SOUTH CENTRE

International Environme
House 2
Chemin de Balexert 7-9
POB 228, 1211 Geneva 19
Switzerland
Tel.: +41(0)22 791 80 50

South Centre Comments on Pillar One – Amount B August 2023

I. Background

The South Centre is the intergovernmental organization of developing countries that helps developing countries to combine their efforts and expertise to promote their common interests in the international arena. The South Centre has 55 Member States coming from the three developing country regions of Africa, Asia, and Latin America and the Caribbean. It was established by an Intergovernmental Agreement which came into force on 31 July 1995. Its headquarters are in Geneva, Switzerland.

The South Centre in 2016 launched the South Centre Tax Initiative (SCTI). This is the organization's flagship program for promoting South-South cooperation among developing countries in international tax matters.

The South Centre submits the following comments and recommendations to the OECD Secretariat on Pillar One – Amount B.

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II. General Comments

The work on Amount B addresses an important need of developing countries who continue to face profit shifting from abusive transfer pricing of Multinational Enterprises (MNEs). The African Tax Administration Forum (ATAF) states that its Members, which also include many South Centre Members, report between 30-70% of their transfer pricing disputes in respect of distribution activities, with the key issues being characterization and lack of local market comparables.

In this regard it is welcome that the work on Amount B seeks to address this issue. However, while Amount B does indeed provide a simpler mechanism for determining arms' length return for baseline distribution functions, it comes with major risks for developing countries that should be addressed to ensure the solution results in lower disputes and higher tax collection for Low Capacity Jurisdictions (LCJs) via fixed returns exclusively for baseline distribution functions.

The first major risk of Amount B is that in the name of 'simplicity' it may capture non-baseline distribution functions as well, with the implication that higher-value functions will be given a lower return and deprive LCJs of tax revenues. Alternative B tries to address this risk and is hence more beneficial for developing countries.

The second major risk is that in the name of a 'corroborative' mechanism to address high and low functionality, the dubious test of a Berry ratio cap and collar mechanism will in effect supersede the mechanism of the pricing matrix. Hiding behind seemingly arcane and obscure technicality, this indicator will in a Trojan Horse-like fashion mainly act to reduce the margins and hence tax collection of developing countries. The Berry ratio cap and collar should be completely eliminated from the Amount B mechanism.

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III. Specific Comments and Recommendations

i. Definitions

a. Low Capacity Jurisdictions

This section does not define what constitutes a Low-Capacity Jurisdiction. In the South Centre's previous comments it was highlighted that a low-capacity jurisdiction could imply a jurisdiction with low administrative capacity or a jurisdiction with no local comparable.

Recommendation: In the context of Amount B, the key issue is absence of local comparable data and therefore, the definition of low-capacity jurisdictions should be provided that encompasses the criteria of absence of local comparable data along with other qualifying criteria.

b. *Operating Expenses*

Operating expenses (OPEX) have not been clearly defined. Given that the document proposes a pricing methodology involving an OPEX based mechanism, a vague definition would be prone to abuses.

Recommendation: The definition of Operating Expenses needs to be further elaborated.

c. Sovereign Credit Rating

The definition of sovereign credit rating states that ratings would be taken from "an independent agency(ies)". It would be prudent to specify on what basis the selection will be made.

It must be highlighted that 92% of the global credit rating market is controlled by an oligopoly of three US private companies, namely Standard & Poor's Global Ratings, Moody's Investors Service and Fitch Ratings, the so-called "Big Three". The former UN Independent Expert on Debt and Human Rights highlighted the negative impacts of their outsized influence, their lack of accountability, the fact that they are mainly under the control of one country, namely the USA and the need to strengthen the international regulation of Credit Rating Agencies (CRAs).

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Recommendation: It must be specified on what basis an "independent" CRA will be chosen.

d. *Updation of lists on Inclusive Framework website*

Throughout the section on Definitions, there are certain lists that need to be uploaded online and regularly updated, such as industry groupings, qualifying jurisdictions, datasets etc. Since this work of the Inclusive Framework, which is separate from the 38-Member OECD, it must be treated separately.

Recommendation: All the relevant lists in the definitions which are to be uploaded and updated online should be on a separate website of the Inclusive Framework and not the OECD website.

ii. Scope of Amount B

a. *Alternatives A and B*

The scoping section has provided two alternatives; A and B wherein Alternative A provides a narrow quantitative scoping criterion and Alternative B provides qualitative criterion along with a wider quantitative criterion.

With regard to Alternative A, we observe that, there are some critical deficiencies in this alternative. It presumes that all distributors that are within the pre-defined Opex/sales values would be baseline without giving regard to the functions performed, assets used and risks assumed. Since the paper observes that the relation between functional intensity and Opex/Sales is not clearly evident, using this metric as the main criterion might give erroneous results and may therefore result in inclusion of non-baseline entities or exclusion of baseline entities. The inclusion of non-baseline entities would mean that functions that are entitled to higher returns and thus higher tax collection by LCJs would be given a lower return meant for baseline distribution functions and thus lower tax collection by LCJs. Such a deficiency may also promote tax planning by MNEs and increase Base Erosion and Profit Shifting (BEPS) risks.

With regard to alternative B, we observe that it has advantage of identifying distributors that have functional intensity that can be reliably priced as "baseline distributors". This would avoid creating structures for tax planning purposes and the resultant base erosion, as merely falling within an Opex/sales bracket would not include/exclude an entity from being in scope.

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Recommendation: Alternative B is to preferred over A as it is more in conformity with transfer pricing principles and prevents possibilities of BEPS behaviour and resultant tax loss for developing countries. However, the qualitative criterion in Alternative B should be objectively defined to minimize disputes.

b. *Administrative Simplification*

This section is a welcome addition. Paras 39 to 41 of the consultation paper provide that non-distribution activities can be segmented out and in absence of any checks, artificial segmentation can allow base erosion structures including manipulation of the Opex figures of the distribution segment.

Recommendation 1: In relation to the indirect allocation key safeguard discussed in the box to commentators, it is recommended that the test should be applied to the distribution segment and figures from the distribution segment should be used. Using figures from entity wide financials would increase the administrative burden as well as the burden on taxpayers, during the audit process.

Recommendation 2: In addition, additional safeguards may also be explored such as relative threshold for the distribution segment vis a vis the entity. One approach could be that the distribution segment revenue should be x% of the total entity revenue.

c. *Digital Goods*

The scoping section does not provide any specific section for digital goods and has only provided a definition of digital goods. With regard to their inclusion in Amount B, digital goods and their distribution have distinct business characteristics than the distribution of tangible goods. Absence of warehousing requirement, absent or minimal physical distribution network and packaging with bouquet of digital services are some of the key elements that distinguish digital goods from tangible goods distribution.

Recommendation: In light of the above observations, distribution of digital goods should be taken up as a separate workstream as its assimilation in the present Amount B design is difficult given the distinct structure of the business model.

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iii. Amount B Pricing Methodology

a. *Pricing Matrix*

It is not clear from the document why Net operating assets intensity (OAS) and Operating Expense Intensity (OES) have been used in the pricing matrix as the underlying data from which the relationship is established is not available. Particularly, we observe that OES has a relationship only at lower levels of OAS in the matrix, therefore, for a large portion, the pricing matrix is based primarily on the relationship with OAS and is two dimensional.

Recommendation: In the ongoing work on pricing additional factors may be explored in place of OES that may have correlation with profitability in all the cells of the matrix.

b. *Matrix Range*

The pricing matrix table in Figure 4.1 provides that within the matrix cells a range of +/- 0.5% would be adopted. This range is too wide, specifically for lower profitability cells. For the bottom left cell, a range of 0.5% would translate into around 30% variability in profitability. Such wide ranges may easily allow for manipulation.

Recommendation: Given that the exercise in Amount B is a post-ipso facto exercise, a tighter range or a range that is relative to the median of the cell may be explored.

c. *Industry grouping*

In the paper, the industrial groupings have been created on the basis of the statistical relationship with profit levels within the global dataset. We have our reservations on this approach, especially since the underlying data is not publicly available or shared with the members of the Inclusive Framework. The groupings will have a significant impact on how much tax will be paid by the taxpayer under the Amount B mechanism.

We observe that a significant number of industries lie in group 2 wherein there is no statistical relationship. This group includes industries as diverse as jewellery as well as textiles which, as reported by our Member States, have very distinct profit margins. Another example of the erratic methodology is that the domestic vehicles industry is in group 2 whereas the used domestic vehicle industry is in group 3.

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Such anomalous results may be due to two broad reasons. The first is the reliance on one single data source, namely Moody's BvD Orbis, resulting in database bias. It must be mentioned here that the Orbis database is owned by Moody's Corporation, which also owns Moody's Investors Service, one of the "Big Three" Credit Rating Agencies (CRAs). It is highly problematic to place such enormous power to determine how taxes are allocated internationally as well as the determination of sovereign credit ratings with a single private company that faces almost no international or national regulation.

The second reason for the anomalous results is that the second grouping which comprises no statistical relationship, is an erroneous grouping as it merely represents industries for which there is insufficient data.

Recommendation: Accordingly, the erratic methodology behind the industrial groupings should be relooked into and a more logical industrial grouping should be made.

d. *Data availability mechanism*

The inclusion of the data availability mechanism is important from the perspective of developing countries. The mechanism outlined in the document addresses the question of geographical differences in profitability for jurisdictions where there are no comparable. However, there is a cap of 85% of OAS^{TP} when computing the adjusted return on sales for a tested party in a qualifying jurisdiction where it is exposed to a higher level of country risk. There is no rationale provided for this cap.

Recommendation: As also called for by the African Tax Administration Forum (ATAF), the differences in credit rating should be completely attributed to the jurisdiction for the computation of the adjusted return in the mechanism, therefore 100% of OAS^{TP} should be used instead of 85% in the formula for adjusted return computation in para 67.

e. *Local Dataset Mechanism*

The inclusion of local dataset mechanism is critical to address needs of jurisdictions that have their own local databases and do not face pricing challenges as faced by LCJs. We support its addition and look forward to the ongoing work on the local dataset mechanism.

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f. Corroborative test through Berry Ratio cap-and-collar range

The corroborative test is uncalled for as it does not align with the overall objective of Amount B, which is to provide a simplified (uncomplicated) solution for the benefit of low-capacity jurisdictions.

In any case, the Berry Ratio is an inappropriate indicator. It is an inappropriate device to measure the returns of a distributor. Functional contributions of a distributor are reflected in sales and not in operating expenses.

Further, there is the possibility of manipulation of expenses between Cost of Goods Sold (COGS) and operating expenses. The Berry Ratio is sensitive to cost classifications, with no uniform set of rules applicable at worldwide jurisdictional level, and is therefore prone to manipulation at the net level.

Moreover, baseline marketing and distribution arrangements are generally characterised by not incurring operating loss, hence, any occasion to apply collar range will be very remote and on most occasions, only the cap range would apply that will lead to significant drop in return on sales for developing countries and thus their tax collection.

This becomes more alarming when seen that the Berry ratio cap and collar mechanism will *de facto* supersede the pricing mechanism and thus become the final determinant of the arms length return under Amount B. In all likelihood, in most cases it will mainly serve to reduce tax collection of developing countries under Amount B.

Recommendation: The corroborative test through Berry Ratio cap-and-collar range should be removed altogether.

g. Implementation considerations

The public consultation document does not provide options for implementation consideration. The mechanism for implementation of Amount B is critical for all stakeholders and would provide much needed clarity on the overall design of Amount B.

Recommendation: Feedback from the public in relation to implementation options may also be obtained, once they are crystallised.

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