

TAX COOPERATION POLICY BRIEF

N°. 39
20 November 2024

Determining the Upper Bound of the Scoping Criteria for Amount B in the OECD/G20 Two-Pillar Solution: A Policy Guide for Developing Jurisdictions

By Chetan Rao, Ruchika Sharma and Dr. Vijit Patel *

ABSTRACT

Amount B, a component of the OECD/G20 Two-Pillar Solution, has been designed to simplify transfer pricing for baseline distribution activities. With the aim of developing a practical policy guide for developing jurisdictions to fine tune the quantitative scoping criterion under Amount B, i.e., “annual operating expense to annual net revenue” ratio, this paper critically analyses various aspects of this criterion. The upper bound of this ratio is purported to help jurisdictions in identifying baseline distributors. It is currently set as a flexible range from 20% to 30%, with the choice available to each adopting jurisdiction deciding the exact point in the range for implementation of Amount B within its jurisdiction. Given the lack of any data-backed rationale in the Amount B report for development of this range, the authors suggest that the upper bound range might have been politically negotiated. For this very reason, developing countries need to tread carefully while setting the upper-bound and consider both its tax as well as policy implications. Through an empirical analysis of independent distributors in India, the paper highlights the link between the upper bound, functionality, and profitability, illustrating how these metrics impact developing countries with lower asset and expense intensities. The findings suggest that setting the upper bound at the higher end of the range could unintentionally bring above-baseline distributors into scope, thus foregoing long-term taxing rights for developing jurisdictions. Through this analysis, the paper offers practical insights and recommendations for jurisdictions, especially developing ones, for setting this upper bound to protect their taxing rights and minimize risks of misclassification of above-baseline distributors as baseline.

KEYWORDS: Amount B, Two-Pillar Solution, Transfer Pricing, Taxing Rights, India

Le montant B, qui est une composante de la solution reposant sur deux piliers approuvée par le Cadre inclusif OCDE/G20, a été conçu pour simplifier la fixation des prix de transfert pour les activités de distribution de référence. Dans la perspective de l'élaboration d'un guide pratique permettant aux pays en développement d'affiner le critère quantitatif de délimitation du champ d'application du montant B, à savoir le ratio de dépenses d'exploitation sur recettes nettes annuelles, ce document présente une analyse critique de divers aspects de ce critère. La limite supérieure de ce ratio doit permettre aux pays d'identifier les distributeurs de référence. Elle se situe actuellement dans une fourchette de 20 % à 30 %, le choix étant laissé à chaque pays qui adopte la mesure de décider du pourcentage qui sera retenu dans le cadre de la mise en œuvre du montant B sur son territoire. Étant donné que le rapport sur le montant B ne contient aucune justification fondée sur des données concernant la manière dont la fourchette a été établie, les auteurs suggèrent que la limite supérieure a sans doute été négociée sur

KEY MESSAGES

- Developing countries planning to implement Amount B need to make careful consideration when setting an upper bound for the ‘annual operating expenses to annual net revenues ratio’ scoping criterion, which Amount B provides to be between 20-30%.
- Setting an incorrect upper bound has lasting impacts, potentially weakening these jurisdictions’ taxing rights over controlled distributors not only in the short term but also well into the future.
- Countries should analyse the distributors operating within their jurisdictions before deciding on this upper limit, and in cases where data is unavailable, a cautious approach would be to set the upper bound at the lower end of the range (20%) to reduce the risk of above-baseline distributors being inaccurately classified as baseline under Amount B.

* The authors are officers of the Indian Revenue Service. The views expressed in this paper are solely their own and do not reflect the official position of the Government of India or their organisation.

la base de considérations politiques. C'est pourquoi, les pays en développement doivent faire preuve de prudence lorsqu'ils fixent la limite supérieure et prendre en compte les conséquences qui en résultent sur le plan fiscal et politique. Au moyen d'une analyse empirique du système indépendant de distribution en Inde, le présent document met en évidence les interactions entre la limite supérieure et les aspects liés à la fonctionnalité et la rentabilité, en illustrant l'impact de ces paramètres sur les pays en développement dont l'intensité des actifs d'exploitation nets et des dépenses est plus faible. Les résultats suggèrent que le choix d'opter pour un pourcentage se situant dans la limite supérieure de la fourchette pourrait avoir pour conséquence non anticipée de faire entrer les distributeurs qui se situent au-dessus de la limite de référence dans le champ d'application du montant B, privant ainsi les pays en développement de leurs droits d'imposition à long terme. Au terme de l'analyse, des idées et recommandations pratiques sont formulées à l'intention des pays, en particulier des pays en développement, en ce qui concerne la fixation de la limite supérieure du ratio afin de protéger leurs droits d'imposition et de minimiser les risques liés à une classification qui placerait de manière erronée des distributeurs dans la catégorie des distributeurs de référence.

MOTS-CLÉS: Le montant B, la solution reposant sur deux piliers, les prix de transfert, les droits d'imposition, Inde

El Importe B, un componente de la Solución de Dos Pilares de la OCDE/G20, ha sido diseñado para simplificar la fijación de precios de transferencia para actividades básicas de distribución. Con el objetivo de desarrollar una guía de políticas prácticas para que las jurisdicciones en desarrollo ajusten el criterio de alcance cuantitativo bajo el Importe B, es decir, la relación "gastos de explotación anuales/ingresos netos anuales", este documento analiza críticamente varios aspectos de este criterio. Se supone que el límite máximo de esta relación ayudará a las jurisdicciones a identificar distribuidores de base. Actualmente, se establece como un rango flexible del 20% al 30%, quedando a discreción de cada jurisdicción adoptante decidir el punto exacto dentro del rango para la implementación del Importe B en su jurisdicción. Dada la falta de una justificación basada en datos en el informe sobre el Importe B para el desarrollo de este rango, los autores sugieren que el rango del límite máximo podría haber sido negociado políticamente. Por esta misma razón, los países en desarrollo deben proceder con cuidado al establecer el límite máximo y considerar tanto sus implicaciones fiscales como políticas. A través de un análisis empírico de distribuidores independientes en India, el documento destaca el vínculo entre el límite máximo, la funcionalidad y la rentabilidad, ilustrando cómo estas métricas afectan a los países en desarrollo con menores intensidades de activos y gastos. Los hallazgos sugieren que establecer el límite máximo en el extremo superior del rango podría incluir involuntariamente a distribuidores por encima de la base, lo que podría significar renunciar a los derechos tributarios a largo plazo para las jurisdicciones en desarrollo. A través de este análisis, el documento ofrece ideas prácticas y recomendaciones para las jurisdicciones, especialmente las en desarrollo, para establecer este límite superior y proteger sus derechos fiscales y minimizar los riesgos de erróneamente clasificar como de base los distribuidores que están por encima de la base de referencia.

PALABRAS CLAVES: El Importe B, la Solución de Dos Pilares, los precios de transferencia, los derechos fiscales, India

1. Introduction

1.1 Amount B, formally known as 'Special considerations for baseline distribution activities' is part of the Organisation for Economic Co-operation and Development (OECD)/Group of Twenty (G20) Two-Pillar Solution, which has been designed to streamline transfer pricing for baseline distribution activities. Its goal is to deliver an approximation of the arm's length principle by establishing a pricing mechanism, especially aimed at low-capacity jurisdictions (LCJs) that may lack the resources as well as localized data for complex transfer pricing analysis. A key feature of Amount B is the quantitative scoping criterion, which uses the ratio of "annual operating expenses to annual net revenue" as a filter for determining which distributors fall within its scope.

1.2 While the lower-bound of this scoping criterion is set at 3%, the upper bound is in the form of a flexible range of 20% to 30%, with the choice available to each adopting jurisdiction to decide the exact point in the range for implementation of Amount B within its jurisdiction. The OECD/G20 Inclusive Framework (IF) on Base Erosion and Profit Shifting (BEPS) report titled 'Pillar One - Amount B' released on 19th February, 2024¹ (hereafter referred to as 'Report' in the paper) and its subsequent updates² provide no data-backed explanation for the development of this range, thereby suggesting that the upper bound range might have been politically negotiated. For this very reason, developing countries need to tread carefully while setting the upper-bound and take into account its various tax as well as policy implications. Through an empirical analysis of independent distributors in India, the paper highlights the link between the upper bound, functionality, and profitability, underscoring how these metrics impact developing countries with lower asset and expense intensities. Through this analysis, the paper offers practical insights and recommendations for jurisdictions, especially developing ones, for setting this upper bound to protect their taxing rights and minimize risks of misclassification of above-baseline distributors as baseline.

a. What is Amount B in a nutshell

1.3 Amount B has been incorporated into OECD Transfer Pricing Guidelines (TPG) as an Annex to Chapter IV subsequent to the publication of the Report. The publication of this report was the result of the mandate given by the OECD/G20 IF in October 2021 to simplify and streamline the application of the arm's length principle to in-country baseline marketing and distribution activities, with a particular focus on the needs of low-capacity jurisdictions.

1.4 Amount B has been designed as an optional or elective simplification tool available to jurisdictions for benchmarking buy-sell wholesale marketing and distribution transactions and sales

1 OECD, *Pillar One - Amount B: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (Paris, OECD Publishing, 2024). Available from <https://doi.org/10.1787/21ea168b-en>.

2 This was followed by two updates on 17 June 2024 by the OECD/G20 Inclusive Framework, which released two new documents on the Pillar One Amount B approach for transfer pricing for certain baseline marketing and distribution transactions: (1) a statement on the definitions of qualifying jurisdictions within the meaning of sections 5.2 and 5.3 of the Amount B guidance, and (2) a statement on the definition of covered jurisdictions within the scope of the political commitment on Amount B.

agency & commissionaire transactions involving tangible goods that meet certain pre-conditions laid down in the scoping criteria. It excludes distribution of non-tangible goods, services & commodities, and also retail distribution beyond the specified de-minimis threshold³. It also excludes entities carrying out 'non-distribution activities' unless qualifying transaction can be separately evaluated and reliably priced. Amount B focuses on the needs of low-capacity jurisdictions particularly non availability of suitable comparables, and aims to reduce uncertainties and disputes in transfer pricing for distributor related transactions. Even though Amount A has grabbed headlines, Amount B is an important component of Pillar One and discussions are ongoing on how this elective approach can be reframed into a mandatory one given the fact that some Inclusive Framework members view the close linkage between the two components of Pillar One⁴. Further, Amount B is important because, unlike Amount A, there is no revenue threshold that a transaction or entity needs to meet to be in scope of Amount B. Therefore, Amount B has a much broader sweep and a more far-reaching impact than Amount A. It is worth noting that Amount B admittedly delivers an *approximation* of the arm's length principle.

b. Mode of implementation of Amount B

1.5 The IF Report states that Amount B can be implemented by jurisdictions from 1st January 2025 onwards. There are two options available to jurisdictions for implementation: elective or safe harbour approach and rule approach. In the former, a jurisdiction can permit a tested party resident within its jurisdiction to elect to apply Amount B, while in the latter option, a jurisdiction can make the application of Amount B a mandatory rule. This implies that the choice of the two available options will have to be exercised by the adopting jurisdiction through domestic law changes. An interesting facet of Amount B from the perspective of tax certainty is that it is non-binding on the counter-party jurisdictions except where the adopting jurisdiction is a "covered jurisdiction" as defined by the Inclusive Framework in its statement in June 2024⁵. The political commitment can be operationalised through a Competent Authority level Agreement⁶.

2. The Scoping Question

a. What is the Amount B scoping criteria

2.1 Amount B promises to reduce disputes and enhance certainty through reduction of subjectivity in both accurately delineating the in-scope transaction (through its scoping criteria) as well

3 Wholesale distribution is defined as distribution to any type of customer except end consumers. Additionally, a distributor that carries out both wholesale and retail distribution is deemed to carry out solely wholesale distribution if its net retail revenues do not exceed 20% of total net revenues, calculated based on a weighted average for the past years.

4 "Today, the text of the MLC is stable and has secured near full consensus across the membership of the Inclusive Framework. The focus of the remaining work is refining the consensus on Amount B beyond the elective approach set out below. At this stage, the issues are primarily political in nature, rather than technical, and negotiations are ongoing" (OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors (G20 Brazil, October 2024).

5 OECD, "Statement on the definition of covered jurisdiction for the Inclusive Framework political commitment on Amount B", OECD/G20 Base Erosion and Profit Shifting Project (Paris, OECD Publishing, 2024).

6 OECD, "Model Competent Authority Agreement on the Application of the Simplified and Streamlined Approach", OECD/G20 Base Erosion and Profit Shifting Project (Paris, OECD Publishing, 2024).

as accurately pricing that transaction post delineation (through its pricing matrix). The scoping criteria for Amount B is encapsulated in para. 13⁷ and 14⁸ of the Report, with each paragraph comprising two criterions. Para. 13 has been designed as a positive list while para. 14 has been designed as a negative list.

b. The politics of the open-ended upper bound

2.2 Out of the four criterions, the one that stands out the most for its potential to be the gatekeeper-criterion is the quantitative scoping filter of 'annual operating expense' to annual net revenue' ratio expressed as a percentage. Before one is tempted into believing that this scoping filter may be a panacea for scoping disputes related to baseline distributors, it is helpful to pay a closer look at footnote 22¹⁰ of the Report which reveals that, in view of the IF jurisdictions, this filter in fact does not offer a definitive indication of functionality/characterisation of distributor and has merely been used as a simplification measure. It is not a matter of surprise then that the upper-bound of the filter is not a fixed point but a range as wide as between 20% to 30%. Further, in absence of any explanation in the Report regarding how the suggested range was arrived at, it is safe to assume that it is a result of a political compromise.

c. Policy and tax implications of selecting the right upper bound

2.3 What all of this means is that the jurisdictions, particularly the low-capacity ones, adopting Amount B in the near future will face the conundrum of where exactly in this range should they set the upper-bound for this pivotal scoping criterion. With the aim of providing certain tools and direction to resolve this conundrum, the rest of this paper focuses on fleshing out evidence-based arguments with a focus on developing countries desiring to adopt

7 For a qualifying transaction to be in-scope of the simplified and streamlined approach:

a. The qualifying transaction must exhibit economically relevant characteristics that mean it can be reliably priced using a one-sided transfer pricing method, with the distributor, sales agent or commissionaire being the tested party.

b. The tested party in the qualifying transaction must not incur annual operating expenses lower than 3% or greater than an upper bound of between 20% and 30% of the tested party's annual net revenues.

8 For qualifying transactions that do not fall out of scope of the simplified and streamlined approach

under paragraph 4, a qualifying transaction will nevertheless be out of scope if:

a. The qualifying transaction involves the distribution of non-tangible goods, services or the marketing, trading, or distribution of commodities; or

b. The tested party carries out non-distribution activities in addition to the qualifying transaction, unless the qualifying transaction can be adequately evaluated on a separate basis and can be reliably priced separately from the non-distribution activities.

9 Operating expense has been defined in the report as, "...total costs excluding cost of goods sold, pass-through costs appropriately excluded under the accurate delineation of the transaction 6 and costs related to financing, investment activities or income taxes, calculated in accordance with applicable accounting standards. Moreover, operating expenses should not include any exceptional items that are unrelated to recurring business operations, which should be quantified in accordance with applicable accounting standards."

10 Footnote 22 reads as follows: "Quantitative scoping filters are used in the context of the simplified and streamlined approach as a simplification measure and do not provide any definitive indication of what functions are performed or the characterisation for distributors that fall out of scope or in general. Where a distributor falls out of scope, this should not be taken as implying any arm's length price for the controlled transaction, regardless of the scoping criteria used. For the avoidance of doubt, a determination of arm's length prices in such circumstances should follow the principles articulated in the remainder of these Guidelines. The quantitative filters applied to determine whether a qualifying transaction is within the scope of the simplified and streamlined approach are only used for that purpose, and not, for example, replicated in the pricing methodology used to establish returns for in-scope distributors."

| Factor Intensity | | | Industry Groups ¹³ | | |
|------------------|---|---|-------------------------------|-------|-------|
| Category | Net Operating Asset Intensity (OAS) ¹⁴ | Operating Expense Intensity (OES) ¹⁵ | 1 | 2 | 3 |
| [A] | > 45% | Any Level | 3.50% | 5.00% | 5.50% |
| [B] | 30% - 44.99% | Any Level | 3.00% | 3.75% | 4.50% |
| [C] | 15% - 29.99% | Any Level | 2.50% | 3.00% | 4.50% |
| [D] | < 15% | >= 10% | 1.75% | 2.00% | 3.00% |
| [E] | | < 10% | 1.50% | 1.75% | 2.25% |

Amount B. The authors believe that the determination of the upper-bound for this scoping criterion will not just have a bearing on the jurisdictions' immediate tax revenues but also on their taxing rights in perpetuity. An appropriately set cap will help limit the scope to truly baseline distributors, while an inappropriate cap may inadvertently lead to inclusion of above-baseline distributors in scope, potentially distorting the objective of Amount B. It needs to be emphasized that jurisdictions could lose taxing rights over above-baseline distributors, who are normally expected to earn more than baseline profits, if they deem them "baseline" via a higher upper-bound adopted under this criterion. Even though these distributors may today be in losses, the correct way to do transfer pricing is not via Amount B as the trade-off involved is too large. Furthermore, it is very critical to take an informed, data-driven decision to set this upper bound as there is likely to be pressure on LCJs to adopt the highest or close to highest upper-bound threshold.

3. Criteria for Evaluating the Utility and Disutility of Upper-bound

a. Link between upper-bound and functionality

3.1 The first logical question that emerges when evaluating the utility and disutility of the upper-bound of this scoping criterion is how strong a predictor of functionality is the upper-bound. As discussed earlier, the Report itself admits in footnote 22 that the ratio's promises of objectivity should not be over-estimated. This filter does not offer a definitive indication of functionality or characterisation of distributor and has merely been used as a simplification measure. What this means is that the upper-bound may not denote true functionality or characterisation of the distributor being evaluated. To explain this through a simplified example, let us think of a distributor that has created non-unique but valuable local marketing intangibles several years ago through incurring heavy advertising and marketing expenses and is now reaping the benefits of those locally generated marketing intangibles through increasingly higher revenues earned in the market over the years. Today, the distributor only incurs small/incremental amount of advertising and marketing expenses each year to maintain and exploit the said local marketing intangibles. If this distributor is evaluated under the upper-bound of the ratio today, it may qualify to be in-scope when it is truly not fit to be characterised as a "baseline" distributor, and should in fact be earning above-baseline profits in a normal market.

b. Link between upper-bound and profitability

3.2 The second question that emerges is how strong a predictor of profitability is the upper-bound. The evidence of the lack of statistically significant relationship between the upper bound and profitability lies in the pricing matrix (see table 5.1 of the report¹¹) of the Report itself. The pricing matrix (return on sales %)¹² derived using the benchmarking search criteria in the Report is reproduced above.

3.3 From the above table, it can be noted that the rows A, B and C are set at "any level of Operating Expense Intensity (OES)" in contrast to the Operating Asset Intensity (OAS) which has been neatly categorised. In other words, what the pricing matrix is telling us is that the OES has a weak relationship with profitability only at lower levels of OAS, i.e., below 15%. The relationship between OES and profitability becomes insignificant when OAS levels are more than 15%. The resulting message is that not just is the OES not a true predictor of functionality, it also is not entirely reliable in determining profitability of the scoped-in distributors (irrespective of whether they are baseline or above-baseline).

c. Scope for manipulation by MNEs

3.4 Amount B is unique in its design since a multinational enterprise (MNE) can calculate its profitability as well as tax liability in advance by use of the pricing matrix. While this is an upside from the point of view of tax certainty, it does create a perverse incentive for MNEs to game or manipulate this ratio to either fall within

11 Page 27 of the Report

12 As per the Report, any point in the range of plus/minus 0.5% from the absolute return on sales prescribed in the pricing matrix in Table 5.1 is acceptable for the purpose of demonstrating compliance with the Amount B pricing matrix.

13 Group 1 – perishable foods, grocery, household consumables, construction materials and supplies, plumbing supplies and metal. Group 2 – IT hardware and components, electrical components and consumables, animal feeds, agricultural supplies, alcohol and tobacco, pet foods, clothing footwear and other apparel, plastics and chemicals, lubricants, dyes, pharmaceuticals, cosmetics, health and wellbeing products, home appliances, consumer electronics, furniture, home and office supplies, printed matter, paper and packaging, jewellery, textiles hides and furs, new and used domestic vehicles, vehicle parts and supplies, mixed products and components not listed in group 1 or 3. Group 3 – medical machinery, industrial machinery including industrial and agricultural vehicles, industrial tools, industrial components miscellaneous supplies.

14 OAS is defined as follows in the Report: "Net operating asset intensity (OAS) refers to the ratio of net operating assets to net revenue, expressed as a percentage." This ratio has to be calculated on a three-year weighted average basis, for each fiscal year, for the purposes of determining the factor intensity classification.

15 OES is defined as follows in the Report: "Operating expense intensity (OES) refers to the ratio of operating expenses to net revenue, expressed as a percentage." This ratio should be calculated on a three-year weighted average basis, for each fiscal year, for the purposes of determining whether the scoping threshold is breached and for determining the factor intensity classification.

scope or to avoid falling within scope of Amount B. This can be illustrated through the following examples: in order to minimise its 'operating expense to annual net revenue' ratio with the aim of falling into the scope of Amount B, an above-baseline distributor may assert that its core operating expenses are 'pass-through' in nature, or it may start receiving services at cost from its associated enterprises instead of paying third parties to perform the same, or it may decide to categorise a given expense as revenue or capital in nature depending on where its OAS and OES levels are in a given year.

d. The 'developing vs. developed' angle

3.5 Another very critical factor to note for developing countries is that the operating expense to annual net revenue ratio is likely to be systemically lower in developing countries than in developed countries for distributors with *identical* functional profile. This fact is clear from the Operating expense cross-check (OECC) mechanism¹⁶ in the Report which incorporates an 'alternative cap' (which is nothing else but a slightly higher cap than the default cap) for 'qualifying jurisdictions'¹⁷. What this indicates in the context of setting of the upper bound is that while a developed country may truly be choosing a baseline distributor by setting the upper bound at 30%, for a developing country, setting the upper bound at this level could mean that potentially some or even all of its above-baseline distributors will end up being in scope of Amount B. The clear message being that a one-size-fits-all approach cannot be adopted in determining the upper-bound.

4. Empirical Analysis on Uncontrolled Indian Distributors

4.1 To further understand the impact of the Amount B on the distribution model in empirical terms, the authors believe it can be helpful to visualise how the financial indicators relied upon in the Report (i.e., OAS and OES) appear in India in the case of uncontrolled or independent distributors. Using commercially available transfer pricing databases such as AceTP, Capitaline, Prowess, a cohort of distributor companies was obtained and analysed. It may be noted that the steps followed by the authors to identify these distributors are broadly similar to the search criteria¹⁸ adopted in the Report.

4.1.1 The search criteria in the Report adopts a two-step approach to arrive at the final dataset: first being database filtering and second being "manual review". At this juncture, it is pertinent

¹⁶ Table 5.2, page 29 of the Report. The process for the application of OECC is Step 1: Determine an entity's return under the pricing matrix and determine the equivalent return on OpEx (Equivalent return on OpEx = EBIT / OPEX). Step 2: Determine the return on operating expense cap-and-collar range provided by the OECD. Step 3: Compare the equivalent return on operating expenses to the ROS established in step 1 to the cap-and-collar in step 2. Step 4: Adjust the return established in step 1 to the cap or collar, where step 3 shows standard return is above the cap (a downward adjustment) or below the collar (an upward adjustment).

¹⁷ For purposes of section 5.2, "qualifying jurisdictions" refer to jurisdictions that are classified by the World Bank Group as low income, lower-middle income, and upper-middle income based on the latest available World Bank Group country classifications by income level.

¹⁸ See Appendix 1 of OECD, *Pillar One - Amount B: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (Paris, OECD Publishing, 2024) at <https://doi.org/10.1787/21ea168b-en>.

to highlight certain limitations of the search criteria used in the Report to develop the pricing matrix. The search criteria, in the first step, relies entirely on the use of quantitative filters applied on the BvD database (Orbis) to arrive at the initial dataset of comparables. In the second step, the search criteria relies on "manual" screening which is nothing else but use of "keyword searches" on "business description" that has been captured in the BvD database for the comparables identified through the first step. As is clear, the steps followed in the search criteria are in contrast to the scoping criteria which, apart from using OES based quantitative metric, relies on assessing that the tested party can be reliably priced using a one-sided transfer pricing method through performing a functions, assets and risks (FAR)-based assessment of the tested party¹⁹. Under ideal circumstances, the comparables for the pricing matrix too should have been identified following similar steps as have been prescribed under the scoping criteria to ensure that all above-baseline are excluded from the dataset. Further, the second step too, i.e., "keyword search", allows above-baseline distributors to become a part of the final dataset as business description captured by the BvD database is not meant to capture the FAR profile of these companies. More often than not, these business descriptions are either a loftily worded account of a company's business activities or are identical to the Nomenclature of Economic Activities (NACE) code description of a given business activity, which means that multiple comparables can have an identical business description. This approach, one may argue, is acceptable for a large-scale quantitative analysis as the law of large numbers would ensure that the results are not skewed heavily by any noise (or false positives) in the dataset. However, as the cliché idiom goes, the devil often lies in the details and the authors believe some important policy take-aways for the setting of the upper-bound can be generated by looking closely at such details through an empirical analysis exercise.

4.1.2 Using a similar search criterion as that of the Amount B report, in total, 1065 distributor companies were identified from the Indian databases used by the authors. The key attributes of this cohort are summarised as follows:

| | |
|---|--------|
| No. of distributors | 1065 |
| Median profitability | 3.83% |
| Median Net Operating assets/net revenue % (OAS) | 17.93% |
| Median Operating expense/net revenue % (OES) | 9.8% |

¹⁹ As per the Introduction of the Report, as part of the current workstream, the IF is working on an additional optional qualitative scoping criterion that jurisdictions may choose to apply as an additional step to identify distributors performing non-baseline activities.

4.2 If the above data is further distributed into the three industry categories as they exist in the Report, the economic indicators would be as follows:

| | Number of distributors | Median profitability | Median Net Operating asset/net revenue % (OAS) | Median Operating expense/net revenue % (OES) |
|------------------|------------------------|----------------------|--|--|
| Industry group 1 | 223 | 3.2% | 14.33% | 8.41% |
| Industry group 2 | 605 | 3.6% | 15.89% | 9.63% |
| Industry group 3 | 237 | 4.4% | 18.04% | 11.31% |

4.3 It should be noted that the above results are from the independent or uncontrolled distributors. It would be safe to assume that a controlled distributor operating in India would have similar levels of operating assets/ sales ratio and operating expense/sales ratio as its uncontrolled peers since the economic conditions of operation as well as requirement of business model would be similar. Accordingly, if a hypothetical controlled distributor is assumed with similar indicators as the table above, the comparative results would be as follows:

| | Median Net Operating asset/net revenue % (OAS) | Median Operating expense/net revenue % (OES) | Profitability of comparable (X) | Profitability of controlled distributor as per Amount B (Y) | Difference between X and Y |
|------------------|--|--|---------------------------------|---|----------------------------|
| Industry group 1 | 14.33% | 8.41% | 3.2% | 1.50% | (-1.7%) |
| Industry group 2 | 15.89% | 9.63% | 3.6% | 3.00% | (-0.60%) |
| Industry group 3 | 18.04% | 11.31% | 4.4% | 4.50% | (0.10%) ²⁰ |

4.3.1 From the results in the above table, it is evident that the independent or uncontrolled distributors with similar level of OAS and OES ratio have higher level of profitability than that of a controlled distributor under Amount B pricing methodology. Further, if we look at the median values for the three industry sectors, it is evident that, for a jurisdiction like India, the bottom two rows of the Amount B pricing matrix (which also happen to have least profitability) would be used overwhelmingly, therefore giving the actual matrix results in the context of India a downward skew.

4.3.2 Next, in order to perform another set of analysis, we assumed that each observation in our dataset is a hypothetical tested party and thereafter observed their OES ratio. Since the search criteria used by the authors is similar to the one used in the Report, it is fair to assume that the dataset is bound to have certain noise or, in other words, above-baseline distributors. While one may argue that this noise is acceptable for pricing analysis (as the law of large numbers would have tempered the results), the same cannot be said for the scoping exercise as reliance on an inaccurate quantitative metric ²⁰ As per the Report, any point in the range of plus/minus 0.5% from the absolute return on sales prescribed in the pricing matrix in Table 5.1 is acceptable for the purpose of demonstrating compliance with the Amount B pricing matrix.

is bound to lead to inclusion of above-baseline distributors in scope.

4.3.3 With the above observation in mind, the level of annual operating expense to annual net revenue ratio for the dataset were analysed. The median value of the ratio for the entire set as well for the industry groupings is lower than 12%. Further, in the case of distributors in Industry grouping 1 and Industry grouping 2, the ratio is lower than 10%. This result has an important policy implication for two aspects of Amount B: first, the extremely high likelihood of scoping-in of such distributors through the scoping criteria, and second is the potential triggering of the operating expense cross-check mechanism (OECC) for such distributors. In order to analyse the above-mentioned implications, the centiles of operating expense/sales ratio in the comparable data are tabulated:

| Percentile | Operating expense/net revenue ratio |
|------------------|-------------------------------------|
| 10 th | 2.8% |
| 20 th | 3.4% |
| 30 th | 4.4% |
| 40 th | 6.3% |
| 50 th | 9.8% |
| 60 th | 12.6% |
| 70 th | 17.8% |
| 80 th | 21.2% |
| 90 th | 27.8% |

4.3.4 From the above table, it is clear that if the upper-bound is fixed at 30%, more than 90% of the distributors in the authors' dataset would be categorised as hypothetical tested parties or baseline distributors. In light of the discussion in the foregoing paragraphs about the deficiencies in the "manual review" step under the search criteria and also given the lack of any FAR-based qualitative analysis of the comparables, such result points strongly towards the need to carefully assess the impact of the upper-bound in erroneously categorising above-baseline distributors as baseline distributors. Assuming that we are likely to encounter similar levels of this ratio in controlled distributors in India, it would be safe to conclude that, in case India opts into Amount B, nearly all of its controlled distributors would be categorised as baseline, if the scoping criteria is set at 30%. Needless to say, from a policy implication perspective, such conclusion should invoke serious discussions.

4.3.5 Similarly, if we observe the lower centiles, we would note that, for about 30% of the observations this ratio is 4.4% or below. Such low level of this ratio would result in frequent triggering of the OECC cap. As one is aware, the OECC cap is a mechanism that revises the profitability determined through Amount B pricing matrix downward when it breaches the cap. However, based on the above data, it is clear that this cap would be triggered in case of a large number of observations, implying that it works less as a guardrail and more as a profit moderating device. Further, if we consider the collar under OECC mechanism, based on the centile observations in the table above, it is clear that the triggering of collar is a theoretical scenario that would not be achieved in a real-life case.

5. Policy Recommendations

5.1 Based on the discussion in the foregoing paragraphs of this paper, the authors recommend the following:

- Based on the empirical analysis of independent or uncontrolled distributors in India (refer to Section 4 of this paper), it is recommended that jurisdictions—especially developing ones—conduct an analysis of the distributors operating within their borders before deciding on the upper bound of the scoping criteria for Amount B. Where data is limited or unavailable, a cautious approach would be to set the upper bound at the lower end of the range, around 20%. This approach would help reduce, though not entirely

eliminate, the risk of above-baseline distributors in these jurisdictions being inaccurately classified as baseline under Amount B.

- While integrating Amount B into domestic legislation, it would be essential to draft local legislation appropriately, train the tax administration sufficiently, and ensure complete transparency in the assessment process under Amount B.
- For Amount B adopting Inclusive Framework jurisdictions that are not covered under the definition of 'covered jurisdictions' or, in other words, do not qualify for the political commitment, it would be critical to bear in mind that the Amount B approach is deemed non-arm's length for non-adopting IF jurisdictions (including for the purposes of Article 9 of the Model Tax Convention (MTC) and by extension Article 25).
- The Amount B adopting jurisdictions may consider building in appropriate safeguards in their local legislation to minimise the risk of manipulation of Amount B by the MNEs. These safeguards can be in the form of reporting requirements that create a positive feedback loop, quantitative guardrails to prevent misuse of segmentation under Amount B to artificially carve out a 'baseline distribution' segment, audit mechanisms in case of detection of misuse of Amount B, among others.
- Policymakers in such jurisdictions are encouraged to actively participate in global tax discussions on Amount B and similar initiatives including the discussions for a United Nations Framework Convention on International Tax Co-operation (UNFCITC) which will begin next year once the Terms of Reference for the UNFCITC is adopted by General Assembly, since global standards have a huge impact on the design of local tax systems.

6. Conclusion

6.1 In conclusion, setting an appropriate upper bound for the 'annual operating expenses to annual net revenues ratio' scoping criterion is a key policy choice for all jurisdictions planning to adopt Amount B in the coming months. Both theoretical and practical evidence suggest that jurisdictions—especially developing ones—should analyse the distributors operating within their region before deciding on this upper limit. In cases where data is unavailable, a cautious approach would be to set the upper bound at the lower end of the range, around 20%.

6.2 It is essential to recognize that setting an incorrect upper bound has lasting impacts, potentially weakening these jurisdictions' taxing rights over controlled distributors not only in the short term but also well into the future. As a long-term approach, jurisdictions should continue building capacity and actively participating in global tax negotiations to ensure that international tax rules are both fair and equitable.

PREVIOUS SOUTH CENTRE TAX COOPERATION POLICY BRIEFS

No. 22, 12 January 2022

Global Minimum Corporate Tax: Interaction of Income Inclusion Rule with Controlled Foreign Corporation and Tax-sparing Provisions by Kuldeep Sharma

No. 23, 11 February 2022

Global Minimum Tax Rate: Detached from Developing Country Realities by Sebastien Babou Diasso

No. 24, 29 July 2022

A Global Asset Registry to track hidden fortunes and for asset recovery by Ricardo Martner

No. 25, 30 September 2022

UN Model Tax Convention: Selective Territoriality – The Specter of Privileged Player in a Rigged Game by Muhammad Ashfaq Ahmed

No. 26, 31 October 2022

Revenue Effects of the Global Minimum Corporate Tax Rate for African Economies by Seydou Coulibaly

No. 27, 21 December 2022

Taxing Big Tech: Policy Options for Developing Countries by Abdul Muheet Chowdhary and Sébastien Babou Diasso

No. 28, 20 January 2023

Climate Finance Withholding Mechanism: Exploring a potential solution for climate finance needs of the developing countries by Radhakishan Rawal

No. 29, 3 March 2023

Digital taxation under the OECD Amount A and UN Article 12B mechanisms for market jurisdictions in Africa: a comparative analysis by Erica Rakotonirina

No. 30, 25 March 2023

Enforcing Secondary Taxing Rights: Subject to Tax Rule in the UN Model Tax Convention by Abdul Muheet Chowdhary and Sebastien Babou Diasso

No. 31, 25 March 2023

Taxation of Computer Software: Need for Clear Guidance in the UN Model Tax Convention by Abdul Muheet Chowdhary and Sebastien Babou Diasso

No. 32, 30 May 2023

Global Minimum Taxation of Multinationals: Opportunities and risks for some African States by AMAGLO Kokou Essegbe, KOUEVI Tsotso and ADJEYI Kodzo Senyo

No. 33, 26 June 2023

Taxation of Digital Services: what hope for the African States? by ADJEYI Kodzo Senyo, KOUEVI Tsotso and AMAGLO Kokou Essegbe

No. 34, 24 July 2023

Conceptualizing Remote Worker Permanent Establishment by Radhakishan Rawal

No. 35, 18 August 2023

The GloBE Rules: Challenges for Developing Countries and Smart Policy Options to Protect Their Tax Base by Emmanuel Eze, Sol Picciotto, Muhammad Ashfaq Ahmed, Abdul Muheet Chowdhary, Bob Michel and Tommaso Faccio

No. 36, 26 October 2023

Beyond the Two Pillar Proposals A Simplified Approach for Taxing Multinationals by Sol Picciotto, Muhammad Ashfaq Ahmed, Alex Cobham, Rasmi Ranjan Das, Emmanuel Eze, Bob Michel

No. 37, 29 January 2024

A Decade of the Indian Advance Pricing Agreement Programme: Achievements and Challenges by Priyanka Mashelkar and Apoorv Tiwari

No. 38, 15 May 2024

The Design of a UN Framework Convention on International Tax Cooperation by Sol Picciotto

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 was established by an Intergovernmental Agreement which came into force on 31 July 1995. Its headquarters is in Geneva, Switzerland.

Readers may reproduce the contents of this policy brief for their own use, but are requested to grant due acknowledgement to the South Centre. The views contained in this brief are attributable to the author/s and do not represent the institutional views of the South Centre or its Member States. Any mistake or omission in this study is the sole responsibility of the author/s. For comments on this publication, please contact:



The South Centre
International Environment House 2
Chemin de Ballexert 7-9
PO Box 228, 1211 Geneva 19
Switzerland
Tel.: +41 22 791 8050
south@southcentre.int
<https://www.southcentre.int>

Front cover photo: Monstera Production from Pexels