Navigating Interplay between Pillar 2 and Transfer Pricing

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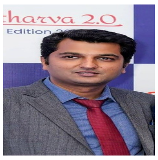

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BEPS & TP: A foundational shift

The original BEPS initiative (2013-2015) outlined 15 actions, including Actions 8-10, aimed at aligning transfer pricing (TP) outcomes with economic substance. This focused on ensuring accurate value creation and proper documentation for intangible assets and cross-border transactions.

The OECD's Transfer Pricing Guidelines in recent years provide further guidance on applying the arm's-length principle and hard-to-value intangibles, which are central to TP compliance under BEPS.

What is Pillar Two?

The OECD’s Pillar Two introduces a global minimum tax of 15% on the profits of large multinational companies (MNEs). Over 140 jurisdictions have agreed on a coordinated system of taxation that ensures large MNE groups pay **at least 15%** tax on profits in each country they operate. If an MNE doesn’t pay at least 15% tax in a country, extra tax—called a "top-up"—will be charged to make up the difference. The Global Anti-Base Erosion (GloBE) rules articulate this framework, and are designed to be implemented in domestic law.

How the Pillar Two System Works?

Pillar Two uses a three-step approach to make sure the 15% minimum tax is paid:

1. **Qualified Domestic Minimum Top-up Tax (QDMTT):** The country where the low-tax income is earned can apply its own extra tax to raise the effective rate to 15%.
2. **Income Inclusion Rule (IIR):** If the low-tax country doesn’t act, the parent company’s home country collects the top-up tax.
3. **Undertaxed Profits Rule (UTPR):** If neither of the above works, other countries where the group operates can collect the extra tax by denying deductions or adjusting taxable income.

This system ensures that someone—either the source country, the parent’s country, or others— collects the top-up tax.

The Subject to Tax Rule “STTR” (if applicable), covers specific intragroup payments, letting the source country reassert taxing rights up to 9%.The STTR is a pre-GloBE, treaty-based mechanism that applies before the GloBE framework, followed by the domestic GloBE top-up chain explained above.

Why is Transfer Pricing Important Under Pillar Two?

Transfer pricing is the method used to set prices for transactions between companies in the same group, across borders. Under Pillar Two, these prices must follow the "arm’s length" principle—meaning they should be the same as if the companies were unrelated. The OECD transfer pricing rules continue to apply under Pillar Two.

If two countries have agreed on a transfer price (through MAP or advance pricing agreements), that price will be respected for Pillar Two. This helps avoid unnecessary disputes. But some conflicts may still arise when adjustments to transfer prices are made later.

Where Pillar Two Meets Transfer Pricing – and Why It Gets Complicated

While Pillar Two and transfer pricing rely on the same arm’s length rules, challenges arise:

- **Mismatched timing:** Pillar Two ETR calculations are based on the consolidated financial accounts for a fiscal year. However, many MNEs make “year-end” transfer pricing adjustments after consolidation to meet arm’s-length targets. These adjustments (often recorded only in local accounts) may not be reflected in the consolidated data used for Pillar Two. Such discrepancies can create “compliance difficulties” under Pillar Two, since there is no clear guidance whether to revise past GloBE calculations if post-close TP adjustments occur. In practice, an MNE might have to restate prior filings in jurisdictions where adjustments were significant.
- **Risk of paying tax twice:** Linked to timing, unilateral TP adjustments can double-tax income. For instance, if a low-tax subsidiary’s profit is later re-attributed to a high-tax affiliate, the parent country may have already imposed a top-up on the original (higher) profit in the low-tax jurisdiction.
- **Cross-country effects:** A transfer pricing change between two low-tax countries could affect a third country that has already collected a top-up tax—without a way to claim it back.
- **PE (Permanent Establishment) disputes:** Pillar Two can lead to more debates about whether a foreign office is a PE, and if so, how much profit can be taxed. More countries may try to claim taxing rights to collect top-ups.

Arm’s-Length Basis for Intra-Group Transactions under Pillar Two:

Article 3.2.3 of the OECD model rules requires that intra-group cross-border transactions must be priced at arm’s length for Pillar Two purposes—consistent with domestic transfer pricing rules. Even if transactions are eliminated in consolidated financial statements, GloBE income is based on those same financials, so discrepancies between book and tax values trigger adjustments.

If the financial statements reflect an arm’s-length amount, and that same amount is used for taxable income, no adjustment is needed. But if tax authorities use a different arm’s-length figure, then the GloBE income calculation must be aligned—typically by adjusting the disposing entity’s net income or loss, and the receiving entity’s income, to reflect the tax-based arm’s-length value

Article 3.2.3 does not apply to timing differences (e.g., booking income in one year vs deducting it in another under tax rules). Nor does it apply to transactions within the same jurisdiction, as these are usually eliminated through jurisdictional blending—unless one of two exceptions applies

1. **Domestic asset transfers at a loss:** If an intra-group asset transfer within the same country causes a loss that is included in GloBE income, it must be at arm’s length to prevent artificial loss

creation.
2. **Minority-owned or investment entities:** These are not subject to jurisdictional blending and file ETR calculations separately. Transactions involving them must follow arm's-length pricing, even when domestic.

Who Pays the Extra Tax?

- The **first chance** goes to the low-tax country (QDMTT).
- If that doesn't happen, the **parent's home country** collects it (IIR).
- If still unpaid, **other countries** step in (UTPR).
- For source-based withholding taxing low-tax payments-STTR.

The system ensures that profits taxed below 15% will face a top-up somewhere.

Where Has Pillar Two Been Adopted?

The Pillar Two framework has seen widespread—but not universal—acceptance. **Over 140 jurisdictions** (members of the OECD/G20 Inclusive Framework) have signed onto the two-pillar solution. Dozens have already enacted or are legislating Pillar Two rules. For example, **58 countries** – including major economies in Europe (France, Germany, Italy, Netherlands, Luxembourg, Sweden, the UK, etc.), as well as Australia, Japan, South Korea, Vietnam, Canada, Singapore, Thailand, New Zealand, Bermuda and others – "have formally enacted the GloBE rules" effective from 2024. An additional group of countries (such South Africa, Hong Kong, Mauritius as, etc.) are at various stages of drafting or approval.

United States has formally withdrawn from the OECD Pillar Two initiative. On January 20, 2025, President Trump issued an Executive Order declaring that the OECD global minimum tax framework "has no force or effect" in the U.S., directing the Treasury Department to notify the OECD of its non-participation. A concurrent memorandum instructed the Treasury, in consultation with the US Trade Representative to assess whether any foreign tax rules disproportionately impact U.S. companies and to consider possible protective measures

Even if a company is based in a country that hasn't adopted Pillar Two, it may still need to comply in countries that have adopted. For example, an Indian MNE operating in low-tax jurisdictions may face top-up taxes in those countries, even before India itself implements the rule.

India's Position on Pillar Two

India supports the OECD's two-pillar solution and Finance Minister has announced plans to adopt it, including steps like removing India's 2% equalization levy on digital services.

India's approach to introduce a domestic minimum tax or an income inclusion rule is yet to announced. Since India's normal corporate tax rate is already above 15%, most Indian companies may not be affected except those in special zones like GIFT City.

Challenges Ahead in aligning TP and Pillar 2

1. **Data and reporting:** MNEs need to gather detailed global data—revenues, taxes, and profits by country. Many don't have the systems in place for this.
2. **Compliance costs:** Companies will face high costs for software upgrades, tax experts, and systems to calculate and report correctly.
3. **Complex rules:** The GloBE calculations involve special tax credits, carve-outs, and transitional rules that add complexity.
4. **Risk of disputes:** Misalignment between transfer pricing and Pillar Two can lead to double taxation and disputes.
5. **Policy changes:** Countries must revise their laws quickly. Developing countries face the added

challenge of revising incentive schemes that may conflict with Pillar Two.

What MNEs should do?

- Revise TP policies to ensure substance and documentation support.
- Assess jurisdictional ETR carefully-TP adjustments factor into Pillar Two calculations.
- Use new safe harbour (transitional CBC, NMCE) to reduce burden.
- Adopt OECD tools: standardized GIR, XML formats, automated ETR reporting.
- Enhance TP documentation and tech systems to address overlapping BEPS/TP/Pillar Two rules.

Conclusion

Pillar Two is a major step in global tax reform. It doesn’t replace transfer pricing rules but adds a new layer to ensure MNEs pay at least 15% tax everywhere they operate. Since profits from intercompany transactions affect how top-up taxes are calculated, transfer pricing remains central.

Most large economies are moving forward with implementation, and India is aligning its policies too. However, both governments and companies will need time and effort to fully comply. As rules evolve, clear guidance and practical solutions will be key to avoiding disputes and managing compliance effectively.