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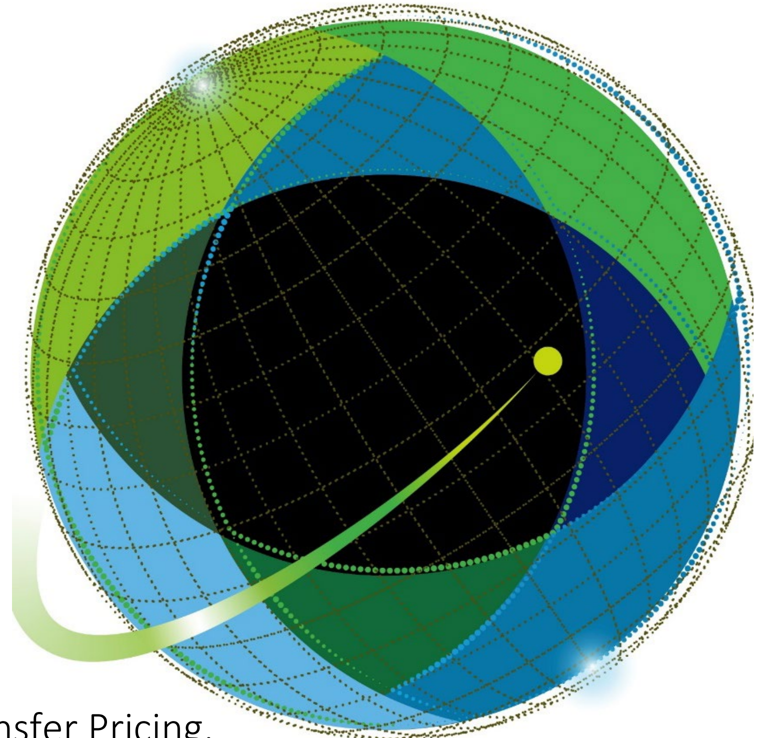
Pillar Two

Considering the implications of Transfer Pricing Adjustments on Pillar Two



Undertaking a proactive approach to Transfer Pricing, and in particular, understanding the consequences of Transfer Pricing Adjustments, is key to tackling the complexities resulting from Pillar Two.

Introduction

The OECD Pillar Two GloBE rules, part of the Base Erosion and Profit Shifting (BEPS) project, promulgate a global minimum tax rate aimed at curbing profit shifting and tax base erosion. The aim being one whereby the minimum tax ensures multinational enterprises (MNEs) pay at least a 15% tax on profits in each jurisdiction in which they operate. However, realizing this aim is easier said than done and with the complexities inherent to Pillar Two, Transfer Pricing is poised for significant transformation.

Transfer Pricing adjustments are commonly used by MNEs, especially close to or immediately after the financial year-end, to ensure results from transactions between related parties reflect arm's length pricing. However, the introduction of Pillar Two brings new challenges to light in relation to Transfer Pricing adjustments, including the timing of such adjustments and issues arising in so-called low-tax jurisdictions. Understanding these challenges and implementing robust solutions is essential for MNEs navigating this new landscape.

In the next paragraphs we will highlight some of the key aspects to consider, and introduce possible solutions.

Timing Issues

Post-Year-End Adjustments: Many MNEs use post-year-end adjustments to align their financial results with their Transfer Pricing policy to ensure consistency with the arm's length principle. These adjustments could take the form of:

- Adjustments made by the MNE after year-end, possibly after the finalization of the Group's Consolidated Financial Statements, but still reflected in the local statutory accounts. Therefore, it may be reflected in the correct financial year for local accounts, but not in the correct year for the Group's Consolidated Financial Statements; or
- Adjustments following a Transfer Pricing audit or Mutual Agreement Procedure from which an adjustment is made several years after the financial year to which the adjustment relates.

Pillar Two rules may stipulate that post-year-end adjustments (either being income and/or tax effects) should be booked in the fiscal year to which it pertains or the fiscal year in which the adjustment was made. Therefore, understanding how these Transfer Pricing adjustments impact GloBE Income and Adjusted Covered Taxes and invariably, the GloBE Effective Tax Rate (ETR), is crucial.

On the other hand, such adjustments may altogether be disallowed and give rise to double taxation under certain circumstances, as described below.

Low-Tax Jurisdictions

Disallowed Adjustments: There is increased scrutiny with respect to

Transfer Pricing adjustments in jurisdictions where an MNE has reported a GloBE ETR less than the minimum rate in fiscal years preceding a given Transfer Pricing adjustment. This naturally follows from the fact that these jurisdictions would have received increased attention from the tax authorities. But secondly, Transfer Pricing adjustments aimed at adjusting taxable income in these jurisdictions could be disallowed for Pillar Two purposes. This could in fact lead to double taxation if adjustments are not mirrored in the corresponding jurisdiction.

Double Taxation Risks: When Transfer Pricing adjustments occur after the GloBE Information Return ("GIR") is filed, resolving disputes can be problematic. For example, if a low-tax jurisdiction makes a post-filing adjustment that reallocates income to a higher-tax jurisdiction, there is no clear mechanism for refunding top-up taxes already paid, leading to potential double taxation.

MNEs should carefully assess existing Transfer Pricing policies, as well as the processes in place for the implementation of these policies, to avoid potentially negative Pillar Two consequences

Managing Transfer Pricing Adjustments in light of Pillar Two

Addressing the challenges of Transfer Pricing adjustments under Pillar Two requires a multi-faceted approach. Three primary solutions are described below.

Creating a Robust Transfer Pricing Policy

Transfer Pricing policies should be aligned with the way the business operates and implemented consistently across the Group: In order to comply with Pillar Two rules, transactions should be priced in line with the arm's length principle. Where this is not the case, adjustments should be made. However, to avoid unnecessary Transfer Pricing adjustments (whether made by the MNE or by a tax authority following an audit), MNEs should firstly assess whether Transfer Pricing policies are aligned with the way the business operates, and if so, ensure that the implementation of such policies is done in a consistent manner across the MNE. The importance of this is underlined by the fact that the GloBE Rules do not provide for a mechanism to address the situation that multiple tax authorities employ differing views on the given remuneration of a transaction.

A process whereby actual results are monitored on a regular basis with the expected outcome of the Transfer Pricing policies can help mitigate the risks associated with post-year-end Transfer Pricing adjustments, and the timing thereof. Transfer Pricing documentation supporting the arm's length nature of related party transactions should be available and kept up to date.

Timing of Adjustments

Proactive Adjustments: MNEs should aim to make Transfer Pricing adjustments contemporaneously with the transactions they relate to. This minimizes the risk of discrepancies between financial accounts and tax returns. Where post-year-end adjustments are necessary, the impact on Pillar Two ETR computations should be considered.

Alignment with Financial Reporting: Collaboration with financial reporting teams should be undertaken to ensure that Transfer Pricing adjustments are accurately captured in the consolidated financial statements. This alignment is crucial for accurate GloBE ETR calculations under Pillar Two.

Advance Certainty

Advance Pricing Agreements (APAs) provide certainty regarding the arm's length nature of transactions. These agreements, especially when concluded on a bilateral or multilateral manner, can eliminate disputes and ensure that Transfer Pricing adjustments are respected by tax authorities in the relevant jurisdictions. Given the complexities introduced by Pillar Two, bilateral and multilateral APAs are becoming increasingly interesting to MNEs as part of their overall strategy to manage risk.

How Deloitte can help

Our multidisciplinary Pillar Two team, with dedicated Transfer Pricing professionals, can support you further on your Pillar Two journey: from designing a robust Transfer Pricing policy to the implementation thereof, as well as in providing you with key insights to understanding and managing Transfer Pricing adjustments to avoid negative Pillar Two consequences.

For more information, visit our solutions page here

Conclusion

In conclusion, while Pillar Two introduces significant challenges for Transfer Pricing adjustments, a clear strategy around the maintenance of a MNE's Transfer Pricing policy, the implementation thereof (which includes carefully timing adjustments), and the seeking of advance certainty through APAs, can help MNEs navigate these complexities effectively.

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