# 2024 YEAR-END PLANNIG GUIDE – TRANSFER PRICING

## I. Transfer Pricing and BEAT Planning

The base erosion anti-abuse tax, known as "BEAT," introduced as part of Tax Cuts and Jobs Act in 2017, was intended to prevent taxpayers from reducing their U.S tax liability by shifting profits through payments to related parties in low-tax jurisdictions outside the U.S. To be subject to the BEAT, U.S. taxpayers must meet the following two requirements:

- A three-year average of gross receipts greater than $500 million (excludes regulated investment companies, REITs, or S-Corps); and
- A base erosion percentage for the taxable year of 3.0% or more (2.0% for banks and special entities), where "base erosion" percentage is defined to be the sum of all base erosion payments (defined below) divided by the total amount of deductions for the year.

If a U.S. taxpayer meets the above thresholds, the following BEAT tax rate applies to its modified taxable income, adjusted for BEAT payments:

- Before calendar year 2026: 10.0%
- After calendar year 2025: 12.5%

The BEAT is an additional tax imposed on applicable taxpayers with base erosion payments including interest, royalties, and service payments to foreign related parties. A taxpayer would need to pay additional amount by which the BEAT exceeds regular income tax if the income tax liability is lower than the BEAT liability.

**Transfer Pricing and BEAT Mitigation**

While BEAT, under Internal Revenue Code Section 59A, has a broad definition of base erosion payments, including services, interest, certain property/assets, and royalties, it also provides types of foreign related-party payments that are exempt from BEAT considerations.

One way to mitigate BEAT exposure is to rely on the services cost method (SCM) for outbound payments for certain intercompany services provided by non-U.S. related parties. The SCM, defined in Reg. §1.482-9(b), permits certain routine back-office and other low-value services to be charged at cost, rather than at the usual arm's length charge. If service payments meet the SCM requirements, the amounts paid or accrued can be excluded from base erosion payments. To meet the SCM exception, all the SCM requirements, except the business judgment rule, must be satisfied:

- The services provided must be specified covered services, that is, either a service specified in Rev. Proc. 2007-13 or a low-margin service to which a markup of less than 7.0% would be applied;
- The service must not be an excluded activity, such as research & development, manufacturing, or resale/distribution;
- The amount must reflect the total cost of the services without a markup; and
- Adequate books and records must be maintained in accordance with the rules under Section 1.59A-3(b)(i)(C).

To utilize the SCM exemption under the BEAT, taxpayers should explore opportunities to classify services as SCM eligible, even if SCM was not previously selected as the transfer pricing method. For example, it is likely beneficial to separate back-office and administrative-type services, which could qualify for the SCM, from marketing services, which would not qualify for the SCM. Given that SCM eligibility does not require the business judgement test, treating certain services as low-margin services, when appropriate, can potentially reduce a BEAT liability.

Another way to mitigate BEAT exposure is to utilize Section 263A and treat certain base erosion payments as part of cost of goods sold (COGS) – i.e., inventoriable costs. For U.S. taxpayers with inventories, amounts paid or accrued to a foreign affiliate through COGS are not treated as a base erosion payment. Section 263A outlines the uniform capitalization rules in which direct and allocable indirect costs of property produced or purchased for resale must be capitalized into inventory. For example, sales-based royalties and management fees are costs that can be capitalized under Section 263A:

- Sales-based royalties can be considered capitalized costs and included in COGS as long as the underlying intangible property is connected to purchasing, production, storage, or handling of inventory. As such, sales-based royalties paid to a foreign affiliate can be excluded from base erosion payments if the costs are properly capitalized and included in COGS under Section 263A. Sales-based royalties associated with trademarks and trade names are expensed and likely not eligible for COGS inclusion.
- Management fees may also be capitalized under Section 263A when the services are directly or indirectly related to purchasing, production, storage, or handling of inventory. For example, management fees that are related to the provision of sourcing or procurement services are likely capitalizable under Section 263A.

Furthermore, there are structural/contractual changes that taxpayers can consider to reduce a BEAT liability. Those changes include, for example, restructuring of financing, creation of a regional headquarters office, and modification of customer/supplier contracts, which would eliminate or decrease the payments from a U.S. entity to a foreign affiliate.

**Planning Considerations**

While BEAT can have a significant impact on tax liability, BEAT planning using transfer pricing has not been a priority for many taxpayers. The strategies discussed above, and other BEAT planning using transfer pricing can be an effective approach for mitigating BEAT liability.

## II. Adopting a Proactive Approach to Transfer Pricing

Adopting a proactive approach to tax process improvements can be an aspirational goal for many tax departments. Resource constraints, business pressures, new technical developments, and other factors can cause even the most meticulously planned schedules to go awry, and before anyone realizes it, year-end is upon them once again.
Rather than feeling discouraged, companies can leverage their experience to understand what is achievable and then prioritize improvement projects that are appropriately sized for their business.

**Common Year-End Transfer Pricing Challenges**

1. **Large Transfer Pricing Adjustments**: Many companies use transfer pricing adjustments to ensure they meet their desired transfer pricing policy. However, significant year-end adjustments can have both tax and indirect tax implications, leading to further issues and risks.

2. **Lack of Transparency in Calculations**: Transfer pricing calculations are often built in Excel and amended over the course of the years, perhaps to address one-time issues or changing situations. This can result in workbooks that lack a sufficient audit trail and contain hard-coded data, both of which undermine a reviewer's ability to validate the calculations. Additionally, without documentation, the process becomes dependent on the few people working directly on the process, which can create significant knowledge gaps if one of more of the key people leave the company.

3. **Data Constraints**: While the mechanics of most transfer pricing calculations are not complex, difficulties arise because of the variety of data needed (revenues, segmented legal entity P&Ls, headcount, R&D spend) and the challenges in accessing that data. This can lead to shortcuts and unvalidated assumptions.

**Planning Considerations**

- **Develop a Multiperiod Monitoring Process**: Implement a process that tracks profitability throughout the year to help reduce significant year-end transfer pricing adjustments. This monitoring can also provide insights into whether underlying intercompany pricing policy changes are needed, allowing for a proactive approach to limit the number and magnitude of year-end adjustments.

- **Identify and Review Material Transactions**: Conduct a detailed review of calculation workbooks to pinpoint deficiencies, such as lack of version control, hard-coded amounts with no audit trail, limited or undocumented key assumptions, and an incoherent calculation process. Companies can address one or more of these issues based on timing and resources. Small changes can have a significant impact.

- **Define a Data-Focused Project**: Consider the data needed for transfer pricing calculations, investigate the form and availability of data, identify new data sources, and help data providers understand their importance in the overall process. This can be done on a pilot basis with a material transaction or group of transactions to keep the project manageable. Companies often discover new data sources and form valuable connections with data providers through these projects.

Learning from the year-end process provides clarity on areas that need improvement. These observations can be captured and converted into small improvement projects as soon as possible after year-end. While companies can't tackle everything at once, prioritizing key projects, developing a timeline with identified resources, and obtaining stakeholder buy-in quickly can significantly improve the next year-end experience.

## III. Implicit Support in Intercompany Loans

The IRS recently released a generic legal advice memorandum that explains the agency's position on the effect of group membership in determining the arm's length interest rate of intragroup loans.

The legal advice memorandum – AM 2023-008 -- concludes that if an unrelated lender would consider group membership in establishing financing terms available to a borrower, and third-party financing is realistically available, the IRS may adjust the interest rate in a controlled lending transaction to reflect group membership.

Generic legal advice memoranda constitute legal advice, signed by executives in the National Office of the Office of Chief Counsel, and are issued to IRS personnel to provide authoritative legal opinions on certain matters, such as industry-wide issues. This memorandum provides non-taxpayer-specific legal advice on the application of IRC Section 482, and it states that the advice should not be used or cited as precedent. However, the memorandum provides insight into the Office of Chief Counsel's position on the role of implicit support in establishing an arm's length interest rate in intragroup loans.

**Example**

The memorandum provides an example to anchor its analysis of the topic. In the example, a non-U.S. parent company directly owns 100% of the equity of a U.S. subsidiary. The U.S. subsidiary owns operating assets and operates businesses essential to the group's financial performance. The assumption in the example is that if the U.S. subsidiary's financial condition were to deteriorate, the non-U.S. parent would likely provide financial support to it to prevent a potential default.

The example states that the U.S. subsidiary plans to obtain capital through an intragroup loan from its non-U.S. parent. An independent rating agency has determined that the non-U.S. parent has a credit rating of A, whereas the U.S. subsidiary has a BBB rating when the implicit support of the corporate group is taken into account. As an independent entity – that is, without considering the group credit profile and the non-U.S. parent's implicit support – the U.S. subsidiary would have a credit rating of B. In the example, the A credit rating corresponds to an interest rate of 7%, the BBB credit rating corresponds to an 8% interest rate, and a B rating would result in a 10% interest rate. The non-U.S. parent lends to the U.S. subsidiary at an interest rate of 10%, and the loan is not supported by an explicit guarantee from the parent.

**Analysis**

The starting point of the analysis is Section 482 and the regulations thereunder, which grant the IRS broad authority to adjust the results of a transaction between controlled taxpayers to comply with the arm's length standard. In the context of intercompany lending, this means that the IRS may adjust the interest rate charged so that it is an arm's length rate, which is generally the rate that would be charged in independent transactions between unrelated parties. The regulations specify that to determine an arm's length interest rate, "[a]ll relevant factors shall be considered, including … the credit standing of the borrower."

The memorandum concludes that the IRS may adjust the interest rate of the foreign parent's loan to the U.S. subsidiary to 8%, the arm's length interest rate the U.S. subsidiary would pay to an unrelated lender based on its BBB rating (if the implicit support by the foreign parent is taken into account). This rate reflects the amount the U.S. subsidiary would be willing to pay at arm's length considering the alternatives available to it. In other words, "the controlled borrower should never accept an interest rate greater than the 8% [at which] it could borrow from the market. In short, the lender may not charge a higher interest rate based on a controlled relationship with the borrower, because an uncontrolled borrower would not accept a higher interest rate than what it could obtain from an uncontrolled lender."

**Planning Considerations**

The guidance provided in the IRS memorandum is largely consistent with Chapter X of the OECD transfer pricing guidelines, released February 11, 2020, which provides guidance on the transfer pricing aspects of financial transactions. The IRS memorandum summarizes the agency's long-held position on its review of intercompany loans, particularly those to U.S. borrowers.

The IRS position on implicit support is reflected in *Eaton Corp v. Commissioner*, No. 2608-23, which as of September 2024 was pending in U.S. Tax Court. In that case, although the IRS took the position that interest rates paid by certain U.S. borrowers should be adjusted downwards to consider implicit support, it also disallowed some deductions related to explicit intercompany financial guarantees executed with respect to the related intercompany borrowings.

Given the above, it will be important for multinational entities, particularly non-U.S.-based groups, to review their intercompany loan agreements and evaluate whether the implicit support derived from group membership is reflected in the interest rates charged to related borrowers. Borrowers should also consider whether any existing intercompany financial guarantees are still warranted, and if so, whether they should be adjusted to first consider implicit support before the application of explicit support.

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