



Insights Transfer Pricing

CRA Charles River
Associates

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Message from Rebel Curd

On behalf of myself and my colleagues, I would like to thank our clients and our referring law and accounting firm partners for their trust in us to advise on the ever-more-complex transfer pricing landscape. Our work during 2022 spanned from assisting start-up companies expanding abroad for the first time to advising large multinationals on multibillion-dollar transactions and acting as expert witnesses in tax disputes. Transfer pricing and related tax guidance and rules have changed, macroeconomic factors continue to challenge corporations, and many clients have restructured. The OECD was particularly productive in 2022, releasing new Transfer Pricing Guidelines (TPG) as well as making progress on Pillars 1 and 2. Brazil is on a path to aligning with the OECD TPG, while the UK and Mexico have notably updated their compliance requirements. Supply chain issues, high inflation and interest rates, and other economic factors have made maintaining transfer pricing policies and hitting arm's length results a more difficult proposition. Restructurings have been driven by business issues, including acquisitions and divestitures, realigning supply chains to increase resiliency, and mitigating tax risks relating to BEAT and DEMPE. Our experience with disputes indicates that it is becoming increasingly hard to reach principled resolutions at the field level.

This coming year, we expect these trends to continue, and we expect a further pickup in disputes as the first COVID-affected tax years come under audit in certain jurisdictions. As ever, we remain at your service and look forward to working together to address your transfer pricing needs.

Best regards,

Rebel Curd, VP and Global Transfer Pricing Practice Leader

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Looking forward to 2023

Economic conditions

As foreshadowed by the title of the latest *OECD Economic Outlook* published in November of 2022, *Confronting the Crisis*, 2023 may be a turbulent year. The global economy is facing significant challenges. Growth has lost momentum, and high inflation has broadened out across countries and products and is proving persistent. Risks are skewed to the downside. Energy-supply shortages could push prices higher. Interest rate increases, though necessary to curb inflation, heighten financial vulnerabilities. The Ukraine War is increasing the risks of debt distress in low-income countries and food insecurity.¹

With the benefit of successfully navigating transfer pricing impacts during the 2007-2009 Great Recession and recent COVID-19 pandemic, our team has assembled resources to tackle challenges that 2023 may bring. In this article, you will find the following topics covered:

- Impacts on company supply chains are explored in [Navigating transfer pricing amidst economic headwinds](#);
- Effects on benchmarks used for transfer pricing analyses in our simulations are summarized;
- Several international case decisions published in 2022, including from Spain and the Czech Republic, dealt with recurring losses; and
- Ten practical steps for dealing with quickly shifting economic conditions, which we summarized in [Cross-border transactions: Lessons learned from the last recession remain relevant](#).

Comparable company trends

One element of meeting the arm's length standard that taxpayers have no control over is the results of comparable companies when applying a profit-based method. During times of economic stability, comparable-company results can be relatively constant, and a taxpayer that targets close to the historical midpoint of the range is not likely to get a nasty surprise when the documentation process starts. However, 2022 was not a stable year, and we have been monitoring the quarterly results of many North American companies that fall into typical comparable sets to preempt any nasty surprises. What we have observed is that the impact of the various economic stresses on companies differs. That said, can we observe trends in our comparable company sets?

Service company profitability ratios are continuing to increase. This is the case across many functional activities. We observe that service companies are benefiting from economies of scale as they increase revenue and continue to tightly control operating expenses. As a result, net cost plus markups are increasing. We advise taxpayers to be cautious if they are relying on the low-margin covered services test to qualify for the Services Cost Method or in their tax planning for BEAT purposes.

Contract manufacturers are also exhibiting an increase in profitability as measured by the net cost plus or the return on assets profit level indicators. As gross profit levels are relatively stable, the increase in operating profitability is due to a decreasing operating expense ratio. We observe an increase in inventory in contract manufacturers, which means that the application of working capital adjustments might result in a more material change in the unadjusted versus adjusted interquartile ranges. This is magnified by the increase in the prime rate.

¹ OECD, *OECD Economic Outlook*, Nov. 2022, <https://doi.org/10.1787/f6da2159-en>.

The year-over-year operating margins for distributors are moving in opposite directions, depending on the industry. However, as the implied operating margins for 2022 remain higher than in the pre-COVID years, the multi-year average results are still trending higher, even in industries where the 2022 operating margin fell. The industry distinction is interesting and is a reflection of demand dynamics, specific supply chain issues, and the ability to pass on increased costs, e.g., freight, to customers.

If you would like to discuss the trends in comparable company results, please reach out to your CRA contact or Robin Hart (rhart@crai.com).

Looking back on 2022

CRA's Transfer Pricing practice enjoyed a successful 2022, attending conferences, working on a wide variety of new projects, and having several team members receive recognition in reputable international publications. Here is a summary of our conferences, projects, and accolades:

Conferences

- In May at the ITR Women in Tax Forum 2022 – East Coast, Anna Soubbotina was a panelist during “Towards global consensus: the remaining challenges of the OECD’s two-pillar solution,” where they discussed the tax challenges of digitalization of the economy. CRA was a proud sponsor of this event.
- During the IFA Tax Challenges Arising from Digitalisation – Pillar I, Anna Soubbotina was a speaker during the session that discussed the current status and practical implications of the OECD’s Pillar I draft rules from a business, legal, and economic perspective.
- CRA was a proud sponsor of the 11th Annual Pacific Rim Tax Conference.
- At the ITR Women in Tax Forum 2022 – West Coast, Rebel Curd spoke on “Digitilization of the economy – implementation and challenges of the OECD’s two-pillar solution.” CRA was also a proud sponsor.
- During the IFA Westchester, NY/CT Region Luncheon Series – Tax Valuation: Lessons from IP Litigation in June, Anna Soubbotina presented during the session to discuss intangible property valuation in the context of transfer pricing.
- In September at the IFA USA Atlanta Regional Fall Conference, Anna Soubbotina spoke during the session titled “Global Tax Update: The Evolving Tax Landscape.”
- At the ITR Global Transfer Pricing Forum USA, Anna Soubbotina presented during the session titled “How to effectively plan ahead and prepare for upcoming transfer pricing controversies” and led the roundtable discussion titled “ESG and transfer pricing.” Robin Hart also presented during the session titled “Tackling transfer pricing challenges arising from global supply chain disruptions.” CRA was also a proud sponsor.
- At the New York City Bar Association Blockchain Institute 2022 in November, Anna Soubbotina was a panelist on “Licensing and Taxation”, discussing taxation of digital assets and the role of transfer pricing for cross border transactions in the blockchain and cryptocurrency industry, including peculiarities of pricing controlled cryptocurrency transactions, activities such as mining and staking, and accounting for evolving business models. Dan William was also a panelist on “Banking on Crypto” and discussed current and future US banking hurdles and international solutions to banking with digital asset companies. CRA was also a proud sponsor.
- In December at the TP Minds West Conference, Robin Hart and Anna Soubbotina presented on the panel titled “Economic Headwinds and their Impact on Transfer Pricing” and Rebel Curd presented during the session titled “Intellectual Property: IP Transfer and Cost Sharing Post COVID.” CRA was also a proud sponsor.

Sample projects



Dispute resolution for inbound distributor

CRA represented a large medical device company at IRS Appeals after a drawn-out field audit handled by the taxpayer. With CRA's economic analyses, Appeals found that no adjustment was required.



Patent valuation for withholding tax purposes

CRA was engaged by a Silicon Valley software company to prepare an economic analysis of the licensing of German registered patents for German withholding-tax purposes.



Cross-border biotech licensing of novel IP

CRA provided economic analysis to a US-based biopharmaceutical company under audit by the French tax authority regarding the outbound license of novel IP from the jurisdiction. The tax authority accepted the licensing framework developed by CRA.



Transfer pricing planning for Brazilian market

CRA was engaged to perform a transfer pricing planning analysis for a SaaS company that involved its Brazilian subsidiary. CRA presented various scenarios and tax implications to plan the transfer pricing policy for the intercompany transaction involving the client (US parent) and its Brazilian subsidiary.



Successful resolution of audit in Japan

CRA managed the audit process with the Japanese NTA for a SaaS client, including managing the IDR process and setting expectations about data availability and liaising directly with the audit team to swiftly resolve the issue.



Bridging U.S. customs and transfer pricing requirements

CRA prepared an analysis and report that bridges income tax and customs requirements for the intragroup importation of finished consumer goods from Mexico, Australia, and the United Kingdom.

Accolades

Our transfer pricing consultants Rebel Curd, David Kemp, and Anna Soubotina have been recognized for their expertise by several industry publications.

International Tax Review – *World Tax Guide 2023*

- **“Women in Tax” Category**
Rebel Curd – USA (California Region)
- **“Tax Controversy” Category**
David Kemp – Canada

International Tax Review – *World Transfer Pricing Guide 2023*

→ “Transfer Pricing” Category

Rebel Curd – USA

David Kemp – Canada

Anna Soubbotina – USA

→ “Transfer Pricing Firm” Category

Charles River Associates – Canada

Legal Media Group – *Expert Guides 2022*

→ “Women in Business Law” Guide – Transfer Pricing Category

Rebel Curd – USA

→ “Best of the Best United States” Guide – Transfer Pricing Category

Rebel Curd – USA

US updates

IRS economic substance doctrine

During 2022, the IRS adopted a more assertive stance with respect to enforcement of the economic substance doctrine as codified in IRC Section 7701(o). Under the doctrine, a transaction is considered to have economic substance only if it has meaningful economic impact other than federal income tax effects and the taxpayer has a substantial purpose for entering into the transaction other than for federal income tax purposes. If an intercompany transaction lacks economic substance, penalties may apply. Specifically, during 2022, the IRS released a memorandum revealing a change in policy such that a revenue agent requires the approval of only their direct supervisor—rather than executive-level approval—before assessing a penalty under the economic substance doctrine. This is consistent with the stated intent of the IRS to impose more penalties on transfer pricing–related issues.

IRS priority guidance

Each year, the Treasury Department and IRS issue a joint Priority Guidance Plan, which is then used by the agencies to identify and prioritize tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other guidance. An initial version of the 2022-2023 plan covering July 2022-June 2023 was issued on November 4, 2022. While the plan does not specify deadlines for completing projects, it lists over 200 projects that are priorities for allocating Treasury Department and IRS resources.

With respect to transfer pricing, the following three items are listed²:

- Regulations under Sections 367 and 482, including (1) regulations addressing the changes to Sections 367(d) and 482 on aggregation, realistic alternatives, and the definition of intangible property, and (2) regulations under Section 482 clarifying certain aspects of the arm’s length standard, including periodic adjustments. (Proposed and temporary regulations were published on September 16, 2015.)
- Regulations under Section 482 clarifying the effects of group membership (e.g., passive association) in determining arm’s length pricing, including specifically with respect to financial transactions.

² In addition to Announcement 2022-7, Announcement and Report Concerning Advance Pricing Agreements, which was published on April 11, 2022.

- Guidance updating Rev. Proc. 2015-41 by providing the procedures for requesting and obtaining advance pricing agreements (APAs) and guidance on the administration of executed APAs.³

Passive association and the role of implicit support resulting from being part of a multinational group is already discussed in Treas. Reg. Section 1.482-9 with respect to intragroup services and is also addressed in Chapter X of the 2022 OECD Guidelines with respect to financial transactions. Clarification of US guidance in this area specifically for financial transactions would be welcome and would reduce uncertainty for taxpayers engendered by the IRS's anecdotally inconsistent history of bringing up this issue.

With respect to an update of Rev Proc 2015-41, it is worth noting that Rev Proc 2015-40 provides parallel guidance with respect to requesting and obtaining assistance under US tax treaties from the US Competent Authority (CA). Therefore, it would be logical to expect updates to the CA process as well. From a practical perspective, the continued ability to submit requests digitally would be a welcome simplification for taxpayers.

The 2022-2023 plan also continues to list regulations addressing the inbound transfer of intangible property subject to Section 367(d) as a priority item.

Compared to the 2021-2022 plan, the following guidance under Section 482 has been dropped:

- Regulations under Section 482 further clarifying certain aspects of the arm's length standard, including (1) coordination of the best-method rule with guidance on specified methods for different categories of transactions, (2) discretion to determine the allocation of risk based on the facts and circumstances of transactions and arrangements, and (3) periodic adjustments.

The plan notes that items are removed "because they are no longer considered priorities for purposes of allocating resources" during the current year, although some of them may be considered for inclusion in the future.⁴

FTC and the arm's length principle

The US Department of the Treasury and the IRS issued final foreign tax credit regulations on December 28, 2021, in Treasury Decision 9922 (TD 9959).⁵ Among other things, these regulations limit US foreign tax credits to foreign income taxes that largely conform with US tax laws, including the arm's length principle.

Specifically, these regulations set forth the following requirements for a tax imposed on a resident of a foreign nation to be creditable from a US perspective:

"The base of a foreign tax imposed on residents of the foreign country imposing the foreign tax may include all of the worldwide gross receipts of the resident, but must provide that any allocation to or from the resident of income, gain, deduction, or loss with respect to transactions between such resident and organizations, trades, or businesses owned or controlled directly or indirectly by the same interests (that is, any allocation made pursuant to the foreign country's transfer pricing rules) is determined under arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion."⁶

³ Department of the Treasury, *2022–2023 Priority Guidance Plan 14* (2022).

⁴ Department of the Treasury, *2022–2023 Priority Guidance Plan 2* (2022).

⁵ TD 9959 was added to the Federal Register on January 4, 2022, and subsequently corrected on July 27, 2022.

⁶ Treas. Reg. § 1.901-2(b)(5)(ii) (2021).

This update to the foreign tax credit regulations serves only to further emphasize the need for global transfer pricing compliance, as US multinationals are now likely to find all transfer pricing transactions, even those not directly involving a US entity, the subject of future tax audits.

OECD updates

The OECD continues to advance technical design and implementation considerations regarding the initiative that was conceived as the two-pillar solution to the tax challenges of the digitalization of the economy. We note that the scope of Pillars 1 and 2 has evolved to be far broader than the original focus on the digital economy. Pillar 1 is a framework for a standardized allocation of certain profit components within a multinational enterprise (MNE) based on formulae for routine distribution returns (Amount B) and a reallocation of certain residual profit to market jurisdictions (Amount A). Pillar 2 refers to the framework to establish a global minimum tax of 15 percent.

Pillar 1: Amount A

During 2022, the OECD advanced Amount A of Pillar 1 by issuing the following three public consultation documents seeking public comments on the progress and proposed rules thus far developed:

- OECD (2022), Progress Report on Amount A of Pillar One, Two-Pillar Solution to the Tax Challenges of the Digitalisation of the Economy, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris, <https://www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf>
- OECD (2022), Progress Report on the Administration and Tax Certainty Aspects of Pillar One, Two-Pillar Solution to the Tax Challenges of the Digitalisation of the Economy, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris, <https://www.oecd.org/tax/beps/progress-report-administration-tax-certainty-aspects-of-amount-a-pillar-one-october-2022.pdf>
- OECD (2022), Pillar One – Amount A: Draft Multilateral Convention Provisions on Digital Services Taxes and other Relevant Similar Measures, Public Consultation Document, OECD, Paris, <https://www.oecd.org/tax/beps/public-consultation-document-draft-mlc-provisions-on-dsts-and-other-relevant-similar-measures.pdf>

Through these publications, Amount A has started to take a more concrete form; however, the Inclusive Framework countries have not yet reached consensus on the Amount A rules, and no country has yet adopted Amount A into its tax code.

Does this apply to you?

When effective, Amount A will be applicable to MNEs with greater than 20 billion euros in annual revenues and operating margins greater than 10%, which is estimated to only affect up to 200 companies initially. However, the scope of Amount A may be expanded to a lower revenue threshold after a review period.

Pillar 1: Amount B

On December 8, 2022, the OECD released a public consultation document relating to Amount B, which refers to the return for baseline marketing and distribution activities. The goal of Amount B is to simplify and streamline the determination of remuneration of what are commonly referred to as low-risk distribution (LRD) entities as well as sales agents and commissionaires. The aim is to provide increased tax certainty to taxpayers and assist low-capacity jurisdictions with the application of the arm's length

principle, particularly due to the documented issue that comparable companies can rarely be identified in those countries.

The consultation document provides a progress report with respect to the work performed in creating a framework for benchmarking LRDs and determining what the arm's length return should be. The document is premised on the application of the transactional net margin method (which is akin to its US counterpart, the comparable profits method) and the use of the operating margin. The framework contemplates the application of adjustments, when statistically significant to the forecasting of profitability, to increase the accuracy of results. By the OECD's admission, the statistical analysis is nascent and meaningful correlations are few and far between. That said, the OECD has put forth two potential applications of Amount B: (1) a matrix of operating margins, e.g. based on operating expense ratio, asset intensity, and/or other ratios and (2) a mechanical computation applying a regression equation to tested party financial data and relevant characteristics or applying a series of adjustments to a starting operating margin.

Does this apply to you?

While the vast majority of MNEs fall below the revenue and profitability threshold of Amount A and many fall below the revenue threshold of Pillar 2, Amount B might apply because it has no size threshold. That said, there are many scoping limitations, which means that MNEs of any size may not be subject to Amount B. Generally, Amount B may apply if the LRD:

- purchases from a single related party supplier;
- distributes tangible goods (services and digital goods are scoped out);
- distributes at the wholesale level (retailers are scoped out);
- distributes primarily in its country of incorporation;
- does not engage in value-added activities, such as regulatory, technical, or specialized services supporting its sales and marketing that generates a value intangible asset;
- has financial ratios that fall below certain (to-be-determined) thresholds for sales to end customers (including via online stores), marketing and advertising expenditure, packaging and assembly, and after-sales product support, or has an operating expense-to-sales ratio that falls between minimum and maximum thresholds; and
- does not assume economically significant risks or own unique intangibles.

If you are interested in discussing whether your entities may be in or out of scope, please reach out to your CRA contact or Robin Hart (rhart@crai.com).

The public consultation period closes on January 25, 2023, and the OECD has a significant amount of work to complete, including the identification and statistical analysis of financial ratios and economically relevant characteristics. Meanwhile, the Inclusive Framework countries have to debate and agree on foundational questions, such as whether Amount B is a safe harbor or should apply only to jurisdictions where comparable companies cannot be located.

Pillar 2

While less focused on intercompany transactions than Pillar 1, elements of the Pillar 2 Model Rules issued in 2021 (Model Rules)⁷ and the related Commentary issued in 2022 (the Commentary)⁸ place an added emphasis on pricing-controlled transactions according to the arm's length standard when computing the global anti-base erosion (GloBE) income or loss for purposes of applying the minimum tax rules.

Specifically, with respect to cross-border transactions, the model rules state as follows:

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 so as to be in the same amount and consistent with the Arm's Length Principle.”⁹

In practice, the application of this article may require a global reconciliation of transaction amounts in the financial accounts of constituent entities on a transaction-by-transaction basis, which is generally not otherwise performed if there are minor deviations in the amounts booked. More complications arise if the transfer price used in the financial accounts is different from the one used for tax purposes, for example because of a unilateral APA or local tax authority adjustment. In such instances, the Commentary states that the transfer price used for tax purposes is presumed to be consistent with the arm's length principle, and a unilateral transfer pricing adjustment would result in a corresponding adjustment for all counterparties, “unless the adjustment increases or decreases the MNE Group's taxable income in a jurisdiction that has a nominal tax rate below the Minimum Rate or that was a Low-Tax Jurisdiction with respect to the MNE Group in each of the two Fiscal Years preceding the unilateral transfer pricing adjustment (an under-taxed jurisdiction).”¹⁰ Furthermore, adjustments may not be made under this rule if they would result in double taxation or double non-taxation.¹¹ However, this rule does not require the MNE Group to conform the timing of an item of income or expense for GloBE purposes to the timing of that item for local tax purposes.¹²

With respect to same-country transactions, the Commentary recognizes that adjustments are generally not needed because they may already be eliminated or otherwise adjusted for local tax purposes pursuant to a consolidation or group tax relief regime. Nevertheless, according to the Model Rules, “[a] loss from a sale or other transfer of an asset between two Constituent Entities located in the same jurisdiction that is not recorded consistent with the Arm's Length Principle shall be recomputed based on the Arm's Length Principle if that loss is included in the computation of GloBE Income or Loss.”¹³

Transactions between minority-owned constituent entities and others must also be recorded at arm's length. Finally, although not explicitly stated in Article 3.2.3 of the Model Rules, the Commentary clarifies that transactions between Constituent Entities in the same jurisdiction must also be recorded in the same amount in both Constituent Entities.¹⁴ Partly to alleviate the burden of applying the arm's length principle

⁷ OECD, Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS (2021), <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf>.

⁸ OECD, Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two) (2022), <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf>.

⁹ Model Rules art. 3.2.3.

¹⁰ Commentary ¶ 101.

¹¹ Commentary ¶ 103.

¹² Commentary ¶ 104.

¹³ Model Rules art. 3.2.3.

¹⁴ Commentary ¶ 109.

to same-country transactions, the Model Rules allow an election to consolidate financial accounts of entities in the same jurisdiction.¹⁵ However, this in itself results in an added analysis for jurisdictions that do not have a consolidation regime.

In combination, these requirements are likely to lead to further differences between the adjusted financial accounts for GloBE income or loss purposes, and the MNE Group's financial and tax accounts, requiring an extra level of reconciliations to be performed.

Does this apply to you?

When enacted, Pillar 2 will apply to MNEs with revenues greater than 750 million euros, which is generally the same threshold as the OECD's country-by-country reporting and master file requirements.

Let's talk

Tax authorities will continue to scrutinize documentation reports, and the need for well-delineated contemporaneous documentation submission or preparation continues to increase. In this highly complex regulatory environment, a proactive approach to evaluating the level of transfer pricing compliance is not only encouraged but also a crucial step to protect against penalties and audit adjustments. Our consultants provide a customized contemporaneous documentation package tailored to each client's multinational operations by performing a risk–benefit assessment and reviewing all intercompany transactions in place, including intercompany loans, cross charges, and business restructuring compensation.

Contact Rebel Curd, Anna Soubotina, or Harrison Vale to start the conversation about getting a customized package of contemporaneous documentation proposals.

Contacts

Rebel Curd

Vice President, Practice Leader
of Transfer Pricing
rcurd@crai.com

Anna Soubotina

Principal
Transfer Pricing
asoubotina@crai.com

Harrison Vale

Associate Principal
Transfer Pricing
hvale@crai.com

www.crai.com/transferpricing



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¹⁵ Commentary ¶¶ 133–35.