Tax alert: Public Consultation document – Pillar 1 Amount B

31 August 2023

OECD issued revised proposal on Amount B under Pillar 1 of Public Consultation to streamline the process of pricing baseline marketing and distribution activities in accordance with the arm's length principle ("ALP").

In a nutshell

Amount B under Pillar 1 needs to simplify and streamline the pricing of in-country baseline marketing and distribution activities in line with arm's length principle.

First proposal on Amount B was released in December 2022 for public consultation. With the benefit of comments received on December 2022, further work was done on Amount B and a revised proposal has now been released again for public consultation.

The pricing-matrix approach has been proposed for determining the arm's-length return for in-scope transactions based on industry, geography, and functional and asset intensity of the tested party.

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Executive Summary

The Organization for Economic Co-operation and Development ("OECD") released a public Consultation Document on Amount B of Pillar One on 17 July 2023, in relation to the ongoing G20 project for addressing tax challenges of the digitalization of the economy ("the BEPS project"). The current proposal under Amount B is intended to streamline the process of 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 comments are required to be submitted by 1 September 2023.

Public Consultation Document was first released in December 2022 that required inputs from stakeholders by 25 January 2023. After considering the responses on the first consultation document, the OECD revised the proposal and issued another public consultation document in July 2023 to obtain inputs from stakeholders.

Under the revised proposal for pricing under Amount B with the simplified and streamlined ("S&S") approach, the Transactional Net Margin Method ("TNMM") has been considered as the most appropriate method ("MAM"). Under S&S approach, the pricing-matrix approach has been proposed for determining the arm's-length return for in-scope transactions based on industry, geography, and functional and asset intensity of the tested party.

The aim of the public consultation document released by the OECD in July 2023 is to adopt an Inclusive Framework ("IF") and to publish the much-awaited final report on Amount B by the end of the year. It is to be noted that the IF plans to incorporate the key content of Amount B into the OECD transfer pricing guidelines ("TPG") by January 2024.

Overview

The public consultation document on Amount B has been released with the sole purpose of including the same directly into the OECD TPG in 2024.

The S&S approach proposed under the public consultation document establishes the application of the general principles of the TPG, including but not limited to the scoping criteria for the qualifying transactions viz. baseline distribution activities, the selection of the most appropriate method for the in-scope transactions viz. TNMM and the application of a pricing matrix to determine the arm's length return for in-scope activities.

The consultation document also discusses documentation requirements, transitional issues related to the adoption of Amount B and tax certainty.

Scope of the document

As per the public consultation document, the scope of Amount B would apply / not apply to the following transactions:

In connection with transactions pertaining to sales agency and commissionaire transactions, the associated enterprise and the counterparty must sell the goods directly to unrelated parties without engaging other related parties as intermediaries.

Application of the scoping criteria:

The public consultation document has further provided guidance on the application of the above scoping criteria:

- Accurate delineation of the qualifying transaction is required to be undertaken in accordance with Chapter I of the OECD TPG. MNE Groups are required to determine whether “baseline” activities are undertaken using the scoping criteria set out under Amount B by the OECD.
- The qualifying transaction must exhibit economically relevant characteristics viz. it can be reliably priced using a one-sided transfer pricing method with the simpler party to be tested under the transfer pricing rules.
- A quantitative filter to be applied to specify that the ratio of operating expenses is lesser than 3% and greater than 30%-50% (this is yet to be specified) of its net sales, based on a three-year weighted average.

Application of the most appropriate method for in-scope transactions

The TNMM has been considered the most appropriate method for pricing the qualifying transactions. Where “internal” comparable uncontrolled transactions are available to reliably price the qualifying transactions, businesses and tax authorities may opt to use the comparable uncontrolled price (“CUP”) method.

Pricing methodology

The pricing matrix is the heart of Amount B as it provides the agreed returns on the marketing and distribution activities that are intended to compensate source countries and provide certainty to taxpayers. The consultation document presents the pricing matrix based on return on sales (“ROS”) for Amount B and has two dimensions – industry grouping and factor intensity.

There are three industry groupings and five factor intensity - the matrix segments have been presented according to the operating asset to sales intensity (“OAS”) and operating expense to sales intensity factors (“OES”) and the range is from 1.5% to 5.5%. A tabular representation of the same is provided below for ease of reference.

Industry Grouping Factor Grouping	Industry Grouping 1	Industry Grouping 2	Industry Grouping 3
[A] High OAS / any OES >45% / any level	3.50% +/- 0.5%	5.25% +/- 0.5%	5.50% +/- 0.5%
[B] Med / High OAS / any OES 30% - 44.99% / any level	3.25% +/- 0.5%	3.50% +/- 0.5%	4.50% +/- 0.5%
[C] Med / low OAS / any OES 15% - 29.99% / any level	2.75% +/- 0.5%	3.25% +/- 0.5%	4.25% +/- 0.5%
[D] Low OAS / non-low OES <15% / 10% or higher	2.00% +/- 0.5%	2.25% +/- 0.5%	3.00% +/- 0.5%
[E] Low OAS / low OES <15% OAS / < 10% OES	1.50% +/- 0.5%	1.75% +/- 0.5%	2.25% +/- 0.5%

Further, a Berry Ratio (“BR”) cap and collar approach is applied as a corroborative test and guardrail within which the primary return on sales net profit indicator would be applied.

To apply the pricing matrix to an in-scope qualifying transaction, the tested-party distributor would be mapped to the appropriate target ROS within the pricing matrix based on its industry category and the factor intensity combination.

The basic or default pricing matrix is proposed to be applied for two types of jurisdictions:

a) Jurisdiction that uses a “qualifying local dataset” produced by the relevant tax administration. The methodology for producing the local data set would be similar to the methodology adopted for the global dataset and will be translated into a local pricing matrix that confirms to and supersedes the default pricing matrix; and

b) The second type of jurisdiction is with a sovereign credit rating below BBB. For these jurisdictions, the ROS results of the basic/default pricing matrix can be increased through a formula. This “net risk adjustment” allegedly seeks to accommodate the higher return that an investor would require to invest in a riskier economy.

Documentation

The Consultation Document provides that documentation requirements under Amount B will be included in Chapter V of the current OECD TPG. This approach from the OECD is more flexible than the documentation requirements described in the December 2022 consultation document.

The taxpayer is required to include a consent for applying Amount B for a minimum of three years as part of its local file during the first application. However, the said requirement would not apply where the transactions are no longer in-scope during that period or there is a significant change in the taxpayer's business. Further, the taxpayer is required to notify the tax authorities of the jurisdictions involved in the qualifying transaction of its intention to apply Amount B.

Transitional issues

The consultation document reiterates that MNE Groups are free to organize their business operations as they see fit and tax administrations do not have the right to opine on such matters. However, tax administrations have the right to determine tax consequences of structures resulting from such reorganization and the provisions of Chapter IX of the OECD TPG would apply.

The Consultation Document also notes, where associated enterprises attempt to artificially reorganize their arrangements to derive tax advantages (through application of Amount B), the tax authorities may use targeted approaches to address this concern.

Amount B may also apply to a restructured distributor with built-in losses from prior fiscal years, indicating that the tax treatment of those losses, in particular whether they can be deductible, depends on each jurisdiction's domestic legislation and administrative procedure.

Tax Certainty

According to the IF, competent authorities shall endeavor to resolve mutual agreement procedures (“MAPs”) regarding the application of Amount B. Unfortunately, the IF has not included mandatory binding arbitration in the new consultation document for such Amount B disputes. The document also mentions that any agreement reached under a MAP and advance pricing agreement (“APA”) prior to the adoption of the new S&S approach should prevail in relation to the covered qualifying transactions – this is in order to avoid uncertainty and discussion on already settled disputes.

Observations

The OECD IF has updated the Amount B baseline marketing and distribution return for the sale of goods and the new consultation document sets out a more streamlined proposal. The scoping criteria has been significantly streamlined and the discussion of pricing is much more detailed and includes practical applications for the chosen parameters. The OECD has sought input from the business community and for options, that could be considered and adopted in a number of areas.

As Amount B is not subject to a revenue threshold, it would be widely applicable to a lot of MNE Groups and businesses should consider and evaluate potential impact of Amount B on transactions that are in-scope.