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Transfer Pricing

OECD release of Multilateral Convention for the implementation of Pillar One Amount A

On 11 October 2023, the OECD published the proposed multilateral convention ("MC") for the implementation of Pillar One - Amount A. The release came together with an explanatory statement, an understanding on the application of certainty under Amount A and an overview document (summary). An updated estimate of the economic impact of Amount A has also been released.

In a nutshell: Pillar One intends to reallocate taxable profit to the markets where the customer is located. In doing so, a simple formular defines the amount of profit that shall be reallocated and a further criterion defines which countries shall get the reallocated amount.

This newsflash provides a high-level summary of the proposed MC and key takeaways from a transfer pricing perspective.

Amount A rules – five step approach
The current proposed MC comprises of five steps:

1. Determine if the business is in scope: The Amount A rules would only be applicable to groups having adjusted revenues in the period exceeding EUR 20 billion and an adjusted pre-tax profit margin exceeding 10%. If a group does not meet these thresholds, but one of the segments disclosed in its consolidated financial statements meets the thresholds on a standalone basis, the segment would become in scope of Amount A. Limited exclusions apply for certain specific industries (extractives, financial services, defense) and for autonomous domestic businesses.*
2. Identify eligible market jurisdictions: Covered groups are required to categorize their revenue into nine defined categories (finished goods, digital content, components, intangible property, user data, immovable property, government grants, non-customer revenues and services). The services category provides for nine sub-categories that require a further categorization (i.e. location-specific services, advertising services, online intermediation services, passenger transport services, cargo transport services, customer reward programs, and other services). Appropriate revenue sourcing rules will need to be determined per (sub-)category using a reliable method for jurisdictions meeting the nexus threshold. A reliable method is a method that identifies where revenues arise based on a reliable indicator. This indicator is typically based on information the covered group is expected to have available in its business for commercial, regulatory or legal purposes. If no reliable indicator is available, taxpayers may use an allocation key as a proxy (e.g. GDP).
3. Calculate and allocate a portion of excess profit : The Amount A tax base is determined using the financial accounting profit as included in the consolidated financial statements after certain prescribed book-to-tax adjustments to determine adjusted profit before tax. The Amount A profit reallocates 25% of the profit above a 10% profit margin. Profits are reallocated to market countries in proportion to sourced revenues. Amount A profit will only be allocated for profits exceeding the marketing and distribution profits safe harbor ("MDSH") to address "double counting" issues where a market jurisdiction already has taxing rights over residual profit under normal profit allocation rules.
4. Eliminate double taxation: A 'Return on Depreciation and Payroll' ("RODP").approach is used to identify jurisdictions required to provide relief of double taxation. A formulaic top-down approach is applied, whereby jurisdictions with the highest RODP are required to provide relief using a waterfall approach.
5. File and pay: A central coordinating entity will file the Amount A tax return and common documentation package with the lead tax administration which will exchange the information with affected countries. The deadline for filing will typically be between nine and twelve months from the end of the period, as determined by the filing jurisdiction.

In addition to the five-step approach, the proposed MC includes a mechanism for binding tax certainty in three situations:

- Scope certainty review for potentially out-of-scope businesses (i.e. certainty on step 1);
- Advance certainty review of the (revenue sourcing) methodology (i.e. certainty on step 2);
- Comprehensive certainty review of the Amount A rules in all relevant jurisdictions.

Finally, the MC includes a list of digital services taxes (or similar measures) that must be removed for all businesses as apart of the implementation of Amount A.

Practical considerations
Revenue sourcing rules

Under the revenue sourcing rules, covered groups will be required to categorize their revenues and allocate this to market jurisdictions using a reliable method as provided in Annex D of the MC per revenue category.

In practice it is expected that it will be very difficult for covered groups to identify reliable indicators for their revenue categories, and that the use of different indicators may result in significant differences in outcome. Helpfully, during an initial transition phase (first three Amount A periods), covered groups are not required to apply the specific sourcing rules and instead may apply the (more practical) allocation keys. After the transition phase, allocation keys shall only be considered as a reliable method if it is expressly permitted in Annex D and the covered group demonstrates that it has taken reasonable steps to identify a reliable indicator among the indicators enumerated in Annex D and has concluded that no such reliable indicator is available.

Marketing and distribution profits safe harbor

The definition of MDSH is still work in progress (also called Amount B). This includes the definition of what classifies as MDSH and which amount is seen as safe harbor. The MDSH aims to address "double counting" issues where a market jurisdiction already has taxing rights over certain portion of excess profit based on existing profit allocation rules. Excess profit in a local jurisdiction is being calculated as the higher of ("D&P": Depreciation and Payroll):

- RODP threshold: (10% of the group revenue / Group D&P) * market Jurisdiction D&P;
- Return on Revenue floor: 3% * revenue sourced in market jurisdiction.
  Subsequently, 90% of excess profit is offset for predominantly local marketing and distribution (M&D) activities and 35% of excess profit is offset for local activities going beyond M&D activities. Activities are considered predominantly M&D where the ratio of local depreciation & payroll to local sales (sourced under Amount A rules) is lower than 75% of that of the group.

As can be observed, the MDSH uses quantitative metrics solely and therefore leaves little room for interpretation. Interesting is that the MDSH only partially offsets excess profits potentially leading to bias in overcompensating market jurisdictions.

RODP Metric

The new RODP metric introduced looks akin to use of a Berry Ratio, with the difference that a Berry Ratio generally also includes other operating expenditures in the denominator. From a transfer pricing perspective, one would expect that the limitations in the use of Berry Ratios would be similar to the use of RODP. As such, there would typically be a bias to an allocation of Amount A profit to jurisdictions with significant (depreciable) assets and employees (at least these jurisdictions will not likely be identified to be required to provide relief).

Additionally, accurate qualification of costs for the calculation of the denominator in the RODP will become crucial. In this respect, it will be interesting to observe how (for example) outsourced activities, leased assets and seconded personnel may impact net Amount A allocations.

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