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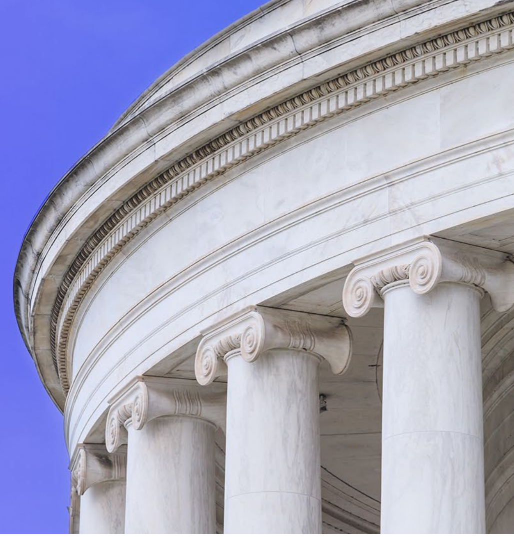

Transfer Pricing and International Tax Year-End Considerations

by the Washington National Tax Transfer Pricing and International groups

As the end of 2023 approaches, it's a good time for multinational companies to focus on year-end tax planning and identify 2024 focus areas. This article covers some key year-end transfer pricing and international tax issues including:

— Pillar One's Amount B: Planning for the future

— Pillar Two: Country-by-country ("CbC") safe harbor, compliance, and mitigation

— Impending public CbC reporting

— Capital markets and sustained higher interest rates

— Planning for evolving business models

— Ongoing concerns about economic uncertainty

— Brazil: tax rule changes and planning opportunities

— Transfer pricing controversy preparedness

— Foreign tax redeterminations

— Foreign-derived intangible income ("FDII") planning

— Base erosion and anti-abuse tax ("BEAT") planning

— Corporate alternative minimum tax

— Issues arising from year-end adjustments

— Key upcoming changes in the transfer pricing compliance landscape

Overview

2023 has been a rollercoaster in the world of transfer pricing and international tax—and 2024 looks to be more of the same. However, many key tax initiatives have progressed to a point that multinational enterprises ("MNEs") can now consider tax planning opportunities going forward. Though there have been delays in the OECD's BEPS 2.0 project, Pillar Two (minimum tax) will come into effect during 2024 in many countries, including those in the European Union and the United Kingdom, Australia, Canada, and South Korea. Although the future of Pillar One Amount A (revised profit allocation rules) remains uncertain, the work on Amount B (transfer pricing simplification measure for routine distributors) advanced significantly during 2023 and may be incorporated into the OECD Guidelines in early 2024.

All of these developments have important implications for transfer pricing and international tax and should factor into how MNEs are thinking about the future. At the same time, existing planning opportunities will continue to play a crucial role in year-end considerations.

Pillar One's Amount B: Planning for the Future

Going into 2024, it is critical that MNEs analyse the ramifications of the OECD's July 2023 Amount B consultation document. Amount B is the OECD's project to simplify and streamline the application of the arm's length principle to so-called "baseline marketing and distribution activities." While the document does not reflect consensus across the Inclusive Framework, it does present the actual return on sales ("ROS") results that distributors in scope of Amount B would generally be expected to achieve (and thus may provide a reference point for tax auditors regardless of whether Amount B is finalized in this form).

The OECD appears poised to move very quickly—with a stated target of including Amount B in the OECD Guidelines as soon as January 2024. MNEs should review the distributors in their supply chains to determine if they are likely to be in scope of Amount B and, if so, perform modelling to understand the impact of the pricing matrix vis-à-vis their existing transfer pricing. Some MNEs—depending on the results of their modelling—may want to consider potential steps to ensure that they are more clearly included or excluded from Amount B, to determine the position in the Amount B pricing matrix befitting their functional profile, or to ease operational transfer pricing challenges associated with Amount B. The OECD's use of operating asset intensity places an imperative on having accurate balance sheet data—which some MNEs will struggle to obtain. In addition, the need to target a specified narrow Amount B ROS range will mean some MNEs will need to upgrade their systems and processes.

Pillar Two: Country-by-Country Safe Harbor, Compliance, and Mitigation

With the global anti-base erosion (GloBE) rules component of Pillar Two coming into effect in 2024 in many countries, almost every MNE will need to prepare for new Pillar Two-related compliance burdens. As a way to prepare for this, MNEs should consider the availability of the transitional CbC reporting safe harbor which—to state the obvious—is largely based on CbC data. This safe harbor reduces the circumstances in which an MNE group would be required to undertake the detailed Pillar Two calculations. MNEs have been and will continue to analyse how they can qualify under this safe harbor; including the importance of having a "qualified" CbC report and comfort in the underlying data.

On a longer-term basis (or earlier to the extent operations fall outside the transitional safe harbor), MNEs need to ensure they have the myriad of data required for Pillar Two compliance. This involves reviewing their Pillar Two calculations, identifying data gaps, and working across different functional groups in the company to bridge those gaps.

As the dust settles on the Pillar Two rules, many MNEs are considering how to mitigate the impact of Pillar Two. For example, MNEs may explore how blending within a jurisdiction can achieve a rate close to 15 percent, maximizing the benefit of the substance-based income exclusion, or discuss with governments how incentive regimes could be amended in light of Pillar Two. MNEs may also consider restructuring out of jurisdictions that are no longer aligned with their business needs in favor of jurisdictions that are better aligned with such business needs and improve their GloBE outcomes in the process.

Impending Public Country-by-Country Reporting

While companies categorize data needed for Pillar Two compliance, many are also categorizing additional data they would like to obtain for impending public CbC reporting because—in the next few years—almost every U.S. MNE will need to disclose country-level data in some form. The pressure is coming from around the world:

- The EU's public CbC reporting directive was approved in 2021 and comes into effect for calendar year companies in 2025, although some countries like Romania have adopted it early.
- Australia's public CbC reporting will apply to periods beginning on or after July 1, 2024.
- The Financial Accounting Standards Board (FASB) approved a proposal to require companies to provide a detailed breakdown of the income taxes they pay globally.

Public CbC reporting requirements will typically mean that MNEs are required to disclose parts of the CbC reports they have been attaching to their tax returns for the last seven-plus years. However, corporate income tax data does not tell the entire story of an MNE's total tax contribution. MNEs are responsible for significant other types of taxes, such as indirect taxes, customs, payroll, real estate, and carbon taxes, to name a few. While most MNEs do not have this data easily arranged by country, many are asking whether now—while they work through their Pillar Two data gaps—is the right time to reconfigure systems, collect the data, and consider if it makes sense to report each country's tax data that extends beyond corporate income tax to give a more complete picture of just how much tax they are contributing.

Capital Markets and Sustained Higher Interest Rates

2024 is poised to be an active year for transfer pricing issues for financial transactions. Despite high interest rates, the M&A market is set to bounce back this coming year, and the boost in capital markets activities is expected to drive up both the volume and depth of leveraged deals. Companies will have to maintain a fine balance to obtain an efficient capital structure as well as meet the requirements being proposed and imposed by the various tax authorities. For example:

- Several countries across the globe (e.g., Netherlands, Germany, Brazil) have officially adopted some version of OECD's Chapter X Guidance on Financial Transactions. This implies that companies need to pay attention to both sides of any financing transaction, not just analyze the borrower, but also consider the decision-making and risk-taking ability of a lender, or the substance in a cash pool header.
- New limitations on interest deductibility (as a % of EBIT or EBITDA) globally will put caps on total amounts of deductions allowed.

Although companies have just emerged through the LIBOR transition and adopted SOFR as the new alternate base rate in the United States, they might yet have to reconsider how to optimize their financing needs subject to the various constraints on amount of debt funding, applicable interest rates, and total amount of interest expense deductions. While a floating interest rate loan generally would have been considered a flexible arrangement, spiking base rates have now resulted in companies running into losses trying to service their existing debt obligations. In this landscape companies should review financial transactions and consider other realistic alternatives as follows:

- **Intercompany Lending**: Is the current capital structure sustainable or is there a challenge in servicing existing debt and should a company reevaluate its capacity to borrow and/or sustain its current level of debt? Obtaining resources to avoid default on interest servicing and considering the implications of debt forgiveness would be of the utmost importance.

- **Cash Pooling Arrangements**: Cash pool participants may have other options realistically available to invest their funds more profitably outside a cash pool considering dated transfer pricing policy.
- **Factoring**: Selling of receivables, although more expensive, is an effective way of maintaining liquidity and avoiding short term liquidity crises. Further, factoring transactions may have a favourable impact on interest deduction limitations, the company's BEAT position, or planning surrounding Amount B.

Planning for Evolving Business Models

The trend towards digitalization has accelerated during the past few years, spurred by the COVID-19 pandemic. Companies are creating new digital assets and finding new uses for the vast amounts of data they are collecting. New technologies, such as artificial intelligence (AI) and clean energy technologies, are leading to transformations of business models in industries as disparate as the entertainment and automotive industries. In the field of medicine, emerging cell and gene therapies are leading not only to exciting new therapeutic breakthroughs but also to fundamental transformations of value chains. In addition, many MNEs are investing significantly in ESG—from developing new technologies to moving to greener suppliers to buying carbon credits. Some MNCs are moving into new ESG-related businesses, such as buying and selling carbon credits and are looking towards potential SEC climate disclosure rules to consider if they should be burdening their business with an internal carbon price.

The evolution of business models is creating both opportunities and risks for companies. It is creating opportunities for rethinking transfer pricing structures to better align them to the new value chains while achieving greater tax efficiency. Conversely, the application of legacy transfer pricing models without regard to the fundamentally different value chains risks misalignment of value creation and transfer pricing outcomes, creating the potential for greater tax authority challenges. Companies should consider undertaking an analysis to understand changes in their value chains and determine appropriate changes to their transfer pricing structures going forward.

Ongoing Concerns about Economic Uncertainty

While the economic challenges of the past year did not materialize into a recession as many had feared, the markets continue to be jittery, and companies continue to face uncertain economic conditions. Some companies may want to consider adjusting their transfer pricing based on slowdowns—or expected slowdowns—in their businesses. For example, companies expecting systemwide losses should consider where they expect to incur those losses and how they will support those positions. Tax administrations will be reluctant to accept losses, so companies should be well prepared to defend those positions with robust transfer pricing documentation to support extraordinary results. Companies expecting systemwide losses may also want to revisit their structures and explore if alternative structures are better suited.

Brazil: Tax Rule Changes and Planning Opportunities

Brazil published new transfer pricing rules on September 29, 2023, which align Brazilian transfer pricing law with the 2022 OECD Guidelines. Companies can make an election by December 31, 2023, to adopt the system in 2023 (i.e., applied retroactively from January 1, 2023). The new rules will be mandatory beginning January 1, 2024, giving companies little time to transition from Brazil's rigid guidelines and specified transfer pricing methods to those aligned with the OECD Guidelines.

For companies operating in Brazil, this represents a change to be managed, but also an opportunity to simplify their transfer pricing operating models and consider how they can structure their Brazil operations going forward for planning efficiency. There may still be opportunities for companies to restructure their operations in 2023 (under the historical Brazil rules).

In addition, Brazil is expected to enact further tax reform to rationalize their complicated Brazilian consumption tax structure. However—if that change proceeds forward—it will likely be a decade before it is finally implemented. Given the expected continuing myriad of non-corporate Brazil taxes, one structure that continues to generate interest is the usufruct, which, if structured properly, could result in outbound payments being subject to a relatively low financial transaction tax in Brazil and reduce Brazilian corporate income taxes and U.S. global intangible low-taxed income ("GILTI") inclusions as a result of Brazilian amortization deductions.

Transfer Pricing Controversy Preparedness

Given that the IRS is bolstering transfer pricing enforcement through increased staff and data analytics, companies should thoughtfully evaluate potential weaknesses in their positions and consider how they can bolster transfer pricing documentation, background support for positions, or ways to get advance certainty (APAs).

On transfer pricing documentation, the IRS has begun taking a much harder line in assessing the robustness of documentation and assessment of potential penalties, consistent with a series of announcements over the last few years. Companies with high-risk transactions or those where they made significant comparability adjustments, should review their documentation and consider if corroborative methods may be appropriate. Recent court decisions and ongoing litigation serve as a reminder that companies should not rely on prior settlements, expired IRS agreements, or audit history to protect against future adjustments.

We are also observing continuing controversy outside the United States about transfer pricing issues. Now is a good time to consider APAs to obtain certainty—especially if the intercompany transaction may be considered high risk, or the volume of the transaction is significant. Updates to the IRS's APA acceptance procedures earlier this year have not materially changed the APA program; things are largely business as usual, though companies should anticipate a slightly longer pre-filing process.

The OECD's International Compliance Assurance Program ("ICAP") may be another avenue for companies to engage with tax authorities to obtain assurance about their transfer prices and practically reduce audit risks. The ICAP program, which is relatively new, enables a company to potentially obtain assurance across multiple jurisdictions that its transfer prices are "low risk"; however, the risk assessments resulting from ICAP are not binding on tax authorities.

Foreign Tax Redeterminations

Taxpayers continue to see audit activity focused on transfer pricing, which often results in transfer pricing settlements that cause significant changes to the amount of foreign income taxes paid with respect to prior tax years. These changes are very likely to result in foreign tax redeterminations and the attendant section 905(c) [1] "notification" of the IRS via amended U.S. tax returns and reporting via Form 1118, Schedule L. While compliance with the notification requirements can be administratively costly, failure to properly notify the IRS of foreign tax redeterminations could result in missed U.S. federal income tax refunds, assessments of additional U.S. federal income tax, and penalties. KPMG is well positioned to help our clients with transfer pricing controversy, and the mitigation of the administrative burden and risks related to the section 905(c) notification requirements. In addition, clients should be aware that in many cases, it is necessary to pursue MAP relief with respect to foreign transfer pricing adjustments in order to obtain U.S. foreign tax credits.

FDII Planning

Having foreign affiliates make prepayments for FDII-eligible sales or services provided by the U.S. group may significantly increase the FDII deduction for certain clients. This strategy may be particularly attractive for companies that typically enjoy only modest FDII benefits because their eligible income is from low-margin activity (e.g., cost-plus services provided to related parties) or they have a significant amount of fixed assets in the United States. Depending on the company's profile, the "supercharged" FDII deduction in the year of the prepayment can be significantly larger than the sum of the FDII deductions that would otherwise be available in

[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

each of the years to which the prepayment relates. Notably, prepayments may be made in the form of cash or other property, including a note.

BEAT Planning

As inflation continues to climb, more and more taxpayers are finding themselves subject to the BEAT under section 59A. Additionally, barring action from Congress, the BEAT rate is scheduled to increase from 10 to 12.5 percent for tax years beginning after 2025. Transfer pricing techniques will, therefore, continue to be important tools to help companies manage their BEAT exposure, including to establish eligibility for the BEAT services cost method (SCM) exception under section 59A(d)(5).

Corporate Alternative Minimum Tax

A new corporate alternative minimum tax ("CAMT"), effective for tax years beginning in 2023, was enacted as part of the Inflation Reduction Act. CAMT generally applies to certain large corporate taxpayers (i.e., those with over $1 billion adjusted book income) to the extent that 15 percent of a taxpayer's adjusted book income is greater than the taxpayer's regular tax plus BEAT. Although the tax base for CAMT is book income, many of the adjustments require applying tax concepts and unpacking consolidated financial statements to disaggregate transactions between taxpayers that are consolidated for book but not for tax.

Moreover, CAMT liability is triggered by differences between adjusted book income and tax, which suggests that transfer pricing choices may be important for some clients. Notice guidance has been trickling out, but regulations are not expected until 2024. In the absence of clear guidance, and as the year-end approaches, companies will be increasingly looking for advice on how to navigate CAMT risk, both in determining whether they are in scope and, if so, what their CAMT liability is—because, once a taxpayer is in scope for CAMT, it generally remains in scope for the foreseeable future.

Year-end Adjustments

When companies are struggling to perform their year-end adjustments correctly or need to make large adjustments at year-end, they should be exploring operational transfer pricing ("OTP") solutions. OTP refers to the implementation of transfer pricing policies to effectuate or account for them in an organization's financial statements. It includes gathering and wrangling data to apply the policies, setting transfer prices, and monitoring and calculating adjustments. The increased scrutiny on transfer pricing results and the ever-changing tax regulatory landscape highlight the importance of strong OTP. For MNEs that have made acquisitions during the year, it is critical that they understand the applicable transfer pricing policies, identify the needed financial data to apply the policy and book the appropriate transactions (with the correct related parties). Companies that are able to reflect year-end adjustments on their books for the year will avoid the necessity to make Schedule M book-tax adjustments after the books are closed and will likewise avoid the secondary adjustment consequences associated with such adjustments.

Changing Transfer Pricing Compliance Requirements

Transfer pricing documentation requirements continued to evolve this year and it's important to assess the impact on compliance for 2024 and future years. Two key examples are (1) the updated U.K. transfer pricing documentation requirements that commenced earlier this year (April 2023) and (2) the complete overhaul of Brazil's transfer pricing rules and the related compliance obligations (discussed above). There have been other important updates around the world, such as transfer pricing disclosures in Saudi Arabia and Kenya, changes to transfer pricing documentation and timing in Malaysia, and adoption of transfer pricing rules in Seychelles. This will continue to be an evolving space going forward, specific countries to watch for transfer pricing changes include France, Canada, Korea, and Luxembourg.

Conclusion

There is a lot to consider in terms of transfer pricing and international tax as 2023 comes to a close and the 2024 year starts. While we expect to see more changes in 2024, many of the key tax initiatives have progressed such that now is a good time for MNEs to consider tax planning opportunities going forward.

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