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### **Transfer Pricing Implications of Pillar Two Minimum Tax Rules**

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*MNEs should examine the transfer pricing implications of Pillar Two Minimum Tax and think again about the potential benefits of Advance Pricing Agreements, say Alistair Pepper, Quyen Huynh, and Samira Varanasi of KPMG.*

The Pillar Two Minimum Tax (or GloBE) rules are coming soon with many countries expecting to implement a Qualified Domestic Minimum Top-Up Tax (QDMTT) and/or Income Inclusion Rule (IIR) starting in 2024. So far, it has generally been the international tax planning or provision teams that have been at the forefront of MNEs' response to Pillar Two. This article discusses four reasons why businesses should also keep a close eye on the transfer pricing implications of these rules and involve their transfer pricing teams.

### **Getting Country-by-Country Reporting Right**

The [Pillar Two Transitional Country-by-Country Reporting \(CbCR\) Safe Harbor](#) is the first port of call when thinking about Pillar Two.

The Safe Harbor allows eligible groups to avoid the complexity of the full Pillar Two analysis for 2024, 2025, and 2026, if the jurisdictions where they operate meet one of three safe harbor tests:

- de minimis test;
- simplified effective tax rate (ETR) test; or
- routine profit test.

For most groups, the safe harbor math is the easy part. What is proving to be more challenging is determining whether their CbC Report meets the new "Qualified" standard that the OECD has set.

For this reason, multinationals are revisiting their approach to CbCR to make sure that they are relying on "Qualified Financial Statements" and are not adjusting this data when preparing their CbCR. In many cases, since it was the transfer pricing team that implemented CbCR in the first place, it is the transfer pricing team that tax departments are going back to for assistance.

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## Uncertainty Around TP True-Ups

Transfer pricing professionals know that designing a robust transfer pricing policy is important. But also, that implementing that policy is not always straightforward.

Many, if not most, multinationals use post-year end transfer pricing true-ups to ensure that the group entities achieve an arm's length return. These adjustments are frequently made after a group's consolidated financial statements have been closed and filed. So, they are not reflected in the entity-level accounts used to prepare these statements, which will generally be the starting point for the Pillar Two calculation (unless the group is subject to a QDMTT that requires them to use local statutory accounts).

For example, assume a group makes a post-year end transfer pricing true-up (and associated return to provision (RTP) adjustment) relating to a transaction that occurred in 2024 in its 2025 fiscal year, but before the group files its [GloBE Information Return](#) (GIR) in June 2026. What does this mean for Pillar Two?

It seems clear that the transfer pricing true-up should be accounted for when computing the group's GloBE income in 2024. Ignoring the slightly confusing [Commentary, Article 3.2.3 of the GloBE Model Rules](#) requires transactions between group entities located in different jurisdictions to be accounted for at arm's length. However, it is less clear whether the GloBE Model Rules provide for a corresponding adjustment when computing covered taxes. While Article 4.6.1 covers post-filing adjustments to covered taxes, the Commentary specifically limits its scope to adjustments made after the GIR has been filed. So, on its face the GloBE Model rules would seem not to apply to changes in tax expense resulting from an RTP adjustment that occurs between the end of a financial year but before the GIR is filed.

This could have negative implications for taxpayers. In a year where a transfer pricing true-up is made to increase a group's income in a jurisdiction this could depress its GloBE ETR, as its GloBE income would be increased without a corresponding increase to covered taxes. In contrast, if a transfer pricing true-up was made to decrease a group's income in a jurisdiction, this would effectively increase its ETR.

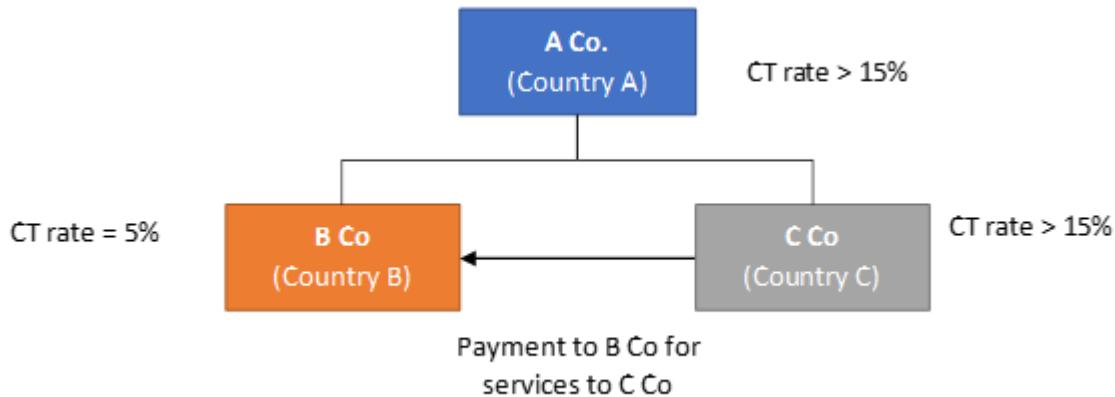
The Commentary to the Model Rules provides that further guidance may be provided in respect of Article 3.2.3 "where adjustments are necessary to avoid double taxation or double non-taxation." This seems like an issue that could well be addressed by such guidance.

## Double Taxation Arising from TP Adjustments

We have talked about post-year end transfer pricing true-ups, but what happens when transfer pricing adjustments occur after the GIR is filed?

Assume that a multinational group that is in-scope for Pillar Two is comprised of A Co., the ultimate parent entity located in Country A and its wholly owned subsidiaries, B Co. and C Co., which are located in Country B and C, respectively. Country A implements an IIR starting in

2024. Country A and C have tax rates above 15%, but Country B has a 5% corporate tax rate. In 2024, on \$100m of income earned in Country B from services provided to C Co., B Co. pays \$5m in taxes. Setting aside complexities such as the various adjustments required to compute GloBE income and the substance-based income exclusion (SBIE), Country A's IIR will impose a top-up tax liability of \$10m on the group, bringing its Country B ETR up to the 15% minimum rate.



Imagine that in 2027, Country C makes a transfer pricing adjustment asserting taxing rights over half the income realized in Country B in 2024, i.e., \$50m. And that after discussion with Country B's competent authority, this is held to be an arm's length adjustment. This means that half of \$100m of low-taxed income realized in Country B in 2024 is now subject to tax in Country C at above the 15% minimum rate and hence no longer low-taxed. So presumably, Country A needs to refund half the top-up tax it collected in 2024?

Unfortunately, this is not how the rules work. Because the transfer pricing adjustment has reduced the covered taxes paid in Country B by more than €1m, the group will need to recompute its GloBE ETR and top-up tax liability for 2024. The group's ETR will be unchanged at 5%, but its top-up tax liability will be reduced from \$10m to \$5m due to the reduction in income recognized in Country B. The GloBE Rules do not provide a mechanism for Country A to refund the top-up tax it collected in 2024. Instead, the Commentary (but not the Model Rules) states that where a redetermination would result in a refund of top-up tax to B Co, "such redetermination is taken into account in the re-determination year (i.e., the current Fiscal Year)." It is important to emphasize that a redetermination is not a refund, but rather a reduction to the top-up tax liability the group would otherwise face in respect of Country B in 2027.

It is possible to envisage this approach leading to different outcomes, depending on both whether Country B remains low-taxed in 2027 and, where it does, what Pillar Two charging provisions it is subject to.

- If, in 2027, Country B has raised its corporate tax rate to 20%, then Country B will no longer be low-taxed for GloBE purposes. As there is no top-up tax due under any GloBE

charging provision, then the \$5m reduction in the group's top-up tax has no practical effect for the group and hence the group will be left with \$5m in unrelieved double taxation.

- If, in 2027, Country B is still low-taxed for GloBE purposes and the resulting top-up tax liability is still collected by Country A under its IIR, then Country A will be required to reduce the top-up tax it collected in 2027 by \$5m, provided that the top-up tax liability exceeds \$5m. It is unclear what would happen if the group's top-up tax liability was less than \$5m. For example, if the group's top-up tax liability was \$4m, would Country A reduce the top-up tax it collects in 2027 to zero, and then carry forward the excess reduction of \$1m to 2028?
- But what if, in 2027, Country B is still low-taxed for GloBE purposes but has introduced a QDMTT; does this mean that Country B should reduce the top-up tax it collects? And if this is how the rules work, will Country B be willing to accept that it should essentially reduce the tax it collects because Country A has collected too much in a prior period?

Transfer pricing adjustments create three fundamental problems that it is difficult to resolve. First, a group's GIR might be filed five years (or more) before a transfer pricing dispute is ultimately resolved. Second, as in this example, it is feasible that a transfer pricing adjustment between two countries (e.g., Countries B and C) could affect the top-up tax that should have been collected in a third country (Country A). Third, without the option to refund overpayments of top-up tax in prior periods, changes in the jurisdiction that collects any top-up tax due (e.g., due to the introduction of a QDMTT in Country B) may affect the efficacy of the proposed rules.

As outlined above, the Commentary to the Model Rules leaves open the possibility that further guidance could be issued to address the double taxation that can result from the scenario outlined above.

## More Risk Around Permanent Establishments

Disputes around whether operations in a particular country constitute a permanent establishment (PE) and how much profit to attribute to a PE are recurrent issues in international tax, and the Pillar Two rules are only going to increase the problems caused by these disputes.

The double tax risk associated with transfer pricing adjustments also arises in respect of the profit attributed to a PE. So that is something groups should be watching out for.

The existence (or not) of a PE affects how a variety of Pillar Two provisions apply, particularly the rules relating to Flow-through Entities. And if countries assert a PE (and identify some people and assets connected to that PE) then they'll be able to apply the Undertaxed Profit Rule (UTPR) and take a shot at any of a group's low-taxed income that remains after applying the IIR and QDMTT.

## **What Actions Should Groups Be Taking Now?**

First, MNEs should include transfer pricing professionals in discussions on Pillar Two, get them up-to-speed and have them start thinking about potential challenges.

Second, MNEs should get their operational transfer pricing as accurate as possible, as quickly as possible.

Third, MNEs should think again about the potential benefits of Advance Pricing Agreements (APAs). The importance of APAs and the tax certainty they provide is only going to increase, particularly where groups have low-taxed profits.

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