Potential updates to the OECD Guidelines that stem from Pillar I - Amount B

Transfer Pricing webinar series: TP Lab

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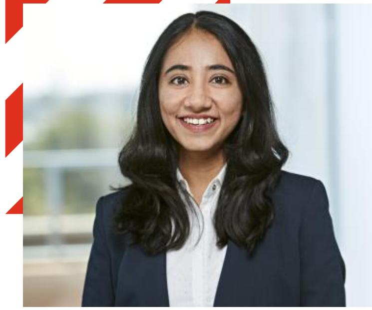

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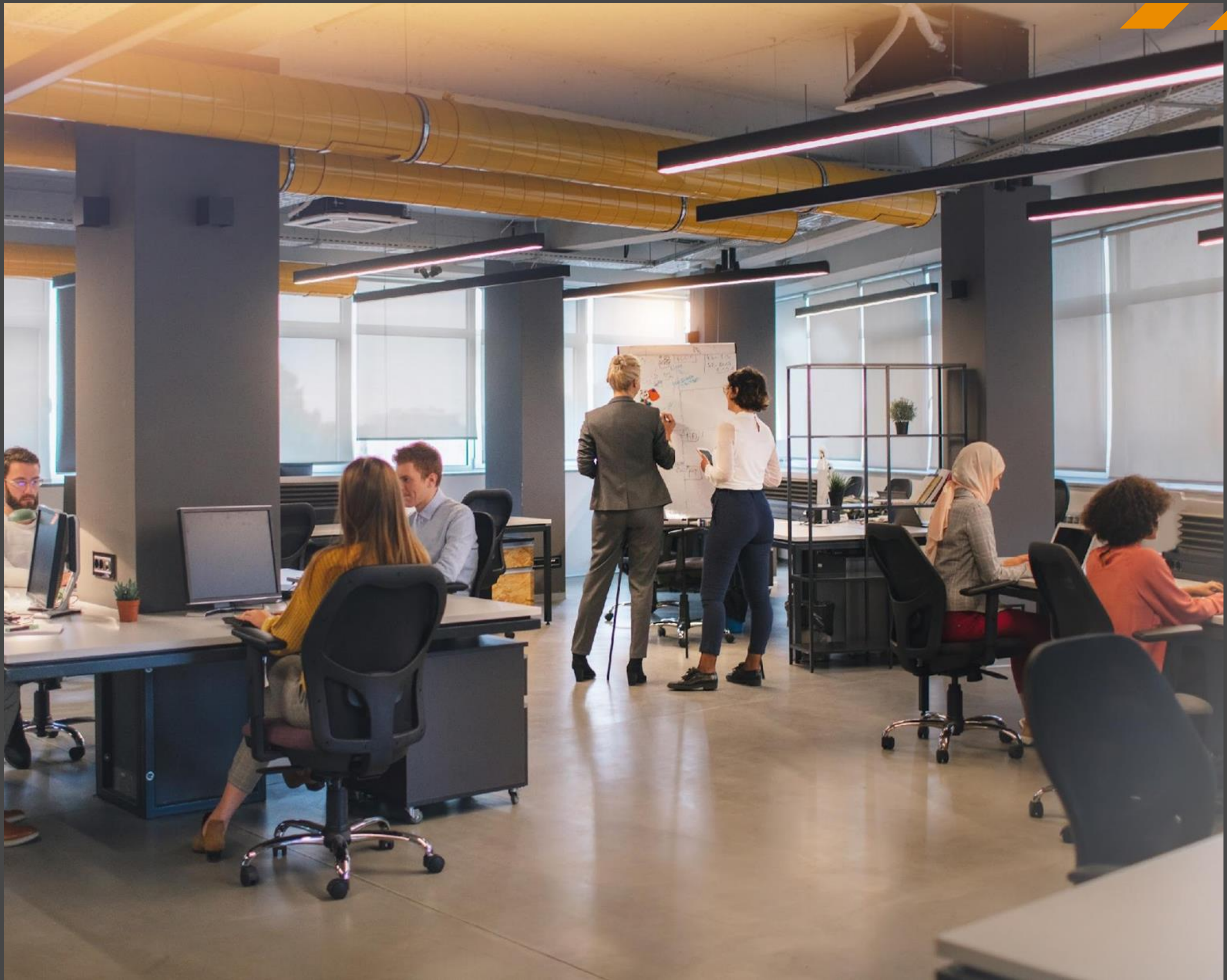
Updates to the OECD Guidelines that stem from Pillar I - Amount B

- What is Pillar I, Amount B?
- The expected impact of the updates to the OECD Guidelines
- How should you prepare?

01

What is Pillar I, Amount B?



Pillar 1 – Amount B

On 17 July 2023, the OECD issued its most recent public consultation document on Amount B, aimed at streamlining the process for pricing "baseline marketing and distribution" activities in accordance with the arm's length principle*.

As part of the above, for defining in-scope distributors for the fixed return envisaged under Amount B, certain scoping criteria / hallmarks have been defined for distributor meriting such fixed returns.

"Core distribution functions"	First-level criteria	Second-level criteria
• Buy-sell marketing and distribution, sales agency and commissionaire activities • Maximum of 20% net revenue from retail distribution	• "Economically relevant characteristics" means the distributor can be tested using a one-sided method • Annual operating expenses between 3% and 30%** of annual net sales	• Non-distribution activities (if any) to be priced separately • Distribution of services, commodities excluded • Makes only "baseline contributions"
	Focus of Alternative A	Focus of Alternative B

*Once final, the guidance is intended to be reflected in the 2024 OECD Transfer Pricing Guidelines.

**While Alternative B focuses on qualitative criteria, it still includes a quantitative criteria of maximum 50% of annual net sales for annual operating expenses.

Pillar 1 – Amount B

High levels of operating expenses may indicate high functional intensity – hence, both alternatives include a scoping criteria of maximum 30% / 50% as annual operating expenses to annual sales, calculated using a three-year weighted average:

	2022	2021	2020
Net Sales	200	150	100
Annual operating expenses	45	40	35
Weighted average opex to sales ratio for 2023		**26.67%**	

In scope as per both alternatives (subject to qualitative conditions)

	2022	2021	2020
Net Sales	200	150	100
Annual operating expenses	70	65	60
Weighted average opex to sales ratio for 2023		**43.33%**	

Out-of-scope as per Alternative A, in-scope as per Alternative B (subject to qualitative conditions)

NB - The current guidance does not clarify the definitions of operating expenses / point towards the accounting standards to define the same.

Pillar 1 – Amount B

Once assessed that the distributors are in-scope i.e., they meet the quantitative and qualitative criteria, the pricing matrix may be applied as shown below, which is derived from a global dataset.

Industry Grouping / Factor intensity	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%

Perishable foods, household consumables

IT hardware, software, electronics, clothing

Pharmaceuticals, industrial components

ROS determined based on industry, operating asset (OAS) and operating expense (OES) intensity

“Qualifying jurisdictions” may design and apply a modified pricing matrix incl. country risk adjustments.

Corroborative mechanism included to adjust pricing in cases of very low or very high functionality, measured by an implied Berry ratio* (1.05 – 1.50)

(*Gross Profit / Operating Expenses)

Pillar 1 – Amount B

Industry Group 2	Distributor A	Distributor B
Revenue	100	100
COGS	80	80
Gross Profit	**20**	**20**
Value added expenses / Operating expenses	5	5
EBIT	**15**	**15**
Operating asset intensity	14%	16%
Position as per pricing matrix	E2	C2
Attributed ROS% as per pricing matrix	**1,75%**	**3,25%**

- A difference of only 2% in the operating asset levels between distributors can cause a difference of 1.5% in the ROS levels attributed
- This is tempered by the corroborative Berry ratio mechanism

Industry Group 2	Distributor A (OAS 14%)	Distributor B (OAS 16%)
Pre-adjustment P&L		
SalesCo Revenue	100	100
COGS	80	80
Gross Profit	**20**	**20**
Value added expenses / Operating expenses	3	3
EBIT	**17**	**17**
Target EBIT to sales %	1.75%	3.25%
Target EBIT after TP adjustment	1.75	3.25
TP adjustment	(15.25)	(13.75)
After TP adjustment		
COGS	95.25	93.75
Gross Profit	4.75	6.25
Berry ratio	1.58	2.08
Berry ratio adjustment		
Cap / collar target Berry ratio	1.5	1.5
Required Gross Profit	4.5	4.5
COGS after further TP adjustment	95.5	95.5
Net Profit after further TP adjustment	1.5	1.5
EBIT margin after further TP adjustment	1.50%	1.50%
Berry ratio after TP adjustment	1.5	1.5

Note: The above illustration is prepared based on inspiration from responses to the OECD's public consultation document.

02

How does it impact you?

Pillar 1 – Amount B

Scope
- No quantitative thresholds of size of MNE Groups (as with Amount A) – leading to a wider broader impact from Amount B.
- Manner of implementation in the OECD Guidelines is yet to be determined – safe harbour vs. mandatory approach.

In-country impact
- While the OECD Guidelines are not codified law (they are "soft law") – tax authorities will most likely look to these rules as guidance in terms of broad concepts.
- In countries where local regulations refer to the OECD guidance, this could become codified law.
- Shift in tax audit focus from benchmarking to functional characterisation / method selection.

Impact of Amount B rules in the OECD Guidance

Wider than 'just TP' impact
- Amount B rules and related mechanisms depend quite heavily on effecting transfer pricing adjustments (preferably through goods).
- Significant spill over impacts on other tax areas such as customs / VAT.

Cross-border impact
- Potentially impacts the manner of interaction between tax authorities themselves, in the cases of MAPs / APAs going forward.
- Mismatches in approaches may occur where one country adopts the rules and the counterpart does not.

03

How should you prepare?

Pillar 1 – Amount B

Assessment

- Intensive data requirements to identify in scope baseline wholesale distributors; or for financial modelling of impact of Amount B rules – involving calculation of multiple ratios at entity / functional level
- Important to identify impact on distribution of system profit (especially in light of specific industry / future projections), ETR, potential interaction with Pillar II efforts, etc.
- Analysis / review of spillover VAT / Customs impact
- Assessment of system readiness to ensure implementation feasibility

Implementation

- Multiple potential implementation issues could be faced (unclear definitions, scoping questions in case of mixed functional profiles, in / out of scope goods, combined wholesale / retail sales, etc.)
- Ensuring alignment of contractual framework
- Clear documentation of analysis regarding Amount B, ensuring updates of regular transfer pricing documentation in light of the Amount B rules (e.g. functional profiles, economic analyses)
- ERP / system requirements to be implemented

Q&A

Thank you!