Pillar Two implications of U.S. self-initiated transfer pricing true-ups

February 8, 2024

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Contents

Introduction 1
U.S. self-initiated transfer pricing adjustments under IRC section 482 1
Adjustments to GloBE income for transfer pricing adjustments 3
- Bilateral transfer pricing adjustments 3
- Unilateral transfer pricing adjustments 4
- Adjustments for transitional CbCR safe harbor 5

Adjustments to covered taxes for transfer pricing adjustments 6
Application of GloBE rules to U.S. transfer pricing true-ups 7
Examples — unilateral and bilateral U.S. transfer pricing true-ups 8
- Unilateral transfer pricing true-ups — United States is not an “under-taxed jurisdiction” 8
- Unilateral transfer pricing true-up — United States is an “under-taxed jurisdiction” 9
- Bilateral transfer pricing true-up 11

Mitigation 11
Conclusion 12
Appendix 13

Introduction

When preparing their tax return, taxpayers often determine that a transfer pricing adjustment is needed because the prices charged during the year in a controlled transaction did not produce an arm's-length result. U.S. transfer pricing regulations under IRC section 482 allow U.S. taxpayers to report the results of controlled transactions based on prices different from those actually charged in order to reflect an arm's-length result.[1]

Because the Organisation for Economic Co-operation and Development (OECD) Pillar Two global anti-base erosion (GloBE) rules focus on determining the effective tax rate (ETR) of a multinational enterprise (MNE) on a country-by-country basis, how multinational groups' profits are allocated between countries is a key consideration in applying the GloBE Rules. Under the GloBE rules, a taxpayer is generally required to adjust its GloBE income if the taxable income of one or more of its group members is determined using a transfer price different from the transfer price reflected in its financial statements due to a transfer pricing adjustment.[2] However, the GloBE rules do not allow a taxpayer to adjust its GloBE income for unilateral transfer pricing adjustments when the adjustment increases or decreases the taxable income in a country with either (1) a nominal tax rate below 15%, or (2) a GloBE ETR less than 15% in the previous two years, because in these instances adjustments would result in double taxation or double non-taxation.[3] This rule would prevent adjustments to GloBE income for a U.S. unilateral transfer pricing adjustment in instances when the U.S. GloBE ETR is less than 15% in the two years before the adjustment. In addition, year-end transfer pricing true-ups (also known as "return to provision adjustments") will generally result in a difference between financial statement tax expense and the actual tax liability reported on the tax return. The GloBE rules do not allow adjustments to GloBE covered taxes to account for this difference in most cases.

The impact of a U.S. entity's transfer pricing true-up on U.S. and foreign GloBE ETR will depend on whether the adjustment is bilateral or unilateral, whether the U.S. GloBE ETR in prior years is less than 15%, and whether the adjustment increases or decreases U.S. taxable income.

This article lays out several examples of how U.S. entities' transfer pricing true-ups may affect GloBE ETR in the United States or a foreign jurisdiction. In instances when the GloBE rules restrict adjustments to GloBE income or covered taxes, a taxpayer may have options to mitigate the impact to its U.S. or foreign GloBE ETR. However, tax modeling is required to assess the tax impact of transfer pricing adjustments under the GloBE rules.

U.S. self-initiated transfer pricing adjustments under IRC section 482

IRC section 482 allows the IRS to make allocations of income to ensure taxpayers clearly reflect income attributable to controlled transactions and to prevent the evasion of taxes. The Treasury Regulations also allow taxpayers to apply IRC section 482 in certain limited circumstances to report the results of controlled

[1] However, a taxpayers may only report a change in prices that reduces its taxable income on a timely filed original return. Reg. 1.482-1(a)(3).
[2] OECD Commentary, page 61, paragraph 98.
[3] OECD Commentary, page 62, paragraph 101; see also Model Rules Art.10.1.1 (defining Minimum Rate and Low-Tax Jurisdiction).

transactions based upon prices different from those actually charged, if necessary to reflect an arm's-length result.[4] The scope of the self-initiated transfer pricing adjustments allowed depends on whether the adjustment is reported on a timely original return versus an untimely or amended return:

- On a timely filed income tax return (including extensions) a taxpayer may make self-initiated transfer pricing adjustments increasing or decreasing taxable income.[5]
- On an untimely or amended return, a taxpayer may not make adjustments that decrease taxable income, but may make adjustments that increase taxable income.[6]

A taxpayer may make a self-initiated transfer pricing adjustment, even if the adjustment reflects prices that are different from the prices originally recorded in the taxpayer's books and records.[7] Thus, self-initiated transfer pricing adjustments will result in book-to-tax differences.

The Treasury Regulations provide that if a primary adjustment is made to the income of one member of a controlled group, an appropriate correlative adjustment must be made to the income of another member of the group.[8] For example, if an adjustment is made to increase the income of a U.S. corporation with respect to a transaction with a foreign member of the group, a corresponding decrease should be made to reduce the income of the foreign corporation.[9] However, absent a corresponding change to the foreign member’s tax return, this correlative adjustment would be effective only for U.S. tax purposes. The Regulations also require conforming adjustments to align secondary accounts, such as cash accounts or earnings and profits (E&P), with primary adjustments under IRC section 482.[10] Conforming adjustments may include the treatment of an allocated amount as a dividend or a capital contribution.[11] Conforming adjustments may also include repayment of an allocated amount without further income tax consequences.[12] However, similar to correlative adjustments, absent a corresponding change to the foreign member’s tax return, such conforming adjustments would be effective only for U.S. tax purposes and any actual movement of cash (or lack thereof) may be characterized differently in the foreign jurisdiction.

Thus, unless a corresponding increase or decrease is made to the taxable income of the related party for foreign tax purposes, a U.S. transfer pricing adjustment may cause the transfer price used to determine the taxable income in the U.S. to be different from the transfer price used to determine the taxable income in the foreign country. As discussed below, in certain situations the GloBE rules may not permit adjustments to GloBE income for such unilateral transfer pricing adjustments.

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[4] Reg. 1.482-1(a)(3).
[5] Reg. 1.482-1(a)(3).
[6] Reg. 1.482-1(a)(3); See also, FSA 200031025.
[7] See TD 8552, 1994-2 CB 93, 98–99.
[8] Reg. 1.482-1(g)(1), (2).
[9] See Reg. 1.482-1(g)(2)(iv), Ex. 3.
[10] Reg. 1.482-1(g)(1), (3).
[11] Reg. 1.482-1(g)(3)(i).
[12] Reg. 1.482-1(g)(3)(i); Rev. Proc 99-32.

Adjustments to GloBE income for transfer pricing adjustments

The GloBE rules[13] require transactions between Constituent Entities[14] in different jurisdictions to be priced consistently with the arm's-length principle and recorded at the same price for GloBE purposes for all constituent entities that are parties to the transaction.[15] Thus, any transaction between constituent entities located in different jurisdictions that is not recorded in the same amount in the financial accounts of both Constituent Entities or that is not consistent with the arm's-length principle must be adjusted to be in the same amount for both entities and consistent with the arm's-length principle.[16] When an MNE uses the transfer price reflected in its financial accounts to compute local taxable income and the tax authorities do not require a transfer pricing adjustment, this price must be used to calculate GloBE income or loss.[17]

However, many companies may need to make transfer pricing adjustments to align intra-group transactions with the arm's-length principle. If necessary to reflect an arm's-length result, a taxpayer may report prices for intra-group transactions on a tax return that differ from the prices actually charged.[18] Any transfer pricing adjustment made after the closing of the financial statements will create a book-tax difference. When the taxable income of one or more constituent entities that are parties to a controlled transaction is determined using a transfer price different from the transfer price used in the financial accounts, then an adjustment to GloBE income or loss is generally required to align the transfer price used in calculating GloBE income or loss with the transfer price used in calculating local taxable income.[19]

Bilateral transfer pricing adjustments

A bilateral transfer pricing adjustment occurs where parties to a controlled transaction in different countries each make a transfer pricing adjustment to adjust the transfer price used to determine local taxable income. Where parties to a controlled transaction in different countries each adjust a transfer price to the same price in order to reflect the arm's-length principal for local tax purposes, the GloBE rules require both entities to adjust their GloBE income or loss based on that price.[20] This may occur, for example, where the company

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[13] OECD (2021), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD Publishing, Paris, https://doi.org/10.1787/782bac33-en (hereinafter, the "Model Rules"); OECD (2022), *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*, OECD, Paris, https://www.oecd.org/tax/beps/tax-challenges-arising-from-thedigitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf (hereinafter "OECD Commentary"); OECD (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)*, December 2023, OECD/G20 Inclusive Framework on BEPS, OECD, Paris, http://www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosion-rules-pillar-two-december-2023.pdf. (hereinafter "December 2023 Administrative Guidance") (collectively, the "GloBE" Rules").

[14] A Constituent Entity is an entity that is a member of a group of entities that are related through ownership or control such that the assets, liabilities, income, expenses and cash flows of those Entities are (a) are included in the consolidated financial statements of an ultimate parent entity; or (b) excluded from the consolidated financial statements of the ultimate parent entity solely on size or materiality grounds, or on the grounds that the Entity is held for sale.

[15] Model Rules Art. 3.2.3.

[16] Model Rules Art. 3.2.3.

[17] OECD Commentary, page 61, paragraph 97. GloBE Income or Loss is the financial accounting net income or loss determined for a Constituent Entity for the Fiscal Year adjusted for the items described in Article 3.2 to Article 3.5 of the Model Rules.

[18] See e.g., Reg. 1.482-1(a)(3). Adjustments may also arise later when a tax return is audited by local tax authorities. OECD Commentary, page 61, paragraph 98.

[19] OECD Commentary, page 61, paragraph 98.

[20] OECD Commentary, page 61, paragraph 99.

makes a self-initiated transfer pricing adjustment on the local tax return in both jurisdictions or where the competent authorities of all counterparty jurisdictions agree to adjust the prices actually charged in a transaction. In such cases, the GloBE income in one country would generally increase and the income in another country would decrease by a corresponding amount.

Unilateral transfer pricing adjustments

The GloBE rules refer to transfer pricing adjustments that change the transfer price used to determine the local taxable income of one party to a controlled transaction but not the taxable income of the other party as a unilateral transfer pricing adjustment.[21] In these cases, the transfer price used to determine the taxable income in one country (the "Change Country") may be different from the transfer pricing used to determine the financial accounting income in that country, while the transfer price used to determine the taxable income in the other country (the "Book Country") is not. Such unilateral transfer pricing adjustments may occur, for example, when:

- An entity files a tax return under a self-assessment system that includes book-to-tax adjustments in order to comply with domestic transfer pricing rules such as IRC § 482;
- A tax authority challenges and adjusts the transfer price used in the local tax return of one of the Constituent Entities; or
- A unilateral advance pricing agreement (APA) has been agreed[22]

In such cases, the transfer price used in the financial accounts of the counterparties would be different from the transfer price used to calculate local taxable income in the Change Country but the same as the transfer price used to calculate taxable income in the Book Country.[23] When these differences arise due to a unilateral transfer pricing adjustment, the GloBE rules presume that the adjusted transfer price used to determine taxable income in the Change Country is arm's-length and *generally* require the GloBE income or loss of both parties to the controlled transaction to be adjusted based on the amount of the unilateral transfer pricing adjustment.[24]

However, the OECD Commentary to the Model Rules clarifies that adjustments to GloBE income or loss for unilateral transfer pricing adjustments are not permitted where the unilateral transfer pricing adjustment changes the taxable income in a jurisdiction that the GloBE rules view as an "under-taxed jurisdiction."[25] Specifically, adjustments to GloBE income or loss for unilateral transfer pricing adjustments are not permitted if the transfer pricing adjustment increases or decreases the taxable income in a country that:

- Has a nominal tax rate below 15%; or
- Had a GloBE ETR less than 15% in each of the two fiscal years before the year of the unilateral transfer pricing adjustment.[26]

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[21] See, OECD Commentary, page 62, paragraph 101.
[22] OECD Commentary, page 62, paragraph 100.
[23] OECD Commentary, page 62, paragraph 100.
[24] OECD Commentary, page 62, paragraph 101.
[25] OECD Commentary, page 62, paragraph 101.
[26] OECD Commentary, page 62, paragraph 101; see also Model Rules Art.10.1.1 (defining Minimum Rate and Low-Tax Jurisdiction). It is unclear how this rule would apply if GloBE ETR has not been calculated for each of the prior two years, e.g., because the GloBE Rules were not effective in the prior two years or the Transitional CbCR or Transitional Undertaxed Payments Rule ("UTPR") safe harbor applied. One possible approach would be to adopt a similar simplified approach to that used to compute a jurisdiction's GloBE ETR for the purposes of allocation Blended CFC Taxes (i.e., Global Intangible Low-Taxed Income ("GILTI") taxes) as outlined in the December 2023 Administrative Guidance. However, this is not something that the OECD has addressed to date, nor is it clear is this approach could feasibly be applied to periods before the GloBE Rules apply.

This restriction is intended to prevent double taxation or double nontaxation under the GloBE Rules.[27] The Commentary to the Model Rules explains that without this rule, unilateral transfer pricing adjustments in an under-taxed jurisdiction may lead to income being taxed twice or not at all under GloBE and local tax rules. For example, a unilateral upward transfer pricing adjustment in an under-taxed jurisdiction would result in double taxation, because the adjustment would increase the GloBE income and, thus top-up tax liability, in the under-taxed country while producing no corresponding reduction in the local tax paid in the high-tax jurisdiction.[28] On the other hand, a unilateral downward adjustment in an under-taxed jurisdiction would result in double non-taxation by reducing the GloBE tax imposed with respect to the under-taxed jurisdiction with no change in the tax liability of the high-tax jurisdiction to the extent that its adjusted rate was still at least 15%.[29]

Adjustments for transitional CbCR safe harbor

Although the GloBE Rules require adjustments to GloBE Income or Loss for self-initiated transfer pricing adjustments, similar adjustments are not permitted for purposes of the transitional country-by-country reporting (CbCR) safe harbor if the transfer pricing adjustments are not reflected in the company's financial statements.[30] The transitional CbCR safe harbor identifies "lower-risk jurisdictions" through the application of three quantitative tests,[31] all of which leverage the MNE group's country-by-country (CbC) report.[32] If a jurisdiction meets any one of the three tests, the top-up tax for that jurisdiction is deemed to be zero and there is no need to undertake the full GloBE calculation for that jurisdiction.[33] The transitional CbCR safe harbor applies only where the safe harbor calculations are performed using a "Qualified CbC Report"[34] prepared using "Qualified Financial Statements."[35]

OECD Administrative Guidance released December 15, 2023, clarifies that a taxpayer may not make adjustments to the data drawn from its qualified financial statements when preparing its qualified CbC report to account for transfer pricing true-up adjustments made after the close of its financial accounts, even if the adjustments are consistent with the adjustments required under GloBE rules for calculating GloBE income or loss.[36] Adjusting the company's CbC report for a transfer pricing adjustment which is not reflected in the financial statements will disqualify the CbC report for that jurisdiction.[37] Similarly, making adjustments to other financial statement information used in the transitional CbC report safe harbor calculations would

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[27] OECD Commentary, page 62, paragraph 103.
[28] OECD Commentary, page 62, paragraph 103.
[29] OECD Commentary, page 62, paragraph 103.

[30] December 2023 Administrative Guidance, Section 2.3.3, paragraph 16.
[31] Specifically, to qualify for the Transitional CbCR Safe Harbor in a particular jurisdiction, an MNE group must pass either (1) a de minimis test (i.e., the MNE group has less than €10 million in revenue and less than €1 million profit or a loss in the jurisdiction on its Qualified CbC Report for the year), (2) a simplified ETR test (i.e., the MNE group has a simplified ETR in the jurisdiction equal to or greater than a minimum rate, which escalates from 15% to 17% over the three-year transition period), or (3) in the jurisdiction for the year; or a routine profits test (i.e., the MNE group's profits in the jurisdiction do not exceed the substance-based exclusion).
[32] OECD (2022), *Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two)*, OECD/G20 Inclusive Framework on BEPS, OECD, Paris. www.oecd.org/tax/beps/safe-harbours-and-penalty-relief-global-anti-base-erosion-rules-pillar-two.pdf., Section 1, paragraph 9 (hereinafter "Safe Harbours and Penalty Relief").
[33] Safe Harbours and Penalty Relief, Section 1, paragraph 1.
[34] A "Qualified CbCR" means a Country-by-Country Report prepared and filed using Qualified Financial Statements. Safe Harbours and Penalty Relief, Section 1, paragraph 13.
[35] Safe Harbours and Penalty Relief, Section 1, paragraph 10. Qualified Financial Statements are (a) the accounts used to prepare the Consolidated Financial Statements of the ultimate parent entity; (b) separate financial statements of each Constituent Entity provided they are prepared in accordance with either an Acceptable Financial Accounting Standard or an Authorised Financial Accounting Standard if the information contained in such statements is maintained based on that accounting standard and it is reliable; or (c) in the case of a Constituent Entity that is not included in an MNE Group's Consolidated Financial Statements on a line-by-line basis solely due to size or materiality grounds, the financial accounts of that Constituent Entity that are used for preparation of the MNE Group's CbRC. Safe Harbours and Penalty Relief, Section 1, paragraph 13.
[36] December 2023 Administrative Guidance, Section 2.3.3, paragraph 16.
[37] December 2023 Administrative Guidance, Section 2.3.3, paragraphs 15-16.

disqualify the calculations from the safe harbor, unless such adjustments are explicitly required in the Commentary or Agreed Administrative Guidance.[38]

Adjustments to covered taxes for transfer pricing adjustments

The starting point for the computation of the covered taxes[39] taken into account in the GloBE ETR calculation is the current tax expense accrued in the financial statements of a constituent entity.[40] The GloBE rules then require a number of adjustments to the current tax expense accrued in the financial statements.[41] However, while the GloBE rules include provisions to adjust GloBE income or loss for transfer pricing adjustments, the GloBE rules appear to only allow for a corresponding adjustment to covered taxes in limited circumstances. Although Article 4.6.1 of the Model Rules provides for adjustments to covered taxes as the result of a change in the amount of income recognized for local tax purposes,[42] the OECD Commentary specifically limits the scope of the adjustments allowed under Article 4.6.1 to adjustments to covered taxes which occur "after the GloBE Information Return for the period has been filed."[43] Thus, the adjustment to covered taxes allowed by Article 4.6.1 appears not to apply to changes in an entity's tax expense that occur after it has finalized its financial statements for a financial year but before the GloBE Information Return is filed.[44] The OECD Commentary indicates that further guidance may address scenarios "where adjustments are necessary to avoid double taxation or double non-taxation," which may include instances where transfer pricing true-up adjustments result in changes to GloBE Income or Loss without a corresponding adjustment to Covered Taxes.[45] However, no such guidance has yet been released.

The GloBE information return is generally due 15 months after the last day of the relevant fiscal year, and the filing period is extended to 18 months for the first fiscal year an MNE is within the scope of the GloBE rules.[46] For example, for a calendar year company that is subject to the GloBE rules in 2024, the GloBE information return relating to the 2024 year would be due in June 2026. Thus, many self-initiated transfer pricing adjustments will occur after close of the 2024 financial year, in early 2025, but before the GloBE information return is filed in June 2026. This seemingly will cause the change in tax expense resulting from the return-to-provision adjustment not to be reflected in the covered taxes used in the GloBE ETR calculation.[47]

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[38] December 2023 Administrative Guidance, Section 2.3.3, paragraph 15
[39] The definition of Covered Taxes is set out in Article 4.2. The term is broadly defined to include taxes imposed on a Constituent Entity's income or profits as well as taxes equivalent to income taxes and taxes on retained earnings and corporate equity.
[40] Model Rules, Art. 4.1; OECD Commentary, page 85, paragraph 4.
[41] See, Model Rules, Art. 4
[42] Model Rules, Art. 4.1.6; OECD Commentary, page 111, paragraph 119.
[43]OECD Commentary, page 111, paragraph 119.
[44] Alistair Pepper, Quyen Huynh, and Samira Varanasi, *Transfer Pricing Implications of Pillar Two Minimum Tax Rules*, Tax Management International Journal, December 14, 2023 (available at: https://kpmg.com/us/en/home/insights/2023/12/tnf-kpmg-report-transfer-pricing-implications-pillar-two-minimum-tax-rules.html)
[45] OECD Commentary, page 63, paragraph 105.
[46] Model Rules, Art. 8.1.6 and Art. 9.4.1
[47] Alistair Pepper, Quyen Huynh, and Samira Varanasi, *Transfer Pricing Implications of Pillar Two Minimum Tax Rules*, Tax Management International Journal, December 14, 2023 (available at: https://kpmg.com/us/en/home/insights/2023/12/tnf-kpmg-report-transfer-pricing-implications-pillar-two-minimum-tax-rules.html)

Application of GloBE rules to U.S. transfer pricing true-ups

As discussed above, a bilateral transfer pricing true-up that changes the taxable income in both the United States and a foreign jurisdiction would result in adjustments to GloBE income in both the United States and the foreign jurisdiction to reflect the bilateral transfer pricing adjustment.[48] In addition, because the 21% U.S. corporate income tax rate exceeds 15%, the GloBE rules should generally allow the globe income or loss of both parties to a controlled transaction to be adjusted based on the amount of a unilateral U.S. transfer pricing true-up *unless* the United States has a GloBE ETR less than 15% in each of the two prior years.[49] Although the U.S. corporate income tax rate is 21%, a number of factors may cause U.S. GloBE ETR to fall below 15%.[50] Thus, the GloBE rules' restriction on adjustments to GloBE income or loss may apply to U.S. entities' unilateral transfer pricing true-ups in certain circumstances.

However, although the GloBE rules provide for adjustments to GloBE income or loss for transfer pricing adjustments, the GloBE rules apparently do not allow for corresponding adjustments to covered taxes to account for changes in an entity's tax expense occurring after the corporation has finalized its financial statements for the financial year but before the GloBE information return is filed.[51] Because U.S. corporate income tax returns are generally due by the 15th day of the fourth month following the close of the corporation's tax year[52] while the GloBE information return is due at least 15 months after the end of the fiscal year, transfer pricing true-ups and the associated return-to-provision adjustments to financial statements will generally occur before the filing of the GloBE information return for that year. Accordingly, covered tax amounts used in the GloBE ETR calculation may not be adjusted for the change in tax expense resulting from the return-to-provision adjustment.[53]

The GloBE impact of a U.S. transfer pricing true-up will depend on whether the transfer pricing adjustment is bilateral or unilateral, whether the U.S. GloBE ETR in prior years is less than 15%, and the direction of the transfer pricing adjustment. As shown in the examples below, U.S. transfer pricing true-ups can increase or decrease GloBE ETR in the United States or a foreign jurisdiction.

The impact on overall tax liability of a transfer pricing true-up may not be readily apparent because of the interaction of the GloBE rules with local tax liability. Factors such as whether the adjustment is bilateral or unilateral, the direction of the transfer pricing adjustment, tax rates in each jurisdiction, and each entity's tax attributes may impact the overall tax liability following a transfer pricing adjustment. Thus, tax modeling is required to assess the tax impact of unilateral and bilateral transfer pricing adjustments.

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[48] OECD Commentary, page 61, paragraph 99.
[49] OECD Commentary, page 62, paragraph 101.
[50] Factors which may result in a U.S. GloBE ETR less than 15% include a combination of material general business tax credits, special tax deductions, and the GloBE Rules' recast of deferred tax expense to 15%. See Model Rules Art. 4.4.1 (requiring that deferred tax expenses be taking into account for GloBE purposes at the rate at which it is booked in the financial statements if that rate is below 15% or at 15% if the rate at which booked in the financial statements is above 15%).
[51] See, OECD Commentary, page 111, paragraph 119.
[52] IRC § 6072(a).
[53] OECD Commentary, page 111, paragraph 119.

Examples — unilateral and bilateral U.S. transfer pricing true-ups

Consider the following examples where "US Co" makes a self-initiated transfer pricing true-up with respect to royalties received from "Foreign Co." For all examples, assume that:

- US Co licenses IP to Foreign Co in exchange for a royalty.
- US Co has pre-royalty financial statement income of $750 and receives a royalty from Foreign Co of $250, resulting in a total financial statement income of $1,000.
- Foreign Co has pre-royalty expense financial statement income of $750 and pays a $250 royalty to US Co, resulting in a total financial statement income of $500.
- In the current year, US Co's income is subject to tax at 21% such that its financial statement tax expense is $210 ($1,000 x 21%).
- In the current year, Foreign Co's income is subject to tax at 15% such that its financial statement tax expense is $75 ($500 x 15%).
- US Co and Foreign Co are the only constituent entities in their jurisdictions.
- All transfer pricing true-up adjustments to US Co and Foreign Co's taxable income and the associated return-to-provision adjustments to financial statement tax expense occur before the filing of the GloBE information return such that there is no adjustment to covered taxes under Art. 4.6.1 as a result of the transfer pricing adjustments.
- No other adjustments to GloBE income or covered taxes are required under the GloBE rules.

Unilateral transfer pricing true-ups — United States is not an "under-taxed jurisdiction"

First, consider two examples with the following additional assumption:

- The GloBE ETR in the United States for the previous two years was greater than 15%.

Because the GloBE rules require an adjustment to the GloBE income or loss of both parties if a unilateral transfer pricing adjustment changes the taxable income in a country that has a nominal tax rate above 15% and a GloBE ETR of at least 15% in the prior two years,[54] a unilateral transfer pricing true-up by US Co is reflected in the GloBE income or loss of both US Co and Foreign Co.

Example 1: Unilateral transfer pricing true-up to increase U.S. taxable income

US Co makes a unilateral transfer pricing true-up to increase its U.S. taxable income with respect to the royalty received from Foreign Co by $100. No adjustment is made to Foreign Co taxable income.

Because the U.S. nominal tax rate and the U.S. GloBE ETR in the two years before the transfer pricing adjustment are above 15%, an adjustment to the GloBE income of both US Co and Foreign Co is required based on the amount of US Co's unilateral transfer pricing true-up.[55] Thus, US Co's GloBE income is

[54] OECD Commentary, page 62, paragraphs 101 and 102.
[55] OECD Commentary, page 62, paragraph 101 and 102.

increased by $100 and Foreign Co's GloBE income is decreased by $100. Because the U.S. GloBE income is increased for the transfer pricing true-up, but the U.S. covered taxes remain unchanged since it is assumed that return to provision adjustments related to the current year are not part of the adjustment under Article 4.6.1, the U.S. GloBE ETR decreases from 21% to 19.1%. Similarly, because the foreign country GloBE income decreases but the foreign country covered taxes remain unchanged, the foreign country GloBE ETR increases from 15% to 18.8%.

US Co			Foreign Co		
Financial Statement Tax Exp.	210		Financial Statement Tax Exp.	75	A
Financial Statement Income	1,000		Financial Statement Income	500	B
Adjustment to GloBE Income	100		Adjustment to GloBE Income	(100)	C
GloBE Income	1,100		GloBE Income	400	D = B + C
GloBE ETR	19.1%		GloBE ETR	18.8%	E = A / D

Example 2: Unilateral transfer pricing true-up to decrease U.S. taxable income

US Co makes a unilateral self-initiated transfer pricing true-up to decrease its U.S. taxable income with respect to the royalty received from Foreign Co by $100. No adjustment is made to Foreign Co taxable income.

US Co's GloBE income is decreased by $100 and Foreign Co's GloBE income is increased by $100. Because the US GloBE income is decreased for the transfer pricing true-up but the U.S. covered taxes remain unchanged, since it is assumed that return to provision adjustments related to the current year are not part of the adjustment under Article 4.6.1, the U.S. GloBE ETR increases from 21% to 23.3%. Similarly, because the foreign country GloBE income is increased but the foreign country covered taxes remain unchanged, the foreign country GloBE ETR decreases from 15% to 12.5%, resulting in foreign country top-up tax.

US Co			Foreign Co		
Financial Statement Tax Exp.	210		Financial Statement Tax Exp.	75	A
Financial Statement Income	1,000		Financial Statement Income	500	B
Adjustment to GloBE Income	(100)		Adjustment to GloBE Income	100	C
GloBE Income	900		GloBE Income	600	D = B + C
GloBE ETR	23.3%		GloBE ETR	12.5%	E = A / D

The rationale for imposing top-up tax in respect of Foreign Co's income is that the foreign country has provided a tax deduction for a royalty expense of $250, which is above the arm's-length price of $150 ($250 royalty payment less the unilateral downward adjustment of $100 made in the United States) and hence the group has $100 of income that has not been subject to tax. The GloBE rules require this $100 to be recognized in Foreign Co's GloBE income, leading its income to be potentially subject to top-up tax.

Unilateral transfer pricing true-up — United States is an "under-taxed jurisdiction"

Next, consider another example with the following modified assumption:

- The GloBE ETR in the United States for the previous two years was less than 15% (e.g., due to R&D credits, etc.).

Now, because the U.S. GloBE ETR for the previous two years was less than 15%, the United States is an "under-taxed jurisdiction" and no adjustment is allowed to the GloBE income of US Co or Foreign Co for the US Co unilateral transfer pricing true-up.[56]

Example 3: Unilateral transfer pricing true-up to increase U.S. taxable income

US Co makes a unilateral transfer pricing true-up to increase its U.S. taxable income with respect to the royalty received from Foreign Co by $100. No adjustment is made to Foreign Co taxable income.

In contrast to Examples 1 and 2, neither US Co nor Foreign Co's GloBE income is adjusted for the unilateral transfer pricing true-up. Thus, US Co's GloBE ETR remains 21% because there is no change to its covered taxes or GloBE income. Foreign Co's GloBE ETR remains 15% because there is no change to its covered taxes or GloBE income.

US Co			Foreign Co		
Financial Statement Tax Exp.	210		Financial Statement Tax Exp.	75	A
Financial Statement Income	1,000		Financial Statement Income	500	B
Adjustment to GloBE Income	-		Adjustment to GloBE Income	-	C = 0
GloBE Income	1,000		GloBE Income	500	D = B + C
GloBE ETR	21%		GloBE ETR	15%	E = A / D

Example 4: Unilateral transfer pricing true-up to decrease U.S. taxable income

US Co makes a unilateral transfer pricing true-up to decrease its U.S. taxable income with respect to the royalty received from Foreign Co by $100. No adjustment is made to Foreign Co taxable income.

Neither US Co nor Foreign Co's GloBE income is adjusted for the unilateral transfer pricing true-up. US Co's GloBE ETR remains 21% because there is no change to its covered taxes or GloBE income. Similarly, Foreign Co's GloBE ETR remains 15% because there is no change to its covered taxes or GloBE income.

US Co			Foreign Co		
Financial Statement Tax Exp.	210		Financial Statement Tax Exp.	75	A
Financial Statement Income	1,000		Financial Statement Income	500	B
Adjustment to GloBE Income	-		Adjustment to GloBE Income	-	C = 0
GloBE Income	1,000		GloBE Income	500	D = B + C
GloBE ETR	21%		GloBE ETR	15%	E = A / D

[56] OECD Commentary, page 62, paragraph 101.

Bilateral transfer pricing true-up

Example 5: Transfer pricing true-up to increase U.S. taxable income and decrease foreign taxable income

Consider another example with the same facts as Example 3 above, except that a bilateral true-up adjustment is made so that there is a $100 increase to US Co's taxable income and a $100 decrease to Foreign Co's taxable income.

The United States is still an "under-taxed jurisdiction" because its GloBE ETR in the previous two years was less than 15%. However, because the bilateral transfer pricing true-up applies to the local taxable income in both jurisdictions, an adjustment is required to GloBE income in both the United States and the foreign country. As in Example 1 above, because the U.S. GloBE income is increased for the transfer pricing true-up, but the U.S. covered taxes remain unchanged, the U.S. GloBE ETR decreases from 21% to 19.1%. Because the foreign country GloBE income is decreased but the foreign country covered taxes remain unchanged, the foreign country GloBE ETR increases from 15% to 18.8%.

US Co			Foreign Co		
Financial Statement Tax Exp.	210		Financial Statement Tax Exp.	75	A
Financial Statement Income	1,000		Financial Statement Income	500	B
Adjustment to GloBE Income	100		Adjustment to GloBE Income	(100)	C
GloBE Income	1,100		GloBE Income	400	D = B + C
GloBE ETR	19.1%		GloBE ETR	18.8%	E = A / D

Mitigation

In scenarios when the GloBE rules restrict adjustments to GloBE income or loss or covered taxes for transfer pricing true-ups, taxpayers may have options to mitigate the impact of these rules:

- To the extent possible, avoid transfer pricing adjustments on tax returns after the close of the financial statements by ensuring that arm's-length transfer pricing is properly reflected in the company's year-end financial statements.

- If a book to tax adjustment is necessary to achieve an arm's-length result, seek to make a bilateral adjustment with a corresponding adjustment to taxable income in the other country. If taxpayers make a bilateral transfer pricing adjustment, the GloBE rules allow for corresponding adjustments to GloBE income or loss in both jurisdictions, even if the tax rate in one or both jurisdictions is less than 15% or if prior GloBE ETRs are less than 15%.[57] Making a self-initiated adjustment to report an arm's-length result, may also provide protection against IRS penalties.[58]

[57] OECD Commentary, page 62, paragraph 101; see also Appendix 1 summarizing circumstances when adjustments to GLoBE income are permitted for transfer pricing adjustment.
[58] For example, IRC 6662 imposes 20% (substantial valuation misstatement) and 40% (gross valuation misstatement) penalties on certain underpayments arising from noncompliance with IRC 482. The IRC 6662 penalty generally applies based on results of transactions as reported on a taxpayer's return (even if that reporting differs from the taxpayer's initial reporting in its books and records). Treas. Reg. § 1.6662-6(a)(2). Thus, a taxpayer that enters into a controlled transaction with a non-arm's-length price may avoid a penalty by reporting the arm's-length price on its tax return. Further, an amended return that reports an arm's-length price may

Alternatively, a taxpayer may opt to make no self-initiated transfer pricing adjustment, wait for the IRS to make an adjustment under IRC section 482, and then seek competent authority relief if necessary to prevent double taxation in the foreign jurisdiction. Note, however, that waiting for the IRS to make an adjustment may expose the taxpayer to penalties. In addition, financial statement reserves and uncertain tax position reporting may be required.

Conclusion

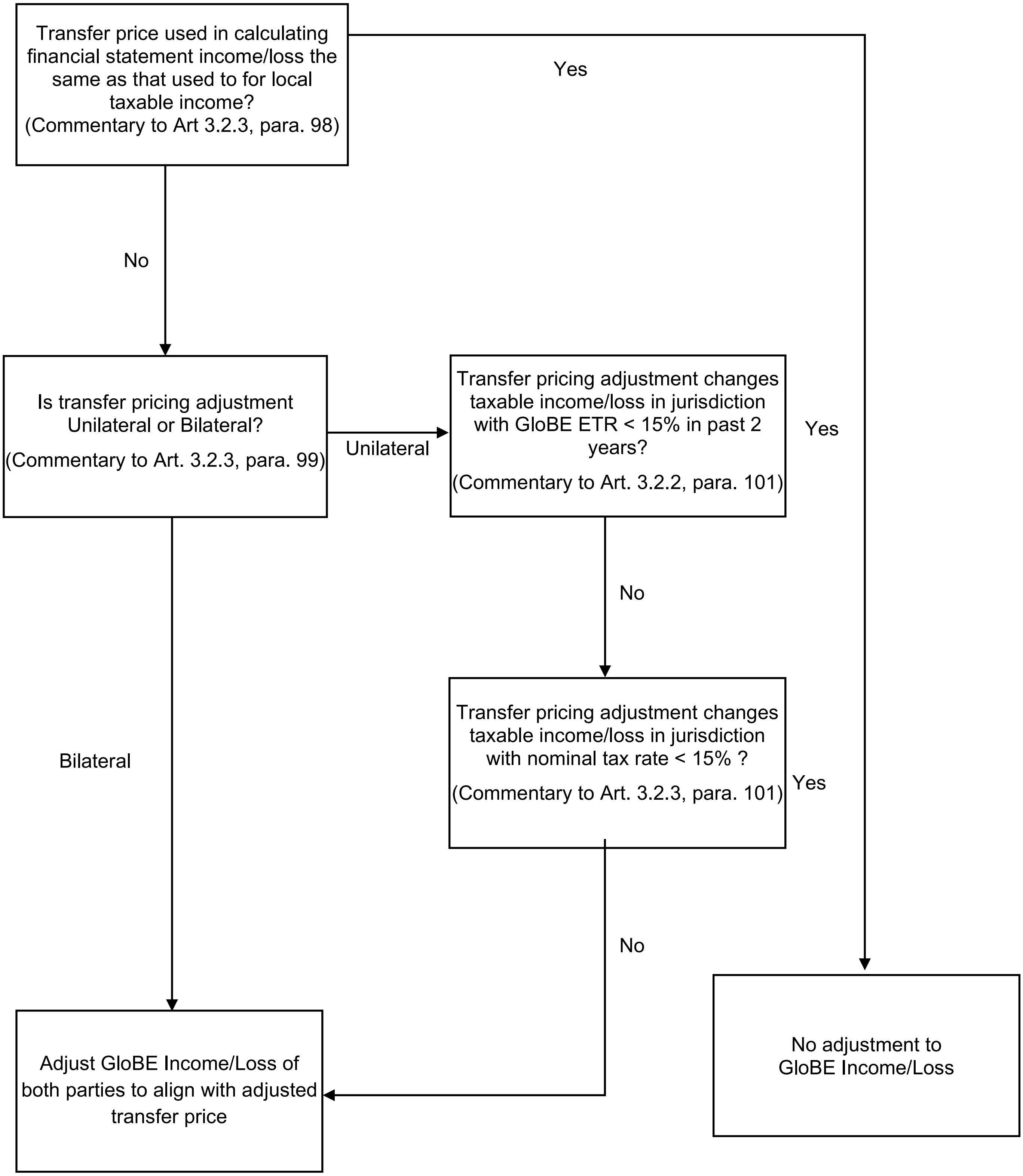
U.S. taxpayers may report the results of controlled transactions using prices different from those actually charged if necessary to reflect an arm's-length result. Although the GloBE rules generally allow adjustments to GloBE income or loss for transfer pricing adjustments that result in a difference between financial statement and taxable income, no adjustment to GloBE income or loss is allowed when a unilateral transfer pricing adjustment would change the taxable income in a country with (1) a nominal tax rate below 15%, or (2) a GloBE ETR less than 15% in the previous two years. This rule may prevent adjustments to U.S. and foreign GloBE income or loss for U.S. unilateral transfer pricing true-ups in instances when the U.S. GloBE ETR is less than 15% in the two years before the adjustment. In addition, covered tax amounts may not be adjusted for changes in an entity's tax expense occurring after the corporation has finalized its financial statements but before the GloBE information return is filed.

Thus, U.S. transfer pricing true-ups may affect GloBE ETR in the United States or a foreign jurisdiction. In instances when the GloBE Rules restrict adjustments to GloBE income or loss or covered taxes, a taxpayer may have options to mitigate the impact to its U.S. or foreign GloBE ETR. However, tax modeling based on each company's facts and tax profile is required to assess the tax impact of transfer pricing adjustments under the GloBE rules.

shield the taxpayer from a penalty if the amended return is filed before the IRS contacts the taxpayer about the original return. Reg. 1.6662-6(a)(2).

Appendix

Summary of adjustments to GloBE income or loss for transfer pricing adjustments



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