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The Key Issues Keeping Transfer Pricing A Top Tax Concern

By **Farnaz Amini and Sophia Castro Jurado** (March 31, 2023)

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While the pandemic is in the rearview mirror, regional wars and a general atmosphere of political and economic uncertainty are exacerbating its lingering effects.

In particular, global supply chain reconfiguration and digital transformation put pressure on transfer pricing, increasing the risk of tax controversy. Simultaneously, rising inflation around the world is introducing additional challenges and straining an already distressed global supply chain.

The various challenges preventing a global economic reemergence from the pandemic era — not just inflation but also rising oil prices and heightened global political risks — are making practitioners reevaluate commonly used transfer pricing models, and embrace new technologies and ways of doing business.

Transfer pricing remains a top tax concern for multinational entities, or MNEs, not only because it can result in multimillion-dollar adjustments, but also because of its complexity.

Additionally, during times of tax revenue reductions, tax authorities view related-party transactions as low-hanging fruit to increase tax receipts. In 2022, the Internal Revenue Service received funding to hire approximately 87,000 new IRS agents to support its review and enforcement objectives.

According to the Organization for Economic Cooperation and Development, mutual agreement procedure statistics transfer pricing disputes represent a main portion of the disputes among treaty members — up to 6.421 in 2021 from 3.328 in 2010.[1]

Meanwhile, transfer pricing audits are rising all over the world. Transparency tools such as the country-by-country report, adopted by several countries since 2016, have contributed to this trend.

The OECD base erosion and profit shifting, or BEPS, initiative continues to dominate international tax discussions. Almost 10 years after the initiative was introduced, the proposed recommendations have been broadly adopted by member and nonmember countries.

The OECD is currently working on a second package, commonly referred to as BEPS 2.0. This second phase finalizes a two-pillar agreement to continue addressing challenges that arise from the digitalization of the global economy.

Pillar One establishes new nexus and profit allocation rules for large multinational enterprises that meet certain revenue and profitability thresholds. Pillar Two establishes mechanisms to ensure large multinationals pay a minimum 15% tax. Significant progress has been made toward implementing these pillars since the progress report released in October 2022.[2]

There are ongoing discussions about the new alternative minimum tax, or AMT, enacted by the Biden administration and effective for tax years beginning after Dec. 31, 2022.

These discussions center on how the AMT will affect international tax measures introduced in the Tax Cuts and Jobs Act, specifically global intangible low-taxed income tax, and base erosion and anti-abuse tax, both of which are aimed at counteracting tax avoidance.

The consensus is that these changes will directly and indirectly affect the tax treatment of international transactions.

While large MNEs tend to focus on transfer pricing, middle-market entities often overlook it as a tool for planning. Given the projected lackluster economic growth in the U.S. and abroad, governments are refocusing efforts on reviews and enforcement in the face of significant declines in tax revenue.

Transfer Pricing Under the Inflation Reduction Act

In August 2022, President Joe Biden signed into law the Inflation Reduction Act, which addresses climate change, health care, inflation and taxes.

The act applies a 15% minimum tax on corporations with over $1 billion in revenue and a 1% excise tax on corporate share buybacks. It also provides about $80 billion of additional funding over 10 years for the IRS. Changes introduced apply to taxable years beginning after 2022.

The corporate AMT, equal to the excess of 15% of a corporation's adjusted financial statement income over its corporate AMT foreign tax credit, will apply to C corporations that, for a period of three taxable years, have an average annual adjusted financial statement income greater than $1 billion. There are limited exceptions to this rule and a special rule applicable to foreign-parented multinational groups.[3]

Half of the additional $80 billion in funding for the IRS is expected to be dedicated to compliance enforcement, specifically focusing on MNEs' transfer pricing activity.

However, the U.S. House of Representatives — now controlled by the Republican party — voted to cut the additional funding significantly, eliminating all new funding except the amount dedicated to system modernization and taxpayer services. Regardless of whether the IRS gets additional funding, transfer pricing audits are expected to rise.

Transfer pricing remains a key area of concern for tax compliance and tax collection. As one of the top audit priorities of the agency, the IRS not only has been hiring additional transfer pricing specialists, but also investing in technology and data analytics to enhance its risk assessment capabilities. Moreover, the IRS has been collaborating with other tax authorities around the world to exchange information and coordinate transfer pricing audits.

Relevant Economic Trends

Three years after the onset of the pandemic, the U.S. and global economies still struggle to realize the gains promised when the world began to reopen in mid-2021.

After an initial spike in economic activity, buoyed by low interest rates, significant inflationary pressures arose. Some inflationary factors were foreseen, such as the Federal Reserve Bank's continued policy of quantitative easing and three rounds of stimulus checks to taxpayers. Other factors were not anticipated, such as Russia's invasion of Ukraine and the subsequent stress on the oil market.

Inflationary threats were realized in 2022, with the inflation rate reaching 9.1% in June.

The combination of persistently high inflation rates, anemic supply chains and greater risks to cross-border activities will continue to affect MNEs in the short to medium term. As such, it is imperative to ensure intercompany pricing strategies consider macroeconomic as well as industry-specific factors, where applicable.

Brazil's Adoption of the OECD Standard

Brazil's long-awaited adoption of the OECD's international transfer pricing standard finally took place in December 2022 when the Brazilian tax authority published draft legislation — though the draft still needs to be approved by the legislative branch of the government by an April deadline.

If passed into law, Brazilian taxpayers may be able to opt for the new OECD standard-based transfer pricing rules instead of the current rules for fiscal year 2023. The new set of rules will be mandatory starting Jan. 1, 2024.

Among the most important changes included in the proposed legislation are Brazil's decision to embrace the arm's-length standard, as well as a comparability analysis, transfer pricing methods, special considerations for intangible and financial transactions, and other technical aspects.

The legislation also includes advance pricing agreements, or APAs, and mutual agreement procedures, or MAPs, as alternatives to mitigate uncertainty and double transactions, respectively.

It's important to remember that even if the new regulation follows the OECD guidelines, some aspects will not be consistent with the OECD standard. Examples include the specific treatment of commodities transactions, which are significant in the Brazilian economy, and the limitations on loan interests and guaranteed deductions.

U.S. MNEs with operations in Brazil would benefit from this change in relation to the application of the foreign tax credit final regulations released in December 2021.[4]

Updates From the OECD

The OECD continues to be relevant in the international tax arena not only by providing transfer pricing technical guidance, which is followed by member and nonmember states, but also by leading efforts to help international tax systems adapt to the new business circumstances driven by the digitalization of the economy.

In 2015, after a lot of initial skepticism, the OECD launched the final version of the BEPS 15 actions package. The focus of this initiative was to address the tax challenges arising from the digitalization of the economy. It does so by tackling tax avoidance, making international tax rules more coherent and promoting a more transparent tax environment.

Specifically, Action 13 introduced a three-tiered approach for transfer pricing documentation, including preparing a country-by-country report, a master file and a local file.

The report, which discloses aggregate data on the global allocation of income, profit, taxes paid and economic activity among MNEs' tax jurisdictions, can be shared with tax administrations for use in high-level transfer pricing and BEPS risk assessments.

Today, more than 137 countries and jurisdictions collaborate to implement the BEPS package, participant countries,[5] while 100 countries and jurisdictions have joined the multilateral instrument on BEPS.

Updated Guidance on Implementation of Country-by-Country Reporting

The adoption of a country-by-country report alongside other transfer pricing documentation measures is unprecedented. By 2016, 58 jurisdictions had implemented the country-by-country report, and by 2022 that number was over 100.

Less developed countries have adopted this higher standard of transfer pricing documentation, which has increased the compliance burden on MNEs. It has also increased the possibility of audit activity by the taxing authorities, since MNEs are supposed to be more transparent about their operational schemes.

In 2016, the U.S. adopted the country-by-country report by requiring MNEs with a U.S. parent and global revenues over $850 million to complete an IRS Form 8975 country-by-country report. The U.S. does not require MNEs to prepare a master or local file because existing transfer pricing documentation requires taxpayers to prepare equivalent information.

The fourth edition of the OECD corporate statistics, which contained aggregated and anonymized data from country-by-country reports for 2018, was released in November 2022.[6] The U.S. registered the largest number of country-by-country reports filed during that year at 1,641, followed by Japan and China with 861 and 394, respectively.

During 2023, European countries will have to transpose into law the European Union Public Country-by-Country Reporting Directive, enacted in 2021. As a consequence, EU-headquartered multinationals' country-by-country reporting data will start to be publicly disclosed. The first financial year of reporting will be the year starting on or after June 22, 2024, however EU member states can opt to adopt the rules earlier.

Guidance Update on MAPs and APAs

Following the publication of MAP statistics for 2021 and the Bilateral APAs Manual in 2022, the OECD published the manual on handling MAPs and APAs in February.[7]

Even if it is widely accepted that multilateral MAPs and APAs can offer tax certainty to both taxpayers and tax administrations, both mechanisms can result in a situation in which the solution is more complex than the problem. Historically both have taken a long time to complete. Moreover, despite the advantages they can offer, most countries have limited experience conducting bilateral MAPs and APAs.

In this regard, any additional guidance on navigating multilateral MAP and APA processes from both legal and procedural perspectives is more than welcome.

BEPS 2.0: Pillar One and Pillar Two Updates

The OECD BEPS 2.0 two-pillar package, aimed at combating BEPS, has made great advances since it was first announced in 2019.

Pillar One proposes a new taxing right with respect to the digital economy, which could allocate a percentage of MNEs' residual profits to end users' or customers' jurisdictions, where the company may not have a traditional taxing presence.

Meanwhile, Pillar Two proposes a minimum global corporate tax on MNEs with profits in each country or jurisdiction that are subject to an effective tax rate lower than the minimum rate. In that case, those profits will be taxed at a minimum of 15%.

Pillar One, also called the Global Anti-Base Erosion Model Rules or GloBE, will affect a much smaller group of MNEs than under Pillar Two. The Pillar One in-scope threshold considers MNEs with global turnover above €20 billion and profitability above 10%, which covers about 100 of the largest and most profitable MNEs. Extractive and financial corporations are excluded. After seven years of application, the turnover threshold will reduce to €10 billion.

On the other hand, Pillar Two will apply to MNEs meeting the €750 million threshold, which is consistent with the country-by-country report's threshold.

Pillar One Advancement

Pillar One revisits profit allocation and nexus rules by proposing allocating profit to market jurisdictions regardless of any physical presence in those jurisdictions. It recommends a two-fold approach.

On one hand, amount A will grant new taxing rights to the market jurisdiction over the MNE's residual profits by using a non-arm's-length-based formula. On the other hand, amount B, aiming at simplifying the analysis of the marketing and distribution activities remuneration, will propose a standard analysis consistent with the arm's-length principle.

Following the publication of the OECD progress report in October 2022, open consultations to the public were launched with respect to Pillar One, including on amount A in December 2022 and amount B in January 2023.

Despite the technical and political challenges for its implementation, participant countries have expressed their commitment to finding a consensus-based solution and keep supporting its adoption. In this regard it is probable the Pillar One set of rules will be adopted after further revisions and amendment based on ongoing negotiations.

Pillar Two Advancement

In July 2021, the participating countries reached an agreement on the key features of the Pillar Two proposal[8] and in December 2022, EU member states unanimously adopted the directive implementing GloBE rules. The final version of the directive is expected to be published by Dec. 31, and will be applicable for fiscal years starting on or after Dec. 31, 2024.

Responding to the expectation of further guidance on implementing key features of the GloBE, in February the OECD published administrative guidance that replaced the commentaries from March 2022. The package made available to the public includes guidance on safe harbors and penalty relief, public consultation on GloBE information return, and tax certainty for the GloBE rules.

The latest administrative guidance clarifies how the GloBE rule and the U.S. global intangible low-taxed income tax will interact, which was a major concern.

More recently there is a growing worldwide consensus on the adoption or Pillar Two. While some countries have expressed concerns in relation to specific aspects, there is strong support by participant countries to implement the GloBE rules. Nevertheless, the U.S. has been actively involved in the OECD BEPS projects including the two-pillar approach, but it has not expressed a final position in relation to the adoption of Pillar Two set of rules.

Controversy Updates

More recently, two major transfer pricing controversy cases have reached major milestones: Altera Corp. v. Commissioner and Coca-Cola Co. v. Commissioner.

The U.S. Supreme Court declined to hear Altera's appeal of the U.S. Court of Appeals for the Ninth Circuit's decision in Altera v. Commissioner. The Ninth Circuit upheld the rule under Treasury Regulations Section 1.482-7(A)(d)(2), which requires stock-based compensation to be included in calculating intangible development costs for cost-sharing arrangements. The Supreme Court's denial was Altera's last point of appeal in the case. Issues may still be presented in future court cases.

In Coca-Cola v. Commissioner, the Tax Court ruled in November 2020 in favor of the IRS, which resulted in an additional $3.3 billion tax liability for Coca-Cola. The case centered on the ownership of marketing intangibles, which Coca-Cola claimed were partially owned by its foreign affiliates, known as supply points.

The Tax Court's opinion relied on the lack of support in the intercompany agreements for the allocation of intangible property rights, and the observation that Coca-Cola could not indefinitely rely on a closing agreement with the IRS from a 1996 audit to provide certainty on its transfer pricing methods.

In addition, the Tax Court showed surprising support for applying the comparable profits method for intangible property transactions.

In October 2022, in Medtronic Inc. v. Commissioner, the Tax Court issued an opinion on using the transfer pricing method to determine income from intercompany licenses for intangible property required to manufacture certain medical devices and leads.[9]

In this third opinion, the Tax Court rejected both the taxpayer's and IRS' approaches to determine an arm's-length royalty rate for the intercompany transaction. Instead, the court deemed an unspecified method to be the most appropriate.

This case will either see further litigation upon appeal by the parties or it will be established as precedent. Either way, there are two important takeaways: Transfer pricing is subject to increasing scrutiny by tax authorities, especially when it involves intangibles — and litigation can turn into an endless battle.

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[1] According to the latest OECD Mutual Agreement Procedure (MAP) statistics for 2021 released in November 2022, the inventory of cases at start of 2021 amounted to 6.421, from which 54% corresponded to transfer pricing cases.

[2] OECD/G20 Inclusive Framework on BEPS: Progress Report September 2021-September 2022.

[3] A corporation member of a foreign-parented international financial reporting group, will be applicable for the AMT if: (a) the three-year average AFSI Test is met for one or more taxable years which are prior to the current taxable year and end after December 31, 2021, and (b) taking into consideration the AFSI of all U.S. members of the group, U.S. trades or businesses of foreign group members and foreign subsidiaries of U.S. members, the three-year average AFSI Test is met for one or more taxable years which are prior to the current taxable year and end after December 31, 2021, applying a greater than $100 million threshold instead of $1 billion.

[4] The foreign tax credit final regulations implemented a new attribution requirement to determine whether a foreign income tax is creditable in the United States, establishing that a foreign tax only meets the attribution requirement when the allocation rules in said tax jurisdiction are consistent with the Arm's Length Principle. As a result, foreign taxes paid or accrued in tax jurisdictions unaligned with the said principle will not be considered creditable in the United States. Brazil's adoption of the OECD standard will allow U.S. taxpayers to apply foreign tax credit regulations for taxes paid.

[5] According to the OECD/G20 Inclusive Framework on BEPS: Progress Report September 2021-Septmebre 2022, 137 countries have joined the landmark agreement reached on October 8th, 2021 Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy (Two-Pillar Solution or 2021 October Statement).

[6] According to the OECD Corporate Tax Statistics: Fourth Edition, the anonymized and aggregated country-by-country report statistics were provided to the OECD only by 47 jurisdictions, not by all the 76 jurisdictions that have received them during 2018 due to sufficiency data limitations.

[7] OECD published the Manual on handling of mutual agreement procedures (MAPs) and advance pricing arrangements (APAs) intended to guide multilateral MAPs and APAs from a legal and procedural perspective.

[8] By introducing the Income Inclusion Rule (IIR) and the Undertaxed Payment Rule (UTPR). The Income Inclusion Rule (IIR) requires a parent company to include in its taxable income the income of its foreign branches and controlled entities that is subject to tax at a rate below a minimum rate. The minimum rate is currently proposed to be at least 15%. The Undertaxed Payment Rule (UTPR) complements the IIR by denying a deduction or imposing a withholding tax on payments made by a parent company to its foreign affiliates if those payments are subject to tax at a rate below the minimum rate.

[9] Facts of this case include a license agreement between Medtronic Inc. and its Puerto Rico subsidiary for the right to manufacture, develop and commercialize intangibles related to medical devices and leads.