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International Tax and Transfer Pricing Ideas for Year-End Discussions

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by the Washington National Tax International Tax and Transfer Pricing groups

Conversations between taxpayers and their tax advisors for year-end planning purposes could include discussions about the key international tax and transfer pricing issues addressed in this article:

- Recessionary concerns
- Foreign-derived intangible income ("FDII") planning
- Supply chain disruptions
- 2022 deduction for worthlessness from Russian operation exits
- Debt-related Russian issues
- Planning due to rising interest rates
- Reevaluating transfer prices in light of a recent U.S. court case
- Foreign tax redeterminations based on transfer pricing settlements
- Impending changes in and planning opportunities in Brazil
- Monitoring BEPS 2.0
- Issues arising from year-end adjustments
- Key upcoming changes in the transfer pricing compliance landscape

2022 has not been normal—not even a new normal—and it is already apparent that 2023 won't be either. The Ukraine-Russia conflict, continued supply chain disruptions, and concern over an impending recession have resulted in economic disruptions that will continue in the coming year. Though there have been delays to the OECD's BEPS 2.0 project, we're expecting that Pillar Two (minimum tax) will be implemented in 2023, coming into effect in countries such as France, Germany, Italy, Spain, and United Kingdom in 2024. By contrast, the future of Pillar 1 (revised profit allocation rules) remains less certain. All these developments bear on international tax and transfer pricing and would factor into year-end discussions. At the same time, existing planning opportunities should play an important role in year-end talks.

Recessionary Concerns

Because of potential recessionary concerns, taxpayers may want to consider mechanisms to advance cash to specific jurisdictions, such as prepayments or intercompany lending. Intercompany lending may be attractive to some companies because of increasing interest rates. Prepayments to a U.S. group may have the additional benefit of being eligible for the FDII deduction. Additional detail related to prepayments for FDII-eligible transactions is provided below.

Many taxpayers may want to consider adjusting their transfer pricing based on the potential economic downturn. For example, businesses expecting systemwide losses should consider where they expect to incur those losses and how they will support those positions. Tax administrations may be reluctant to accept losses, so taxpayers should be well prepared to defend those positions with robust transfer pricing documentation to support any extraordinary results. Taxpayers expecting systemwide losses may also want to revisit their structures and explore alternative structures better suited to the anticipated recessionary environment.

If a recession occurs, some taxpayers (consistent with, and necessitated by, changes in business operations) may want to take the opportunity to restructure their operations and move intangible property ("IP")—especially if a downturn (in combination with rising interest rates) leads to a lower IP valuation. A recession creates pressure for rationalisation, consolidation, and efficiency, often leading businesses to review the existing transfer pricing policies/results and, in many cases, to modify or restructure the operations and contractual allocation of risk in the supply chain. At the same time, tax authorities may resist both changes in pricing policies and business restructurings that lower local profits, for example by imposing significant tax "exit charges" on the restructuring steps or re-characterise intercompany transactions to increase local profits.

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 taxpayers. This strategy may be particularly attractive for companies that typically enjoy only modest FDII benefits because their eligible income is from low-margin activities (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 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.

Supply Chain Disruptions

Continuing supply chain disruptions and concerns about upcoming liquidity may prompt some taxpayers to revisit transfer pricing structures, including by modifying or terminating related party agreements or—in some cases—restructuring their supply chains. These changes fall within the broad scope of restructurings addressed in Chapter IX of the OECD Guidelines, but Chapter IX is clear that the label "restructuring" does not in itself connote that payment is due. The arm's length standard is controlling in this area; and depending on the facts, it may be possible to modify arrangements without triggering a payment obligation. Regard must always be had for the terms of the existing contractual agreements.

If modifying intercompany agreements, taxpayers should consider whether the agreements address with sufficient detail how certain expenses are to be treated (operating vs. non-operating) and shared among the affiliates in line with their functional, asset, and risk profiles. For example, foreign exchange gains/losses, inventory write-offs, bad debts, and contract non-performance costs may become more prominent in a recessionary environment with a host of geopolitical risks.

Considerations from Russian Market Exit and Russian Debt Cancellation

The economic sanctions by Western nations on Russia in response to its invasion of Ukraine led many multinationals to exit the Russian market. These exits may give rise to losses if the stock of a Russian subsidiary becomes worthless. A deduction for worthlessness is only available in the year that the stock becomes wholly worthless, which generally requires a fixed and identifiable event establishing worthlessness in the tax year (or in certain cases, facts and circumstances indicating hopeless insolvency developed during the year). A taxable liquidation of an insolvent subsidiary may be an identifiable event that establishes worthlessness. Taxpayers with Russian operations should consider (1) whether they have an identifiable event for worthless stock deduction and the year to which it applies; (2) the amount of the deduction; and (3) whether the worthless stock deduction qualifies for an ordinary loss deduction, as opposed to a capital loss. For complex fact patterns, pre-filing agreements with the IRS on ordinary deductions for a worthless stock loss could present a valuable opportunity for taxpayers.

In addition, the unwinding of multinationals' operations in Russia may also create cancellation of debt income for U.S. borrowers with loans from affiliated or third-party Russian companies. In case of full or partial forgiveness of debt, a U.S. borrower may be deemed to have taxable income to the extent that the adjusted issue price of the subject debt exceeds the amount transferred or deemed transferred in satisfaction of the debt. The opposite fact pattern may also occur—U.S. lenders may be unable to fully or partially recover debt from Russian companies and may be able to claim a bad debt deduction.

Capital Markets and Rising Interest Rates

Although there was an initial slow-down in the M&A market in early 2022 (compared to 2021), activities are back to a healthy level despite high interest rates, with certain sectors like technology, media, and telecommunications dominating more than others. Given the transitional phase of the capital markets (increasing interest rates, LIBOR transition), taxpayers will want to consider various financial transactions in connection with year-end planning. Examples of financial transactions include the following.

Intercompany Lending

IRS Exam teams have increased enforcement regarding the selection of interest rates for loans between related entities. Rising interest rates have further complicated this area because companies may have the option to reevaluate their current capital structures—including consideration of refinancing or arranging new intercompany loans. In that context, companies must consider pre-payment-options and covenants included in their intercompany loan agreements. For example, if the loan agreement is explicit about a make-whole clause, then the taxpayer will not have the burden of considering refinancing when rates are lower, while the absence of any early payment penalty provides flexibility for future planning. Any changes to a company's capital structure should also consider debt capacity (i.e., debt versus equity), potential implication of the substantial modification rules, and a company's internal treasury department guidelines.

Cash Pooling Arrangements

Deposit rates and borrowing rates in cash pools in most situations historically have been set with reference to LIBOR. With USD LIBOR set to cease in June 2023, and with rising in credit spreads, companies would need to reevaluate their cash pool policies and ensure arm's length return to all participants, while not over-compensating the cash pool leader.

Factoring

Factoring refers to the sale and purchase of accounts receivable invoices at a discount from face value. It is commonly used for financing working capital—companies sell their account receivables at a discount in exchange for cash. Rising interest rates means factoring can be a relatively more attractive option for short-term funding solutions as opposed to longer term loans or credit facilities, and could allow for greater planning opportunities.

Guarantees

Companies could consider using financial guarantees given the increased interest rates. Additionally, performance guarantees provide additional planning opportunities, whether part of the supply chain or part of indemnity to end users or customers.

Reevaluating Transfer Pricing Based on *Medtronic*

The Tax Court's 2022 opinion in *Medtronic, Inc. v. Commissioner* ("*Medtronic II*") criticized both the taxpayer's comparable uncontrolled transaction ("CUT") method analysis and the IRS's comparable profits method ("CPM") analysis. In place of the CUT and CPM analyses, the court embraced the use of an unspecified method based on an alternative analytical framework offered by Medtronic.

Taxpayers should consider reevaluating their transfer pricing method selection and application in light of the *Medtronic II* decision and its implications for method selection, and should consider conducting corroborative analyses to support pricing arrangements that may create exposure. Taxpayers should review their transfer pricing analysis, especially to the extent there are significant comparability adjustments or potential unaddressed comparability issues.

The Medtronic litigation also serves as a reminder that taxpayers should not rely on prior settlements or expired IRS agreements to protect against future adjustments.

Foreign Tax Redeterminations

Taxpayers continue to see audit activity focused on transfer pricing. That audit activity 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 the 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.

Brazil: Impending Changes and Planning Opportunities

Brazil is in the process of considering fundamental changes to its transfer pricing rules to align them with OECD standards (and essentially adopt the OECD guidelines). For taxpayers operating in Brazil, this represents not only a change to be managed, but also an opportunity to simplify their transfer pricing operating models, documentation preparation, and even claim deductions for expenses that were previously disallowed. These changes were slowed by Brazil's presidential election but it is still expected these new rules will be applicable beginning on January 1, 2024, which will leave little transition time for taxpayers to change from Brazil's rigid guidelines and specified transfer pricing methods to those aligned with the OECD guidelines.

Unless and until Brazil changes its transfer pricing rules, taxes imposed by Brazil (both the corporate income tax and withholding taxes) are expected to be non-creditable taxes in the United States. Many taxpayers are exploring ways to reduce, or even eliminate, Brazilian taxes to minimize the double tax burden. One structure that is generating significant interest is the usufruct. If structured properly, it is expected that outbound payments would be subject to a relatively low financial transaction tax in Brazil and would reduce Brazilian corporate income taxes and U.S. global intangible low-taxed income ("GILTI") inclusions as a result of Brazilian amortization deductions.

Monitoring BEPS 2.0

Many multinationals are closely monitoring developments as the OECD continues to move forward with BEPS 2.0. On Pillar 1, the OECD has held two consultations on Amount A (the reallocation of taxing rights over residual profits to market jurisdictions) and we're expecting a consultation draft on Amount B (the attempt to standardize baseline distribution and marketing returns) by the end of the year. There is uncertainty (and legitimate skepticism) about whether Pillar 1 will be implemented by 2024, the OECD's current target. But the key message for taxpayers is that the work the OECD is doing is shaping the future of transfer pricing.

A few key countries have publicly stated they will implement Pillar 2 starting in 2024. So, groups with operations in low taxed jurisdictions should be paying close attention. But it's not just your typical low taxed group that should be concerned. Many U.S. multinationals are discovering they will be affected by some aspects of Pillar 2, either because of a counterintuitive scenario that pushes their effective tax rate below 15 percent in a given jurisdiction or simply the additional compliance burden that they will face.

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[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").

Taxpayers should be mindful of the transition rule in the Pillar 2 model rules, which can be a trap for the unwary. The transition rule generally applies to transfers of assets, other than inventory, between related parties that occur after November 30, 2021, and the time when the relevant jurisdiction is brought within the scope of the global anti-base erosion ("GloBE") rules. When it applies, the transition rule causes the asset to have a carryover basis for purposes of the GloBE rules, even if the transfer occurs in a taxable transaction that would create additional basis for local tax purposes. If the additional basis of the asset is depreciated or amortized for local tax purposes, but not GloBE purposes, this could expose the company to additional tax once the GloBE rules come into effect.

KPMG has developed market-leading technical resources, including a BEPS 2.0 model that contains comprehensive guidance on the operation and intended outcomes of the model GloBE rules. Now is the time to evaluate these issues.

Year-End Adjustments

If taxpayers 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, the ever-changing tax regulatory landscape (with BEPS 2.0), supply chain disruptions, and a potential recession (e.g., when taxpayers may want to better target specific parts of a range to keep cash in specific jurisdictions) highlight the importance of strong OTP. For taxpayers 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). Taxpayers that are able to reflect year-end adjustments on their books for the year would avoid the necessity to make Schedule M book-tax adjustments after the books are closed, and would likewise avoid the secondary adjustment consequences associated with those adjustments.

Changing Transfer Pricing Compliance Requirements

Transfer pricing documentation requirements continued to evolve this year and it's important for taxpayers to assess the impact in their compliance engagements for 2022 and future years. Some examples include:

- Cyprus implemented new transfer pricing documentation requirements to prepare Master File, Local File, and a table of summarized information for fiscal years 2022 and beyond.
- Hungary introduced a new transfer pricing disclosure form and a requirement for related parties to be registered after the first transaction within 15 days for fiscal years 2022 and beyond.
- Effective for 2022, Mexico introduced significant changes for transfer pricing documentation including a requirement to examine domestic intercompany transactions and a requirement to submit the Local File no later than May 15, 2023 (a shorter timeframe for taxpayers to prepare this document).

Looking ahead, one of the most expected developments will be the U.K. transfer pricing documentation rules that are anticipated to apply on or after April 2023. These rules will include a very distinct element: a summary audit trail in the form of a questionnaire detailing the main actions taken by taxpayers in preparing the Local File.

Conclusion

Year-end discussions between taxpayers and their tax advisors have the potential to be particularly fruitful this year. Some items discussed in this article have a higher priority—2022 deduction for worthlessness from Russian operation exits, 2022 Russian debt-related issues, and FDII prepayments—and are critical topics for those year-end conversations.

Transfer Pricing authors:

Thomas Bettge

Jessie Coleman

Sayantani Ghose

Vesela Grozeva

Mark Martin

Jack O'Meara

Alistair Pepper

Milind Shah

Prita Subramanian

International Tax authors:

David De Ruig

Christopher Riccardi

Marissa Rensen

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