The GloBE Knock-On Effects of Transfer Pricing and Other Adjustments

By Brian Jenn

Transfer pricing audits and adjustments have always been a time-consuming resource drain but generally follow a well-worn and well-understood path. Typically, that path culminates in a settlement with a foreign tax authority or possibly a resolution reached through judicial proceedings or a Mutual Agreement Procedure (MAP) agreement between two tax jurisdictions. Beginning with the implementation of Global Anti-Base Erosion ("GloBE" or Pillar 2) regimes in different jurisdictions starting in 2024, making final adjustments for regular corporate income tax purposes will not be the end of the road. Rather, taxpayers will need to consider any knock-on impacts within the GloBE or Pillar 2 regime, which may result in changes to GloBE income, Covered Taxes, GloBE effective tax rate ("ETR"), and Top-Up Tax liability in different jurisdictions.

The GloBE Model Rules say little about transfer pricing other than that transactions that are not recorded at arm's length in the financial accounts must be accounted for at arm's length for GloBE purposes.[1] Nonetheless, the Commentary to the Model Rules ("Commentary") provides a great deal of additional detail about the circumstances in which transfer pricing adjustments for regular income tax purposes will trigger adjustments to GloBE computations. Additionally, both the Model Rules and the Commentary describe the adjustments that must be made to Covered Taxes, GloBE ETR, and Top-Up Tax liability in different years as a result of any adjustment to regular tax liability, whether as a result of transfer pricing or another domestic law provision. This column will survey all of these rules, as well as the GloBE filing and other administrative implications of regular tax adjustments, with the intention of helping the reader understand better what will need to be done for Pillar 2 purposes when there is a regular tax adjustment.

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The Arm's Length Requirement and the Consequences of a Unilateral Transfer Pricing Adjustment

When GloBE Income Adjustments Are Required—In General

Article 3.2.3 of the Model Rules establishes the principle that *any* transaction between constituent entities located in different jurisdictions that is not recorded in the same amount in the financial accounts of both jurisdictions, or that is otherwise not consistent with the arm's length principle, must be adjusted to be consistent across jurisdictions and with the arm's length principle. Notwithstanding this seemingly broad rule, the Commentary significantly narrows the circumstances in which an adjustment can or must be made, focusing on situations where an adjustment is necessary—in the view of the Organisation for Economic Co-operation and Development ("OECD")—to prevent double taxation or double non-taxation. In practice, this means that only a primary transfer pricing adjustment that increases or decreases the multi-national enterprise ("MNE") Group's taxable income in a jurisdiction that is not an "under-taxed jurisdiction" (an under-taxed jurisdiction being one with a nominal rate below 15% or for which the MNE Group had a GloBE ETR below 15% in the two preceding years).[2]

An adjustment under Article 3.2.3 is required where there is a bilaterally agreed transfer pricing adjustment or, more commonly, a unilateral transfer pricing adjustment for purposes of the regular income tax. Such a unilateral adjustment is likely to occur where (1) a unilateral advance pricing agreement ("APA") has been agreed, (2) a constituent entity makes a book-to-tax adjustment to comply with domestic transfer pricing rules, or (3) a tax authority challenges and adjusts the transfer pricing used in a constituent entity's local return. Where such a unilateral adjustment occurs (and the adjustment is not challenged by a counterparty jurisdiction), the transfer price used for taxable income purposes is presumed to be consistent with the arm's length principle.

Primary Transfer Pricing Adjustment in a Higher-Tax Jurisdiction

As noted above, an adjustment under Article 3.2.3 only applies where the primary adjustment is in a higher-tax jurisdiction (*i.e.*, not in an "under-taxed jurisdiction"). For example, taking Germany and Barbados as hypothetical high- and low-tax jurisdictions, respectively, suppose a German audit results in an increase in taxable income in Germany due to a $100 decrease in royalty expense paid to Barbados. If the applicable German and Barbados marginal tax rates are assumed to be 30% and 3%, respectively, the German adjustment would result in $30 of additional tax. If GloBE income attributable to Barbados were subject to Top-Up Tax under an income inclusion rule ("IIR"), for example, and were unreduced as a result of the German adjustment, then $100 of Barbados royalty income would be subject to $12 of Top-Up Tax with no deduction allowed in Germany. Accordingly, the Commentary provides that the GloBE income attributable to Barbados must be reduced by $100 to avoid double taxation.

If, instead, there were a downward adjustment to the income in the high-tax jurisdiction (a less likely scenario), the GloBE income in the counterparty jurisdiction would be increased under Article 3.2.3. For example, if a unilateral APA resulted in a $100 reduction in German taxable income on a transaction with Barbados, the OECD would consider there to be "double non-taxation" of $100 if the taxpayer enjoyed a $30 German tax reduction without a $15 corresponding increase in Top-Up Tax (or Top-Up Tax plus regular corporate income tax) with respect to Barbados. Accordingly, Article 3.2.3 provides for an increase in GloBE income attributable to Barbados, which will have the effect of increasing Barbados Top-Up Tax.

Because the OECD considers that no double taxation or double non-taxation occurs where there is a primary adjustment in an under-taxed jurisdiction, the Commentary provides for no adjustment to GloBE income in that scenario. For example, if Barbados permitted a $100 reduction of royalty income from Germany under a unilateral APA or special transfer pricing method, matching that $100 reduction with a $100 reduction in GloBE income would produce a $15 gross Barbados tax benefit without a corresponding increase in German tax (even if German GloBE income is adjusted upward, since no Top-Up Tax would be due in Germany). Consequently, no adjustment to Germany or Barbados GloBE income is required or permitted. On the other hand, if Barbados adjusted taxable income upward by $100, then an increase in Barbados GloBE income as well would result in double taxation since the $100 would effectively be taxed in both Germany and Barbados.

Bilateral Disputes and Adjustments that Could Affect QDMTT Liability

The rules described above apply where there is a unilateral transfer pricing adjustment in a high-tax jurisdiction. There is no guidance as to what should happen where the counterparty jurisdiction disagrees with the adjustment. In particular, the Commentary indicates the GloBE Implementation Framework will further consider "appropriate adjustments … in situations where … in connection with a proceeding concerning the returns of two or more counterparties, the relevant tax authorities disagree as to whether or to what extent a transfer price needs to be adjusted to reflect the Arm's Length Principle …."[3] It not clear what is meant by "a proceeding concerning the returns of two or more counterparties," so the scope of this kick-out from Article 3.2.3 is not well defined. Although the kick-out may be limited to issues subject to MAP negotiations, it is possible that the OECD may attempt to create new venues for such disputes.

It should be noted that transfer pricing adjustments taken into account under Article 3.2.3 may affect liability under a qualified domestic minimum top-up tax ("QDMTT"). The QDMTT will generally be treated as an under-taxed jurisdiction for purposes of Article 3.2.3, since the QDMTT appears not to be taken into account in the relevant tests for under-taxed jurisdiction status.[4] Accordingly, a primary adjustment in the QDMTT jurisdiction would not affect GloBE liability, but an adjustment in a counterparty jurisdiction could have an impact on QDMTT liability in the under-taxed jurisdiction since the QDMTT is based on GloBE income. Because it is not clear how the under-taxed jurisdiction could challenge a reduction in QDMTT liability, that reduction in QDMTT liability may occur automatically without any mechanism for the under-taxed jurisdiction to prevent it.[5]

Reporting Consequences of an Adjustment Under the Regular Income Tax

As discussed above, a local tax adjustment can result in a GloBE income adjustment that lowers the jurisdictional ETR and generates additional Top-Up Tax with respect to a jurisdiction. A local tax adjustment can also affect the amount of Covered Taxes with respect to a jurisdiction, resulting in a lower jurisdictional ETR and additional Top-Up Tax. The Model Rules generally provide that jurisdictional Top-Up Tax must be recomputed in those jurisdictions but generally do not require filing amended GloBE Information Returns ("GIRs").

Similar to the GloBE rules generally, there is nothing simple about how those rules apply when there is an adjustment to regular income tax liability, including as a result of a transfer pricing adjustment.

In general, if a local tax adjustment results in a change in a constituent entity's Covered Taxes for a prior year—as generally would be the case where there is a transfer pricing adjustment—the MNE Group must recalculate its ETR and Top-up Tax pursuant to Article 4.6 of the Model Rules. Article 4.6 applies differently, however, depending on whether Covered Taxes for the jurisdiction increase or decrease for the prior year. An increase in Covered Taxes for a prior year requires a recomputation of the ETR for the *current year* (*i.e.*, the year in which the adjustment occurs) rather than the prior year. A decrease in Covered Taxes for a prior year, on the other hand, requires a recomputation of the ETR and Top-up Tax for the *prior year*. This disparity could result in a situation in which a bilateral transfer pricing adjustment with respect to a single year results in offsetting the impact on ETR and Top-up Tax in two different years.

Regardless of whether ETR and Top-up Tax are recomputed for the current year or a prior year, taxpayers generally will not be required to amend their GIR for a prior year. Rather, pursuant to Article 5.4.1, any additional Top-up Tax liability with respect to any year will be treated as additional current Top-up Tax for the current year and reported as a liability on the current year GIR.

Conclusion

Similar to the GloBE rules generally, there is nothing simple about how those rules apply when there is an adjustment to regular income tax liability, including as a result of a transfer pricing adjustment. Fortunately, as a practical matter, not every transfer pricing adjustment will impact Top-up Tax liability or require a ETR recomputation, and in any case, an amended GIR should not be required. Rather, taxpayers should be able to focus on transfer pricing adjustments by high-tax jurisdictions on transactions with jurisdictions with "under-taxed jurisdictions" (regardless of whether such jurisdictions have a QDMTT) and report Top-up Tax adjustments with the current year GIR.

ENDNOTES

1 Article 3.2.3.

2 Commentary on Article 3, paragraph 101.

3 Commentary on Article 3, paragraph 105.

4 A jurisdiction may be an under-taxed jurisdiction if it is a Low-Tax Jurisdiction (determined under Article 10.1 by reference to the GloBE ETR, which does not take into account a QDMTT) or if it has a nominal rate (without regard to the QDMTT) below 15%.

5 Nonetheless, a local top-up tax may qualify as a QDMTT notwithstanding that it systematically results in greater tax liability than GloBE Top-Up Tax liability that would be due with respect to the same jurisdiction, so countries may have flexibility to reject unagreed adjustments under Article 3.2.3 that reduce Top-Up Tax liability. *See* Administrative Guidance on the GloBE Rules (February 2023), paragraph 10 of guidance under Article 5.