

OECD Releases Pillar One Amount B Consultation Draft

9 December 2022

In brief

On 8 December 2022, the OECD released a [public consultation document on Amount B of Pillar One](#) (the 'Consultation Document'). The Consultation Document sets out the main design elements of Amount B, which aims to standardise the remuneration of related party distributors that perform baseline marketing and distribution activities. The Consultation Document outlines the progress made in defining what in-country baseline marketing and distribution arrangements are, how they may be identified in practice, and subsequently how in-scope arrangements may be priced in accordance with the arm's length principle (ALP). It also identifies areas where further work is being undertaken and seeks input from stakeholders on a number of specific questions.

The work on Amount B is still planned to be completed by mid-2023, coinciding with the planned completion of the work on Amount A of Pillar One. It is (as always) particularly important to note that the proposals outlined in the Consultation Document represent the work of the OECD Secretariat, since the Inclusive Framework (IF) has not yet reached consensus on them. Their basic design may, therefore, be subject to change, unrelated to the consultation process.

Comments on the Consultation Document are due by 25 January 2023. This alert provides a short overview of the proposed rules and some initial observations.

In detail

Overview

The [October 2021 IF Statement](#) described Amount B as one of the components of Pillar One and mandated the OECD's Working Party 6 and the FTA MAP Forum to jointly finalise the technical work on Amount B. The Consultation Document states that Amount B is intended to be a simplification and streamlining measure in applying the ALP based on the guidance provided in the OECD's Transfer Pricing Guidelines (TPG). The Consultation Document also states that Amount B is intended to address concerns of 'low capacity jurisdictions' (LCJs) on the relative unavailability of appropriate local market comparables through which arm's length prices can be established.

The Consultation Document seeks input on four key design elements of Amount B: 1) scope; 2) pricing methodology; 3) documentation requirements; and 4) tax certainty. The implementation framework for Amount B, which the document defines as the “parameters for determining the baseline marketing and distribution activities to which Amount B applies,” will be considered after completion of the design of Amount B.

Section 3 of the Consultation Document outlines the proposed scope of Amount B, which is the intra-group transactions that would be subject to Amount B based on qualitative and quantitative criteria. If the scoping criteria are met and the taxpayer is therefore within the scope of Amount B, the Amount B pricing methodology, as set out in Section 4, would be applied to establish the arm’s length price for the in-scope transaction, subject to potential exemptions currently under consideration. Section 4 describes the relevant aspects of the benchmarking criteria, the net profit indicators and the comparability adjustments that would need to be considered in pricing transactions in scope of Amount B. Sections 5 and 6 discuss the proposed documentation requirements and tax certainty, respectively.

The Consultation Document notes that the IF is currently assessing the appropriateness of different means of implementing Amount B, which could be achieved through the inclusion of the Amount B guidance in the OECD TPG. It also notes that the IF is considering the mandatory or elective nature of Amount B. The IF is also considering the appropriateness of a mechanism to collect information from jurisdictions on the actual application of Amount B to assess its impact and effectiveness.

The Consultation Document presents the technical work undertaken on Amount B to date, and specifically states that it does not represent the final work of the IF.

Observation: The Consultation Document makes clear that work on the technical aspects of Amount B is far from near completion. Further, the Consultation Document notes that the completion of this work will be challenging given the linkages between the different design elements, i.e., the influence of scoping on the pricing methodologies applied.

Observation: Although there were previous suggestions that Amount B would be implemented through inclusion in the TPG, the Consultation Document points out that there is no ‘common view,’ and mentions other options being discussed, including considering whether Amount B should be mandatory or elective. Even if the TPG is eventually the ‘common view,’ the Consultation Document notes a lack of agreement on exactly what aspect of the TPG would implement Amount B, whether it would be through a safe harbour or an interpretation of the ALP.

Observation: Finally, it is worth noting that Amount B was meant to be of particular benefit to taxpayers, because it removed a significant amount of activity from transfer pricing disputes. And it was meant to be of advantage to LCJs because it would guarantee a certain amount of income from baseline activities. However, with the lack of agreement between countries, especially on issues like electivity, and the availability of comparables, once again this area may not fully meet earlier hopes and expectations.

Scope

The Consultation Document gives a general overview of what type of distribution activities it is targeting - specifically, it envisions Amount B as addressing the application of the ALP to certain ‘baseline’ distribution arrangements, which it identifies as “common type[s] of distribution arrangements involving an associated enterprise that distributes on a wholesale basis to third parties goods supplied by an associated enterprise.” The baseline distribution arrangement is contrasted with more complex distribution activities involving distributors assuming economically significant risks with respect to the distribution of products. The Consultation Document indicates that Amount B is focused on baseline distributing activities because of the potential for transaction costs

related to compliance and dispute resolution to be disproportionate to the amount of tax involved. Within these parameters, the relevant in-scope distribution activities that have tentatively been agreed include:

1. Buy-sell arrangements where the tested party (distributor) purchases goods from an associated enterprise (AE) outside of its jurisdiction for wholesale distribution to unrelated parties primarily in its local market; and
2. Sales agency and commissionaire arrangements where the tested party contributes to the wholesale distribution of goods for a related party, subject to whether the tested party exhibits certain economically relevant characteristics subject to the scoping criteria set forth in the Consultation Document (although this category is still under consideration).

When a transaction is of either category, a taxpayer or tax administration will need to review whether the Amount B scoping criteria are met. The Consultation Document sets about a dozen conditions relevant to the scoping criteria, including the necessity of a written contract, requirement that the distributed product be primarily within the market of residence of the distributor, and limitations on return including the percentage of annual net sales and ratio of annual operating expenses over net sales that currently are marked with placeholders for an exact percentage. The distributor also cannot perform any other economically significant activities for which it receives additional arm's length remuneration (i.e., manufacturing, R&D, procurement, and financing), assume any additional economically significant risks, or perform nonroutine sales or marketing activities.

The scoping criteria discussed in the Consultation Document outline the economically relevant characteristics that a controlled transaction should exhibit to be in scope (under the guidance in Chapter I of the OECD TPG). The Consultation Document states that the determination of whether a transaction is or is not within the scope of Amount B is not driven by the adoption of a specific marketing and distribution business model, but primarily by the level and type of functions performed, assets owned, and risks assumed by the parties to the controlled transaction.

Transactions that are covered by a bilateral or multilateral advance pricing agreement (APA) for the period in question between the supplier and the distributor are excluded from the application of Amount B. The IF is also considering an exemption from Amount B for the distribution of commodities and non-tangible goods (e.g., software or digital goods).

The Consultation Document states that the question of establishing the scoping criteria has been extensively discussed by the IF and the results of those discussions are reflected on a tentative basis in this document. Insights are sought from commentators on certain key questions that aim to support the final determination by the IF of the inclusion or exclusion of certain criteria. These questions include whether sales agency and commissionaire arrangements should be within the scope of Amount B (and if so, whether adjustments are necessary to the pricing methodology), whether Amount B scoping criteria could also apply to retail distributors, and whether data derived to determine scoping requirements would simplify or streamline compliance activities.

Observation: The rising importance of accurately delineating intercompany transactions in contracts continues to be evident in the Amount B Consultation Draft. Further, consistent with the principles set forth in the revised TPG, it is clear that the OECD continues to place great emphasis not only on the terms of the written contract but also on the actual conduct of the parties. The Consultation Document grants authority to tax administrations to challenge the application of Amount B when there is a written contract that is inconsistent with the economic substance of the transaction, or when the actual conduct of the parties differs from the written terms. Conversely, tax authorities may assert that a transaction not covered by a written agreement qualifies for Amount B if the scoping criteria are met.

Observation: The appeal of APAs may rise with the specific exemption from the application from Amount B for these qualifying transactions. Such ability to procure certainty and avoid the additional compliance requirements of Amount B may be useful especially when the distribution function is not stand-alone or the pricing methodology

considerations are less clear-cut. Unfortunately, as a practical matter, APAs are a very time-consuming and resource-intensive exercise for both taxpayers and tax administrations, and anecdotal evidence suggests they have become harder to achieve in recent years.

Pricing Methodology

The Amount B pricing methodology is currently based on the Transactional Net Margin Method (TNMM). The data being analysed by the IF for Amount B pricing purposes has drawn upon

BvD Orbis database using search criteria designed to produce a dataset that represents the available population of businesses that undertake wholesale distribution as their majority business activity. The Consultation Document notes that the Amount B pricing methodology is being developed by the IF through an “iterative process” and will be underpinned by a comparables search deploying common benchmarking search criteria, selection and analysis of independent comparables reflecting the scoping criteria as outlined in Section 3 of the Consultation Document.

The IF is considering two exemptions to Amount B. The first is whether the Amount B pricing methodology should not be applied when local market comparables are available to price the transaction. The second exemption under consideration would apply if a method other than the TNMM is the most appropriate method in particular cases. These potential exemptions are discussed in Box 3.2 in Section 3.4.2 of the Consultation Document.

Observation: Such an exemption from, or ineligibility for, Amount B does open the possibility for disagreements around whether such ‘local’ independent companies meet other comparability criteria to constitute true ‘comparables’ for the tested party. Such a disagreement may originate from a taxpayer or a taxing authority depending on the facts of the case.

The Consultation Document states that the pricing methodology will rely on the application of common benchmarking search criteria to identify comparable entities performing baseline marketing and distribution activities drawing upon publicly available corporate financial information. The Amount B pricing methodology will include the common benchmarking, search criteria (outlined in Section 4.2.1) and the economically relevant characteristics that are, observed to correlate with profitability (outlined in Section 4.2.2) to produce either a pricing matrix, or a mechanical pricing tool (outlined in Section 4.2.3).

While the Consultation Document states that in applying the TNMM a net profit indicator of net profit margin (i.e., operating margin or return on sales) is frequently used to determine the arm’s length price of purchases from an associated enterprise for resale to independent customers, it also notes that some IF members have suggested alternative net profit indicators (e.g., berry ratio (ratio of gross profit to operating expenses), operating margin with a berry ratio cap-and-collar (upper and lower limit), return on assets, or a combination of net profit indicators).

The Consultation Document suggests that the TNMM approach could be applied in a manner where it is complemented with an econometric analysis. In particular, with respect to “*the economically relevant characteristics that are observed to correlate with profitability*” (Section 4.2.2), the consultation document discusses the use of “*econometric analysis*” very generally. The aim of the econometric analysis is to identify both macroeconomic and firm-level factors that affect profitability: e.g., geographical region, country-level GDP indicators, asset intensity (operating assets/revenue) and operating expenses intensity (OPEX/revenue).

Despite the pricing methodology being at the centre of whether Amount B will practically work, it is not clear from the Consultation Document which precise econometric methods have been tabled and analysed so far. This implies that an observer will be unable to assess whether the macroeconomic and firm-level factors put forward by the IF have a ‘*sufficiently reliable correlation*’ to the profitability indicators.

Assessing the robustness of any applied empirical method is fundamental because Amount B is likely to be very influential and have very important, practical consequences for business and tax authorities alike. For an assessment of the robustness of such econometric analysis, an observer would need much more information and details than what is available in the Consultation Document, including with respect to:

- Estimators used;
- Approaches to deal with common statistical issues such as the non-linearity of the data and non-normality of the residuals;
- Treatment outliers and influential observations;
- Lack of sufficient data or sample size; and
- Use of inappropriate or inadequate model assumptions.

For example, as discussed in the document, drawing out of sample inference when there is insufficient data or sample size can limit the accuracy and reliability of the inferences and predictions. Nonetheless, preliminary investigations of the dataset could help in correcting some of the bias. For example, a simple analysis of the BvD ORBIS database shows that countries with a small handful of observations systematically display a higher average and mean profitability. Econometric analysis should and can control for this issue, but, from the Consultation Document, we cannot assess whether this type of correction has been carried out.

Observation: So far, the Consultation Document does not include enough detail for stakeholders to assess whether the econometric analysis proposed is a robust approach to identify macro and micro-characteristics that affect the profitability of limited risk distributors. At least a basic description of the methods and their diagnostic statistics should have been discussed in the Consultation Document.

Documentation

Section 5 of the Consultation Document outlines the proposed approach to documentation requirements for Amount B, which build on the existing transfer pricing documentation requirements in Chapter V of the OECD TPG. It is proposed that taxpayers with controlled transactions in scope of Amount B include additional items of information in their local file. This includes: a taxpayer declaration; an explanation on the delineation of the in-scope controlled transaction(s); information necessary to substantiate the scoping criteria; annual financial accounts; an explanation of the pricing methodology; the written contract; a copy of relevant APAs or other relevant tax rulings; and other items.

The Consultation Document notes that the proposed documentation requirements require information which is already requested under the local file described in Annex II to Chapter V of the TPG, which it states should limit the number of new additional items of information to be prepared specifically for purposes of Amount B.

Observation: It is worth noting again, the immense effort/resources that businesses will require to deal with the massive growth in compliance required by Pillars One and Two. It is also important to underline that the fact that the taxpayer has prepared and submitted the above information to the tax administration does not prevent the tax administration from examining the taxpayer's self-assessment on the application of Amount B.

Tax Certainty

With respect to dispute avoidance and dispute resolution, the Consultation Document states that the general expectation is that Amount B will mitigate disputes involving in-scope baseline marketing and distribution

transactions, although it does caution that just like any other transfer pricing matter, the application of Amount B 'requires the exercise of judgement' by both taxpayers and tax administrations. For tools that would resolve any disputes surrounding Amount B, the Consultation Document specifically recognizes the long-standing mechanisms of APAs and Mutual Agreement Procedures (MAP) as valuable to resolve any possible future disputes or any double taxation arising from the application of Amount B. With respect to MAPs, the Consultation Document notes that any existing MAP agreement should prevail over the application of Amount B, but that Amount B guidance should be considered in ongoing MAP cases.

Observation: The Consultation Document highlights the importance of robust and comprehensive documentation as a means to assist tax administrators in both the supplier and distributor countries to achieve a common application of Amount B. Companies should be prepared to incorporate Amount B documentation into their existing transfer pricing documentation and overall compliance procedures. Such documentation should clearly define the functions, risks, and characterizations of entities that are consistent with the intercompany agreements governing such transactions. Further, companies should be prepared to assess consistency of what is reported in the documentation with what is available in the public domain and what evidence of conduct of the parties exists. But, as highlighted in the observation below, comprehensive documentation will unfortunately not guarantee tax certainty.

Observation: While there is an expressed expectation that Amount B will improve tax certainty and reduce disputes, the Consultation Document offers nothing new in terms of dispute prevention or resolution. Disputes regarding whether a transaction involving the performance of marketing and distribution activities qualifies as an in-scope transaction will arise. In these situations, taxpayers are left to avail themselves of existing mechanisms at preventing and resolving disputes (i.e., APAs and MAP). The Consultation Document seeks feedback on whether the current dispute resolution procedures are sufficient, or whether the IF should consider alternative means such as an elective early certainty procedure.

The takeaway

The technical work on Amount B for both scoping and pricing remains ongoing and the outcome of that work as well as inputs from stakeholders will hopefully inform design decisions to be incorporated into an Amount B pricing methodology that achieves its original intended goal of simplification and added tax certainty. While the Consultation Document makes clear that the IF is still grappling with finding a balance between reliability and administrability in the design of these rules, notable progress has been made to date in developing a broad architectural framework for the Amount B pricing methodology. But there remain a number of challenging technical issues to be tackled, and the interaction among the various issues (including both issues that are addressed in the Consultation Document and those that have not yet been fully analysed) makes it challenging to determine the true extent of such progress.

The OECD has a continuing urgency to move the project forward to its estimated completion date in mid-2023, but time will tell how realistic that is. Taxpayers should model the impact of these rules and engage with government and business organisations to achieve more simplicity and manageability in the final set of rules.

Let's talk

For a deeper discussion of how the proposal might affect your business, please contact:

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