vstn Consultancy

Design of Amount B– Pillar One

OECD issues public consultation document

July 2023

Summary

The Organisation for Economic Co-operation and Development (OECD) / G20 Inclusive Framework (IF) has issued a public consultation document on 17 July 2023 providing the scoping framework for Amount B of Pillar One, based on inputs received on the earlier consultation document issued in December 2022. Inputs from stakeholders on the design of scope and pricing methodology are invited by 01 September 2023.

The consultation document provides the scope of base distribution activities under Amount B and the simplified and streamlined pricing approach ("approach") for pricing the qualifying baseline distribution activities for distributors, sales agents/commissionaires. It contemplates two alternatives for qualitative scoping criteria – Alternate A and Alternate B. The arm's length return using the pricing matrix has also been covered in the public consultation document. On approval / adoption of the approach, sections in Amount B public consultation documentation would form part of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TP Guidelines). There is still clarity awaited as to whether Amount B would be a safe habour or would be prescribed.

Currently no monetary thresholds have been prescribed for Amount B, unlike Amount A of Pillar 1 and Pilar 2. Amount B is aimed to provide an arm's length return for undertaking baseline wholesale distribution arrangements i.e., limited or lower functions performed, assets employed and risks assumed by the distributors as compared to its associated enterprises (AEs). The public consultation document is broadly divided into three segments – scoping of qualifying transactions, pricing approach and other aspects. This alert discusses in detail on the public consultation document in the following sections.

Amount B – Transactions in Scope

The simplified and streamlined Approach proposed:

- Applies to wholesale distributors, sales agents, and commissionaires involved in the sale of goods, including the distribution of digital goods(newly included).
- Currently doesn't cover distribution of services, including digital services.
- Requires retail sales should not exceed 20% of the total annual net sales, when Distributors undertake both wholesale and retail distribution.

Amount B covers baseline distribution activities by distributors (tested parties) that meet qualifying transactions definition and scoping criteria.

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

The public consultation document provides for qualifying transactions that are in-scope as well as out-of-scope. The document also contemplates on whether a separate qualitative scoping criteria is required, in addition to the scoping criteria provided to eliminate non baseline contributions from Qualifying transaction, through considering two alternatives. In Alternative A no separate qualitative criteria are considered, while Alternative B considers separate qualitative criteria.

Several reasons for adopting Alternative A – position taken that separate qualitative scoping criteria **will not** improve reliability of Amount B. One, pricing approach recognizing different operating margins for varying operating assets / expenses, industry and country. Two, removal of non-baseline contributions might give a view that Amount B is minimum return for controlled distribution activities. Three, difficulty in defining qualitative test might result in more dispute and uncertainty, against the purpose of Amount B.

Reasons have also been provided for considering Alternative B – position that separate qualitative scoping criteria **will** improve reliability of Amount B. Reasons include non-baseline contributions requiring two-sided approach that may not have been otherwise excluded, quantitative metrics unable to statistically identify and exclude non-baseline contributions, Alternative A can give rise to tax planning opportunity and increase risk of base erosion.

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).

2. Annual operating expenses/Net sales of the tested party is not lower than 3% and greater than 50% (for Alternative B) / 30% (for Alternative A).

   The three-year weighted average ratio is considered while computing the above ratio, since revenue and operating expenses will vary and may result in taxpayer moving in and out of scope. To ensure consistency the three-year average is considered. The ratio for Year 'y' would be computed as:

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

Out of Scope

Qualifying transactions will be 'Out-scope' if:

1. *In Alternative B* – Tested party makes non-baseline contributions to transactions in a certain manner. Since it is not possible to cover various situations exhaustively, the public consultation document has provided certain examples, summarised below:
   - Contributions in the nature of technical or specialised support activities including customization or modification.
   - Non-baseline contributions specific to highly regulated industries

2. They are involved in distribution of services or the marketing, trading or distribution of 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, or commodities as mentioned in the OECD Transfer pricing Guidelines.

3. 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 or does not meet prescribed administrative guardrail.

   Non-distribution activities include manufacturing, R&D, procurement, financing or retail distribution. The administrative guardrail is intended to address scenarios where there is high dependence on allocation keys to apportion costs between distribution and non-distribution segments, and a cap on the annual indirect operating expenses allocated between distribution and non-distribution segments has been prescribed as not exceeding 30% of the total costs incurred for all the activities.

Amount B – Pricing Methodology

Arm's length price under the pricing approach is determined through 'Pricing Matrix'. In the earlier consultation document, the IF provided two options for pricing viz., Pricing Matrix and mechanical pricing tool approach. In this public consultation document, only the pricing matrix has been used. The arm's length price ranges in the pricing matrix and modified approach will be updated once in 5 years, unless in case of significant change in market conditions, where interim updates will be provided. The risk adjustment percentage and Berry ratio cap-and-collar ranges will be updated annually.

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. Industry grouping is based on relationship to level of returns and is as below:

- Group 1 - Statistically significant relationship to lower levels of return. Industries include perishable foods, animal feeds, agricultural supplies, Grocery, household consumables, alcohol and tobacco, pet foods, construction materials and supplies.
- Group 2 – No statistically significant relationship with level of returns. Industries include Domestic vehicles, IT hardware, software and components, electrical components and consumables, clothing and apparel, textiles, hides, furs, jewellery, plastics and chemicals, consumer electronics.
- Group 3 - Statistically significant relationship to higher levels of return. Industries include Medical machinery, pharmaceuticals, medical, industrial machinery/tools/ components, agricultural and used domestic vehicles, motorcycles, vehicle parts.

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, Secondly, determine relevant factor intensity classification of the tested party. There are 5 classifications provided viz., A,B,C,D and E. 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 consultation 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%	**5.25%** +/- 0.5%	**5.50%** +/- 0.5%
[B] Med to High OAS (30%-44.99%) and any OES	**3.25%** +/- 0.5%	**3.50%** +/- 0.5%	**4.50%** +/- 0.5%
[C] Med to low OAS (15% -29.99%) and any OES	**2.75%** +/- 0.5%	**3.25%** +/- 0.5%	**4.25%** +/- 0.5%

[D] Low OAS (<15%) and non-low OAS (10% or higher)	**2.00%** +/- 0.5%	**2.25%** +/- 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%

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 with reference to the midpoint of the range.

Addressing geographical differences

IF had undertaken econometric analysis and differences in geographies have been observed to influence profitability of baseline marketing and distribution entities in a few jurisdictions, for which relevant data is available. Based on this modified approach and adjustment mechanism are set forth to address the differences.

Modified Approach

For certain qualifying jurisdictions (having sufficient local datasets), there are observed differences in the profitability between global dataset and qualifying jurisdictions, a modified pricing matrix has been established. The list of qualifying jurisdictions for the modified approach will be published on the OECD website and periodically updated. The matrix under the modified approach is in the same format as pricing matrix above, and the 3-step process prescribed under the pricing approach will have to be applied for modified approach as well. The datapoints for modified approach matrix have not been provided in the public consultation document.

Adjustment Mechanism

For certain qualifying jurisdictions there is no local data available but there is evidence of country risk in that jurisdiction, which may influence the profitability attributable to baseline distribution and marketing activities. The country's sovereign credit ratings is being used as an approximation for quantifying credit risk. Adjusted return on sales is arrived by:

$UROS^{TP} + (NRA^{J} * OAS^{TP})$ where $UROS^{TP}$ is the unadjusted return on sales of tested party, 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 the adjustment mechanism will be published on the OECD website and periodically updated.

Corroborative Mechanisms

IF considers that there are certain arrangements that may be at risk of being over or under-remunerated for their functions performed under the net profit indicator – return on sales. Hence, a Berry ratio (gross profit to operating expense) cap-and-collar approach is considered as a corroborative test under this pricing approach. The 3-step process to applied under the corroborative mechanism is –

1. Based on the tested party net profitability, in line with the pricing matrix and addressing geographical differences sub-sections, the implied Berry ratio will have to be derived.
2. Test the tested party's berry ratio with the cap-and-collar range. The range prescribed is 1.50 to 1.05.
3. Where the tested party Berry ratio within the cap-and-collar range, no adjustment is required. In case the Berry ratio of tested party is outside the cap-and-collar range, the profitability (return on sales) of the tested party will have to be adjusted to the nearest edge of the cap-and-collar range.

Other Aspects

- **Documentation**: Local file of the taxpayer opting under Amount B should include accurate delineation and detailed functional analysis of the qualified in-scope transaction, 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 adopt Amount B 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 meet or not meet the scoping criteria of Amount B evaluating both the pros and cons. When doing so the transfer pricing implications provided in OECD guidelines (Chapter IX – Restructuring) will have to be considered
- **Tax certainty**: In MAP (mutual agreement procedure) cases where primary adjustments is on the premise of application of pricing approach, the same should be resolved by competent authorities as per the guidance laid down in the respective sections. 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 Amount B.

Key Takeaways and Conclusion

The ongoing work on Amount B is part of the finalization of Amount B by January 2024 for incorporation into the OECD TP Guidelines, as agreed by 138 countries to implement global tax deal on 12 July 2023. With the aim to simplify the application of arm's length principle, the pricing approach indeed presents a practical and a transparent methodology, that can be adopted globally, for pricing of baseline marketing and distribution activities, backed by sophisticated analysis, including econometric analysis.

Amount B can act as inputs to aid risk assessment for tax authorities in various jurisdictions. Adoption of Amount B in tax legislations of all the jurisdictions in letter and spirit by tax authorities is key to ensure its complete success. Amount B can also aid resolving allied issues such as marketing intangible (AMP issue), where the taxpayer undertakes qualifying transaction and satisfies scoping criteria.

It is however to be noted that divergence between countries on their stand on qualitative criteria, that has materialized as Alternative A and B, has to be agreed in spirit by both the sides. This is crucial as a mere paper agreement to push through the Amount B will result in discontented countries applying additional qualitative filters to identify non-baseline contributions during first level of transfer pricing audits, defeating the purpose of Amount B in the first place.

Another aspect to be wary about in this consultation document is the exclusion of distribution of services, including digital services. While it may be easier to delineate non-digital goods and services, discussion on the digital front is a dispute by itself. Moreover, legal positions on whether it is goods or services in certain jurisdictions may differ as compared to the position of Amount B, resulting in divergence in treatment for Amount B purpose and local tax law purpose. It may be another stand-off between countries while agreeing on Amount B in the first place.

Other aspects requiring deliberation include certain costs included on behalf of the AEs that require to be reimbursed at cost and require treatment as pass through costs, making public the detailed search process (including the accept reject matrices) based on which the pricing matrix have been prepared and other softer aspects on implementation.

Amount B is one of few occasions where the OECD itself has pronounced the arm's length price, and considering over 138 countries have pledged their support on Amount B, adequate clarity on all aspects of Amount B could enable a reduction in transfer pricing disputes on baseline marketing and distribution activities. This can result in reduced resources being devoted to transfer pricing litigation both from taxpayer and revenue sides, which can be channelized in other critical areas such as fast tracking of more complex APA and MAP.

About us

VSTN Consultancy Private Ltd is a boutique Transfer pricing firm with extensive expertise in the field of international taxation and transfer pricing.

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.

We are structured as an inverse pyramid where leadership get involved in all client matters, enabling clients to receive the highest quality of service.

Being a specialized firm, we offer advice that is independent of an audit practice, and deliver it with an uncompromising integrity.

Our expert team bring in cumulative experience of over five decades in the transfer pricing space with Big4s spanning clients, industries and have cutting edge knowledge and capabilities in handling complex TP engagements.

Pillar One – Amount B : OECD Public Consultation 2023

Distributors (act as tested parties) - wholesale distributors, sales agents and commissionaires

Distribution to customers except end customers. Retail sales ≤ 20% of total annual net sales

Amount B Applicability:

Baseline distribution activities by distributors that are qualifying transactions and meet the scoping criteria

Qualifying transactions are:

Buy-sell marketing & distribution transactions – Purchase from AEs and sell to unrelated parties.

Sales agency, commissionaire transactions – contribute to wholesale distribution of goods by AEs to unrelated parties

Scoping Criteria

In Scope

- Transactions can reliably be priced using one-sided TP method – TNMM
- 3 year Weighted average of Annual Operating expenses/Net sales not lower than 3% and greater than 50% (for Alternative B) # / 30% (for Alternative A) #

Out Scope

- Under Alternative B - tested party makes non-baseline contributions
- Distribution of services or marketing, trading or distribution of commodities
- Tested party undertakes non-distribution activities, and they cannot be accurately delineated or cannot be reliably priced separately or indirect expenses allocated between segments is more than 30% of total costs for all activities

Pricing of Baseline distribution activities

Pricing Matrix: Arm's length results from global dataset in matrix.

Factor intensities	Industry Group1	Group2	Group 3
Operating Asset intensity (OAS)			
Operating Exp. intensity (OES)			

Geographical differences

Modified Approach: For qualifying jurisdictions@ having observed difference between local datasets and global datasets. Similar matrix will be issued.

@ to be listed in OECD website

Adjustment Mechanism: For qualifying jurisdictions with no local datasets but evidence of country risk. Formula: Unadjusted ROS + (Net Risk Adjust. using sovereign credit rating* OAS of tested party)

Berry Ratio Cap-and-Collar

Tested party's Berry Ratio (gross profit to operating expenses) to be within range of 1.5 to 1.05. Adjustment to net profit until within the range

 # OECD contemplating on two alternative position on qualitative criteria. Alternative A - No separate qualitative review, Alterative B -Separate qualitative review