HOORAY FOR NEW MATH: IS IT REALLY A SIMPLIFIED TRANSFER PRICING APPROACH FOR 2025?

Author
Michael Peggs

Tags
B.M.A.D.
L.R.D.
Pillar One
S.S.A.
Tangible Property
Transfer Pricing

You can't take three from two
Two is less than three
So you look at the four in the tens place
Now that's really four tens
So you make it three tens
Regroup, and you change a ten to ten ones
And you add them to the two and get twelve
And you take away three, that's nine
Is that clear?

Lehrer, Tom. "New Math." *That Was the Year That Was*, 1965

As promised before the end of 2024, Treasury and the I.R.S. outlined their approach to the codification of Amount B, a component of the O.E.C.D. Pillar One approach[1] ("O.E.C.D. guidance") relevant to controlled distribution transactions of tangible property, in *Notice 2025-04* on December 18, 2024.[2] Taxpayers can elect to use the streamlined, simplified approach ("S.S.A.") for corporate tax years beginning on or after January 1, 2025. The I.R.S. will consider the S.S.A. to be the best method under the Treas. Reg. §1.482-1(c) best method rule if a valid election to apply the S.S.A. has been made. *Notice 2025-04* points out that simplifying measures are not new to regulations issued under Code §482, citing the familiar applicable federal rate ("A.F.R.") available for use in setting an arm's length rate of interest and the services cost method ("S.C.M.") that can be used to price certain types of controlled services transactions.

Notice 2025-04 is a response to the broadening adoption of Amount B by U.S. treaty partners as a near-term political consolation prize to the wider Pillar One transfer pricing reform ambitions of the O.E.C.D. membership and its somewhat skeptical developing country partners. It is not likely that the two-Pillar approach, of which Pillar One is part one of two parts, will become law during the second Trump Administration. From the U.S. perspective, Amount B is a limited-scope practical simplification measure and a way of managing Competent Authority disputes involving relatively straightforward controlled inventory transactions.

---

1 O.E.C.D. (2024), Pillar One - Amount B: Inclusive Framework on BEPS, O.E.C.D./G20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

2 "NOTICE 2025-04: Application of the Simplified and Streamlined Approach under Section 482." Internal Revenue Service. Accessed January 30, 2025.

FROM THE RUINS OF PILLAR ONE EMERGES…

Along with Pillar Two, a series of rules designed to implement a global minimum corporate tax, Pillar One began as a 2019 second-phase of the O.E.C.D./G20 B.E.P.S. transfer pricing initiative to multilaterally change the rules that allocate profit to market jurisdictions in the digital economy and reallocate the right to tax away from countries whose multinationals own valuable intangible property. The Pillar One rules featured three amounts: A, B, and C (C was dropped along the way), that aimed to identify and re-allocate profit of in-scope multinational corporate taxpayers. Amount A uses allocation principles other than the arm's length principle that underlies Code §482, while Amount B applies the arm's length principle in a mechanical way to determine the return to certain qualifying "baseline distributors."

No agreement was reached on Amount A by the O.E.C.D. deadline of June 30, 2024, but work on the relatively less controversial Amount B continued as a substantial guidance report was previously incorporated into the O.E.C.D. Transfer Pricing Guidelines on February 19, 2024. The O.E.C.D. published two supplementary statements to the Amount B guidance on June 17, 2024, and a fact sheet and spreadsheet template to assist with the implementation of Amount B on December 19, 2024. The O.E.C.D. Amount B guidance and the supplementary statements will become part of the proposed S.S.A. regulations by reference.

THE B.M.A.D. TO END ALL L.R.D.'S

To be eligible to apply the S.S.A. as a specified method under the Code §482 regulations, the electing taxpayer must carry on a controlled transaction that is both a qualifying transaction and an in-scope transaction. The S.S.A. defines the terms "distributor," "wholesale distribution," "retail distribution," "core distribution functions," "non-distribution activities," and "baseline distribution." Core distribution functions are those functions typically performed by baseline distributors. Non-distribution activities are activities that are other than wholesale distribution activities, or retail distribution activities accounting for revenue in excess of 20% of entity three-year weighted average net revenues. Examples of non-distribution activities provided in the O.E.C.D. guidance are non-incidental manufacturing, research and development, and procurement or financing.

With these definitions in mind, and following the completion of a functional analysis for the purpose of establishing an understanding of the transaction characteristics, a qualifying transaction is determined as follows:

- A transaction that by reference to the O.E.C.D. guidance involves a distributor that can be selected as the tested party when using a one-sided transfer pricing method. This step accomplishes the qualitative appraisal of the contributions of risk and valuable intangible property to the profitability of the tested party, and the evaluation of the availability of reliable data to use in making these determinations and in calculating a tested party return.
- Other than a transaction involving "the distribution of non-tangible goods, services or the marketing, trading, or distribution of commodities."

- Other than a transaction involving non-distribution activities unless the non-distribution activities can be reliably segmented to obtain reliable financial data directly relevant to the qualifying baseline marketing and distribution activity.
- An in-scope transaction. An in-scope transaction defined as follows:
    - In the case of a U.S. distributor, a transaction carried on between either
        - a related supplier domiciled in a country that has not adopted the S.S.A.[3] and a U.S. distributor that reports an operating expense to sales ratio between 3% and 30%, or
        - a related supplier domiciled in a country that has adopted the S.S.A. and a U.S. distributor that reports an operating expense to sales ratio between 3% and 30%.
    - In the case of a non-U.S. distributor, a transaction carried on between a U.S. related supplier and non-U.S. distributor domiciled in a country that has adopted the S.S.A. that reports an operating expense to sales ratio between 3% and an amount between 20% and 30%.

Consideration of the presence or absence of a controlled tangible property transaction that may qualify to apply the S.S.A. is governed by existing law, as is the economic substance of the activity relevant to the controlled transaction.

Faithful readers will know that *Insights* prides itself on an occasional flash of prescience. You may have heard of a limited-Scope, low-risk or limited-risk distributor or "L.R.D.," an undefined creature of transfer pricing slang that is both well-known and practically problematic. A tax administration's idea of an L.R.D. may not coincide with a taxpayer's understanding of the true taxable meaning of this item of T.P. slang. Enter the proposed "B.M.A.D." or baseline marketing and distribution entity in regulations issued under Code §482 as a defined term by direct reference from O.E.C.D. Guidance.[4] R.I.P. L.R.D.

Finally, note the 'M' in B.M.A.D. is silent in the O.E.C.D. "baseline distribution" terminology. Marketing activities, frequently controversial given their role in creating and popularizing intangible property, are referenced in the O.E.C.D. guidelines definition of "core distribution functions" as "implementing promotional advertising or marketing activities." Differentiating between "good M" and "bad M" for the purpose of identifying a qualifying transaction is accomplished first by the qualitative assessment of functional analysis, and second by the quantitative measure of marketing and advertising expenditure as a component of operating expense intensity.

---

[3] There are seven footnotes beginning "Note by India:" to the Introduction section of the O.E.C.D. guidance that are all critical of the validity of aspects of Amount B.

[4] Michael Peggs and Michael Bennett, "Entering A New Dimension – O.E.C.D. Transfer Pricing Guidance As Hard Tax Law," *Insights* Vol. 10, No. 6, p.17 (2023).

NOW FOR THE EASY PART

Determining whether a transaction is both qualifying and in-scope at this stage might seem neither simple nor streamlined. The remaining steps, however, provide some insight into the motivation of the O.E.C.D. guidance and the notice of proposed regulations under Code §482.

In conventional transfer pricing analysis, the next step would be a search for comparable data, method selection, best method analysis, comparability analysis, and the quantitative application of the selected method. Some inference can then be made about the arm's length return of a distributor in a controlled transaction. The S.S.A. allows taxpayers to opt out of this next analytical step that some taxpayers find to be complicated and costly in terms of compliance.

The I.R.S. and other tax administrations may also skip this step, though there is some variation across countries in the way in which a tax administration can apply Amount B without a taxpayer election. The ability of the I.R.S. to apply the S.S.A. without a taxpayer election will be considered during the drafting of the proposed regulations and through ongoing public commentary and response. Examination disputes and double tax controversy over distribution transactions are the simplification targets of the S.S.A. and of similar legislation or regulations issued by foreign tax administrations.

"Perhaps the most exciting innovation of Amount B is its grant of exemption to properly electing taxpayers and their transfer pricing analysts from the requirement to produce tables, schedules, figures and other such non-streamlined graphics."

Perhaps the most exciting innovation of Amount B is its grant of exemption to properly electing taxpayers and their transfer pricing analysts from the requirement to produce tables, schedules, figures and other such non-streamlined graphics. The S.S.A. references three tables in Section 5 of the O.E.C.D. guidance, and those three tables and their associated eight simple steps along with the choice of one of three possible industry groupings result in a nouveau-arm's length operating margin return for the qualifying, in-scope B.M.A.D. transaction activity. The O.E.C.D. will update the tables and other key data inputs every five years.

THE S.S.A. RECIPE

The how-to of the S.S.A. is outlined in Section 5 of the O.E.C.D. Amount B report. First, an Industry Grouping is chosen from the three lists in the Introduction of the O.E.C.D. guidance. A list of accounting data ingredients in set out as item (v) in the documentation requirements list for the S.S.A. in *Notice 2025-04*.

Using the appropriate operating assets (defined as fixed assets and working capital with a 90-day limit to accounts payable) to net sales ratio (O.A.S. in the table below) and operating expenses to net sales ratios (O.E.S. in the table below), a return on sales percentage (E.B.I.T. as a percentage of net sales) can be identified from the corresponding row and column. Where more than 20% of total B.M.A.D. revenue is derived from more than one industry grouping, a sales-weighted average return on sales should be calculated.

Table 5.1. Pricing Matrix (Return on Sales %) Derived from the Global Dataset[5]

Factor Intensity	Industry Grouping 1	Industry Grouping 2	Industry Grouping 3
[A] High O.A.S. / any O.E.S. >45% / any level	3.50%	5.00%	5.50%
[B] Med/high O.A.S. / any O.E.S. 30% - 44.99% / any level	3.00%	3.75%	4.50%
[C] Med Low O.A.S. / any O.E.S. 15%-29.99% / any level	2.50%	3.00%	4.50%
[D] Low O.A.S. / non-low O.E.S. <15% / 10% or higher	1.75%	2.00%	3.00%
[E] Low O.A.S. / low O.E.S. <15% O.A.S. / <10% O.E.S.	1.50%	1.75%	2.25%

Source: O.E.C.D. Amount B Report, February 2024

An acceptable range of return on sales for the B.M.A.D. lies between the calculated return on sales plus and minus 0.5%.

Next, test your baking with the operating expense cross-check. This step adjusts E.B.I.T. until the B.M.A.D.'s E.B.I.T./operating expense ratio corresponding with its operating asset to sales ratio falls within the minimum ("collar") to maximum ("cap") interval in the table below. The purpose of this adjustment is to truncate the profitability of B.M.A.D.'s with lower than normal operating expense intensity and to increase the return to B.M.A.D.'s with higher than normal operating expense intensity. Readers may recognize this profit level indicator as an expense denominated profit level indicator commonly used in the application of the comparable profits method ("C.P.M.") to services transaction pricing.

Table 5.2. Operating Expense Cap-and-Collar Range[6]

Operating Expense Cap-and-Collar Range			
Factor Intensity	**Default Cap Rates**	**Alternative Cap Rates for qualifying jursdictions**	**Collar Rate**
High O.A.S. (A)	70%	80%	10%
Medium O.A.S. (B+C)	60%	70%	
Low O.A.S. (D+E)	40%	45%	

Source: O.E.C.D. Amount B Report, February 2024

[5] O.E.C.D. (2024), Pillar One - Amount B: Inclusive Framework on BEPS, O.E.C.D./G20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris, p. 27.

[6] *Id.*, p. 29.

The last adjustment is a geographic risk `adjustment and depends on the domicile of the B.M.A.D. in a "qualifying jurisdiction," as defined by the O.E.C.D. in its June 17, 2024 statement.[7] Mexico, Brazil, India, and China are among the countries presently classified as qualifying jurisdictions. The net risk adjustment factor by country credit rating as of the beginning of the relevant fiscal year from the table below is multiplied by the operating assets to sales ratio of the B.M.A.D. and added to the adjusted return on sales to obtain the final result.

Table 5.3. Net Risk Adjustment Percentage to be Applied to the O.A.S. of a Tested Party in Qualifying Jurisdictions[8]

Sovereign Credit Rating Category		Net Risk Adjustment %
Investment Grade	BBB+	0.0%
	BBB	0.0%
	BBB-	0.3%
Non-Investment Grade	BB+	0.7%
	BB	1.2%
	BB-	1.8%
	B+	2.8%
	B	3.8%
	B-	4.9%
	CCC+	5.9%
	CCC	7.5%
	CCC- (or lower)	8.6%

Source: O.E.C.D. Amount B Report, February 2024

For those who don't like to bake from scratch, the O.E.C.D. has released a spreadsheet used to calculate the adjusted return on sales required under the S.S.A.[9] It comes with a disclaimer of liability of the O.E.C.D. to users of the calculation template. A similar disclaimer is expected in the proposed regulations, as the spreadsheet was issued a day after *Notice 2025-04*. Any application of the S.S.A. not in accordance with the regulations and the O.E.C.D. guidance will be treated as an unspecified method and evaluated under the Code §482 regulations.

Helpfully, the S.S.A. anticipates the position of both the supplier and distributor tax jurisdictions in the transfer pricing position of the B.M.A.D. Transfer pricing` positions can often be complicated by different treatment of the same transaction by the relevant tax administrations, causing taxpayers and their advisors to make educated guesses and hedge their positions often by documenting asymmetrically.

---

7 "Statement on the Definitions of Qualifying Jurisdiction within the Meaning of Section 5.2 and Section 5.3 of the Simplified and Streamlined Approach." OECD. Accessed January 30, 2025.

8 *Id.*, p, 31.

9 "Pillar One – Amount B | OECD." OECD. Accessed January 30, 2025.

For anyone who has ever sat through an argument with two or more transfer pricing economists about distribution comparables, the S.S.A. promise of simplification will be meaningful relief.

Whether the S.S.A. remains accessible solely through taxpayer election is a point to watch for in the proposed regulations, and could change the controversy landscape looking ahead. We note that while the narrowed scope for disagreement over the income of a controlled distributor is likely to result in smaller dollar value income adjustments under the S.S.A., this only implies there will be an equal number of lower value double tax issues. Given the time to resolution and cost of engaging in a mutual agreement procedure to eliminate the risk of double taxation, it remains to be seen whether the S.S.A. and its Amount B foreign equivalents will reduce the total global deadweight loss from double tax caused by tax authority controversy over B.M.A.D. returns.

DON'T FORGET TO SHOW YOUR WORK

Specific documentation requirements apply as a result of the election to use the S.S.A. These requirements specifically replace those found in Treas. Reg. §1.6662-6(d)(2)(iii)(B) and (C). Of note is the requirement to include a copy of the intercompany agreement between the related supplier and the B.M.A.D. that has elected to use the S.S.A. This assumes the existence of an intercompany agreement, now in an official way.

"The S.S.A. should not signal to companies that less documentation supporting the existence of the transaction in its actual form is acceptable."

The S.S.A. should not signal to companies that less documentation supporting the existence of the transaction in its actual form is acceptable. This is something that we find companies and their advisors often overlook or ignore in favor of treating transfer pricing as a backward-looking compliance exercise for transactions of settled form and terms. *Notice 2025-04* notes the S.S.A. will not be regarded as the best method if either the taxpayer or the tax administration demonstrates that the comparable uncontrolled price method can be applied more reliably and is instead the best method. Companies must therefore not shortcut transfer pricing method selection and assessment of reliability if an election is made to apply the S.S.A.

The documentation requirement under the S.S.A. and the O.E.C.D. Amount B documentation requirement are similar but not identical, and taxpayers managing global documentation standards should note this point of nuance. As with other transfer pricing documentation, the requirement is that S.S.A. documentation should be present at the time of filing the corporate tax return and provided to the I.R.S. within 30 days following the date of an I.D.R.

Should they appear in the next four years, we expect the proposed regulations to address the question of the application of the S.S.A. across taxation years and across qualifying and in-scope transactions following the receipt of comments. The O.E.C.D. appears to be looking at the same design features, which will help minimize controversy at both the examination and Competent Authority levels.

CONCLUSION AND POSTSCRIPT

Whether transfer pricing analysis and documentation is expected to become simpler for taxpayers as a result of the proposed S.S.A. depends on a taxpayer's facts and circumstances. Taxpayers considering a 2025 election should carefully weigh the

benefits and costs of applying the S.S.A., bearing in mind the state of the law and guidance in the foreign jurisdiction that either supplies the U.S. B.M.A.D. or where the B.M.A.D. purchasing inventory from a U.S. supplier is resident.

An O.E.C.D. January 16, 2025, Pillar One update[10] indicates a remaining lack of consensus on Amount A, ongoing work on finer points of policy design for Amount B, ongoing negotiations concerning the inappropriate outcome of Amount B in the view of certain dissenting jurisdictions, and ongoing efforts to complete the drafting of a multilateral convention to implement Amount A and "a framework for Amount B." Participating countries may view the Pillar One effort as inclusive, but only time will tell whether consensus can emerge. Until then:

> *Hooray for new math*
> *New-hoo-hoo math!*
> *It won't do you a bit of good to review math*
> *It's so simple*
> *So very simple*
> *That only a child can do it!*
>
> Lehrer, Tom. "New Math," *That Was the Year That Was*, 1965

[10] "Pillar One Update from the Co-Chairs of the Inclusive Framework on BEPS," OECD. Accessed January 30, 2025.