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Distribution Models in Transfer Pricing

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Background:

In today's complex global business environment, accurate profit allocation within distribution-driven models is critical to ensuring tax compliance and economic fairness. As revenues grow but margins remain modest, jurisdictions are increasingly scrutinising how profits are positioned along global value chains. A clear understanding of functions performed, assets employed, and risks assumed is essential to align commercial reality with regulatory expectations, particularly under the OECD Guidelines and the UAE's Corporate Tax and Transfer Pricing framework. This document highlights the importance of substance-based characterization in distribution models and its impact on transfer pricing outcomes.

Distribution-driven entities often generate high revenues with low margins, making profit allocation a sensitive issue.

Decisions on inventory ownership, market engagement, and risk assumption critically influence where value is recognized.

Profit attribution must reflect actual functions, assets, and risks, not just contractual terms.

Distribution arrangements are central to transfer pricing analysis, especially in rapidly expanding regions like the UAE.

Inaccurate characterization can distort TP methods, margin expectations, and profit allocation between entities.

Properly structured distribution models ensure alignment with value creation, coherent pricing, and defensible transfer pricing positions.

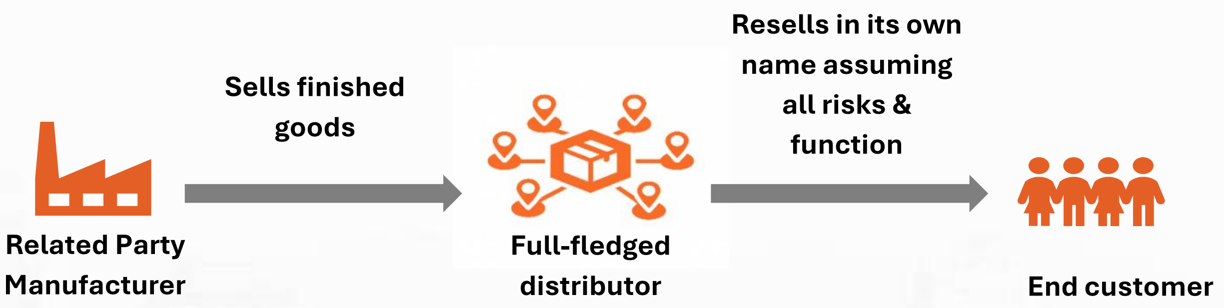
Types of Distribution Models

Distribution Models

- Full-Fledged Distributor
- Limited-Risk Distributor
- Commission Agent / Sales Agent

Full-Fledged Distributor (FFD)

A Full-Fledged Distributor is an entrepreneurial distributor with broad commercial freedom. It purchases goods on its own account, owns and manages inventory, sets pricing and marketing strategy, and assumes all key distribution risks. With this level of control and exposure, the FDD effectively becomes the principal value-driver in the downstream market, responsible for revenue growth and market development.



Transfer Pricing Implications

- **Returns:** Should earn entrepreneurial-level margins, reflecting full-risk ownership and market-building functions.
- **Substance Check:** Must demonstrate real control over pricing, inventory, credit decisions, and market development.
- **Value Alignment:** Profit outcomes must align with local market conditions and its risk-capacity, or the FDD label becomes unsustainable.

Limited-Risk Distributor (LRD)

A Limited Risk Distributor carries out routine distribution and logistics activities within a controlled commercial framework. While it purchases and sells goods locally, major strategic decisions and risk-taking remain with the principal. With minimal exposure to market, inventory, and credit risks, it functions as a routine distributor earning steady, low-volatility returns.

Transfer Pricing Implications

- **Returns**: Earns stable, assured/routine-level margins reflecting its limited functional and risk profile.
- **Substance Check**: Must show it performs basic distribution activities only, with strategic risks controlled by the principal.
- **Value Alignment**: Profitability should remain low-volatility and consistent, matching its insulated risk exposure.

Commission Agent / Sales Agent

A Commission Agent facilitates sales on behalf of the principal without taking title to goods or carrying inventory. Its role is limited to marketing outreach, customer coordination, and order sourcing, with all strategic decisions and risks retained by the principal. As a pure service provider, it earns a stable commission aligned with its routine, low-risk profile.

Transfer Pricing Implications

- **Returns:** Receives fixed commission-based income, reflecting low-risk, routine functions.
- **Substance Check:** Must demonstrate that it does not assume title, inventory, or major market risks.
- **Value Alignment:** Profit should reflect limited functional contribution while supporting principal's overall market reach.

Snapshot: FAR, Method and PLI

Parameter	Full-Fledged Distributor	Limited-Risk Distributor	Sales/Commission Agent
Function	End-to-end distribution, pricing, marketing, inventory planning	Routine distribution, sales execution, basic marketing	Market facilitation, customer acquisition
Assets	Inventory, warehouses, receivables	Limited inventory, basic business assets	No or Minimal assets
Risk	Market, price, inventory, credit	Reduced market risk, limited inventory risk	Bare no or minimum business risks
Typical TP Method	Resale Price Method Or Transactional Net Margin Method	Transactional Net Margin Method	Commission Percentage Or Transactional Net Margin Method
Profit Level Indicator (PLI)	Gross Profit /Sales Or Operating Profit Margin	Operating Profit /Sales	Gross Profit /Sales Or Operating Profit/ Operating Cost

Driving Value Through Strategic Distribution Characterization

Distribution isn't just a commercial function - it shapes where and how value is created. Correctly characterising your entity ensures profits reflect real economic contributions and aligns with OECD and UAE guidance. Whether an FDD, LRD, or Commission Agent, the aim is clear: link profit to genuine value creation and maintain a robust, future-ready TP structure.

Interplay of Pillar One & Pillar Two with Distribution Models

The global tax reset is hitting one spot especially hard **distribution structures**. With Pillar One reshaping *where* profits get allocated and Pillar Two policing *how much* tax you ultimately pay, MNEs can't afford to treat FDDs, LRDs, and Commission Agents as mere operational labels anymore. They're now core levers in managing top-line nexus and bottom-line tax exposure.

1. Pillar One - Amount A: Market Jurisdiction as the

- Amount A pulls a slice of residual profit into the market, regardless of whether the entity is a FFD, LRD, or Agent.
- Even if the distributor is "routine," the group might still owe market-level reallocation if global thresholds and profitability triggers hit.

Your local distributor's characterisation doesn't shield the group from Amount A.

2. Pillar One - Amount B: Routine Returns Under the

- Amount B basically standardises returns for baseline distribution activities.
- LRDs and Commission Agents fall straight into its crosshairs; FDDs may fall partially depending on scope.
- This pushes MNEs toward clean, defensible, quasi-fixed margins, nudging them to revisit legacy distributor models.

3. Pillar Two -GloBE Rules Meet Distributor Footprints

- Pillar Two cares about **effective tax rate** more than functions.
- But distribution models decide *where* profits sit - and that directly impacts whether an entity falls below the 15% minimum.
- FFD = higher margins = more ETR sensitivity, while LRD/Agents = routine profits = low volatility (often easier to keep above 15%).

4. The Real Interplay - Substance, Margin, and

- Pillar One changes profit allocation.
- Pillar Two changes tax cost of that profit.
- Distribution characterisation decides which jurisdiction absorbs the margin and whether it's routine (A/B) or residual (A/A spillover).
- Endgame: MNEs need tight FAR documentation, consistent pricing, and alignment between substance, margins, and jurisdiction level ETRs.

How can we help

01 Conduct **Functional, Asset, and Risk (FAR) analysis** to align profit allocation with actual contributions.

02 Advise on **transfer pricing methods and arm's length margins** for distribution and support functions.

03 Draft **TP documentation and inter-company agreements** to ensure audit readiness.

04 Ensure **compliance with UAE Corporate Tax and OECD Guidelines** while optimizing tax efficiency.

05 Provide **benchmarking and periodic review** of distribution arrangements to reflect operational changes.

06 Recommend **structural or operational improvements** to enhance efficiency and strengthen TP defensibility.

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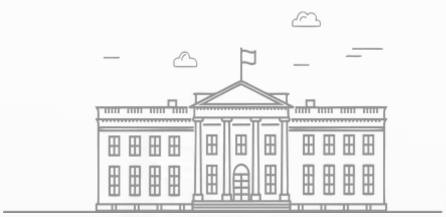

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