., software and technology services) and the scrutiny for the transfer pricing practices is likely to increase. Therefore, it could be important to:

➢ proactively engage with governments and policymakers where the MNE operates, to negotiate advance pricing agreements (APAs) and to stay informed of any local implementations of BEPS measures;

➢ ensure that the business is fully prepared for the increased tax transparency standards and reporting obligations, as the compliance requirements will become more stringent under BEPS 2.0. Therefore, systems and processes for financial reporting and tax data collection may need to be enhanced.

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Strategies and actions for MNEs

- Governance, data and compliance: ultimately, the common denominator for the actions that MNEs need to take could be the following:
  - ➢ strengthening tax governance frameworks to ensure that tax planning strategies are aligned with global tax standards. The focus should be on compliance, risk management, and maintaining a good reputation with tax authorities;
  - ➢ invest in enhanced tax reporting and compliance systems to manage new data requirements, including Country-by-Country Reporting (CbCR), as this will help MNEs to remain compliant with the various jurisdictions' requirements (e.g., the data required for BEPS 2.0 compliance may be not readily available, may be fragmented in different systems or may have different granularity, etc.);
  - ➢ seek advisory and legal support to navigate the technical details of BEPS 2.0 implementation.

- In summary, MNEs should proactively adapt their corporate structures, value chains, and transfer pricing strategies to align with the global tax standards under BEPS 2.0. Strengthening governance frameworks and enhancing the reporting systems will be key to ensuring compliance and mitigating the risk of top-up taxes and increased scrutiny.

Panel Discussion

Thank you!

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