2023 YEAR–END TAX PLANNING GUIDE FOR BUSINESSES

Transfer Pricing

FustCharles

INTRODUCTION

FustCharles has had a very eventful 2023. We moved our headquarters from Widewaters Parkway to Merchants Commons in downtown Syracuse, embarked on a major rebranding, and opened a second location in Rochester. It's been an exceptional year and we're excited to continue our commitment to talent development, innovation and teamwork to provide our clients with a best-in-class service experience.

As of the date of this publication, 2023 has been a relatively quiet year in tax legislation. The IRS has been busy issuing guidance for both the 2022 tax legislative changes and pieces of the Tax Cuts & Jobs Act (TCJA). Given the upcoming US presidential election, there may be continued stalemate in Congress or the potential for more robust legislative changes – only time will tell.

FustCharles Tax professionals grasp the intricate connections between evolving laws, economic dynamics, and the tax implications of various business decisions and are well-positioned to serve as strategic advisors, steering companies toward success. Tax planning remains a vital aspect for businesses seeking to optimize cash flow by managing their long-term tax obligations. Our 2023 Year-End Tax Guide delves into effective tax strategies, taking into account recent administrative guidance and potential legislative changes that are currently under review. For further information and assistance, please reach out to a member of our expert tax team.

Unless explicitly stated otherwise, the information provided in this guide is based on existing tax laws and policies as of the publication date, and it may be subject to adjustments in response to future legislative or tax policy changes.

Transfer Pricing

BEPS 2.0 and Intangible Property Planning

As of July 2023, 138 jurisdictions had signed on to the Organization for Economic Cooperation and Development (OECD) base erosion and profit shifting (BEPS) 2.0 framework aiming to ensure that multinational enterprises with group revenue of more than EUR 750 million pay a minimum corporate tax rate of 15.0%. While BEPS 1.0 led to many changes in rules in various jurisdictions to limit profit shifting, BEPS 2.0 is the largest coordinated effort to help address tax avoidance and bring international tax rules into alignment.

Historically, many multinationals placed their valuable intellectual property (IP) in tax-efficient jurisdictions to reduce their tax exposure. Jurisdictions such as the Cayman Islands, Bermuda, and the British Virgin Islands offered environments with either no direct taxation or a 0% corporate tax rate. Countries such as Ireland, Switzerland, and Singapore provided low corporate tax rates. The latter group of countries house regional headquarters for some of the largest U.S. companies and are regarded as attractive places to conduct business offshore.

Now that many zero-tax and low-tax jurisdictions have signed on to the OECD two-pillar global tax reform plan, which is intended to ensure that large multinationals pay a minimum 15.0% tax *regardless of where they are headquartered or the jurisdictions in which they operate*, does that mean IP planning is not as important, because there seems to be less opportunity for tax arbitrage?

DEMPE Still Triumphs

The short answer is no. Now more than ever, IP planning needs be carefully evaluated to comply with the new global rules and minimize transfer pricing risk exposure. Specifically, multinationals should ensure that the entity legally holding the rights to IP has sufficient substance and control over the development of intangible assets.

Since the introduction of the concept in 2015, DEMPE -- development, enhancement, maintenance, protection, and exploitation of intangibles -- has become a new core framework that many tax authorities follow when analyzing the risks associated with intangible assets. DEMPE concepts have been applied by many tax authorities and multinational enterprises to assess the control of risk, which is then used to determine what portion of profits from IP each entity should be entitled to.

With Pillar Two's significant focus on preventing profit shifting associated with IP, multinationals should be able to demonstrate that any entities earning profits resulting from the ownership of intangible assets possess economic substance and control over the risks associated with the creation of intangible assets. Specifically, multinationals that have historically placed their IP in traditional tax haven jurisdictions may want to evaluate options and consider transferring the IP out of such jurisdictions to alleviate the potential impact of the Pillar Two rules, which are expected to apply from January 1, 2024, in some jurisdictions.

Multinationals may choose to keep their IP in their current locations as long as they can substantiate their position; however, it is often logistically challenging to build sufficient substance and control in certain historically low-tax jurisdictions, considering practical aspects including mobility of important decision makers, attraction of skilled labor, and business infrastructure. Keeping IP in low-tax jurisdictions can also be an easy red flag for tax authorities to scrutinize the characterization of the IP holding entity as well as the transactions involved.

Looking Ahead

Given the new environment, what are some of the factors to evaluate when choosing a location for IP?

- A competitive tax rate
- Favorable tax credits and incentives
- A skilled labor force
- Established financial systems
- Location near key markets

As with any strategic tax planning, multinationals should carefully examine their overall cash tax liabilities and tax positions, and the pros and cons of a proposed structure, including where and how to move the IP. Companies should take a holistic approach that considers geographic location and substance requirements, while ensuring to align their IP strategy with business strategies and priorities. Detailed modeling and a DEMPE functional analysis can together be useful in assessing the appropriateness of profit allocations related to IP and ensure compliance with the new rules by demonstrating that the allocations are consistent with the arm's length principle.

Stock-based Compensation

The complexities of stock-based compensation in transfer pricing

In the context of transfer pricing, the treatment of stock-based compensation – specifically as it relates to cost sharing arrangements (CSAs) -- has been the subject of debate for decades. CSAs are intercompany agreements whereby two or more affiliates agree to divide the rights to intangibles and to divide "intangible development costs" in proportion to the benefits each party to the agreement expects to derive from the intangible.

One question that arose was whether stock-based compensation paid to local employees in a U.S. company that has entered into a CSA should be included in the intangible development costs under that agreement, and if so, how it should be measured. U.S. companies would find it more advantageous not to include stock-based compensation in the intangible development costs bucket to keep their stock option expense deductions in the U.S.

Regulations & Litigation

The IRS has had regulations that included guidance on the sharing of costs by CSA participants since 1968, but those regulations did not explicitly mandate the inclusion of stock-based compensation in intangible development costs until 2003, when Treasury issued a regulation that requires participants in qualified CSAs to share stock-based compensation costs to achieve an arm's length result.

The *Altera v. Commissioner* case challenged the 2003 cost sharing regulations, arguing among other things that the regulation was invalid under the Administrative Procedure Act. In a unanimous 2015 decision, the Tax Court sided with Altera and invalidated the regulation in question. The government appealed the decision, and in 2019, the U.S. Court of Appeals for the Ninth Circuit reversed the Tax Court and upheld the validity of the regulation.

In February 2020, Altera filed a petition for a writ of certiorari asking the U.S. Supreme Court to review the Ninth Circuit's decision. The Court announced in June 2020 that it was denying the petition for certiorari, thus leaving in place the Ninth Circuit's opinion upholding the validity of the Treasury regulations that require related parties to share the costs of stock-based compensation as a component of their intangible development costs in CSAs.

The Court's decision, however, did not completely resolve the issue.

Taxpayers contemplating their return positions on whether to include stock-based compensation in the intangible development costs of their CSAs are faced with two conflicting court decisions: the Ninth Circuit decision by an appellate court with a limited geographic jurisdiction and the unanimous Tax Court decision by a nationwide trial court.

Given this split in authority, what should taxpayers consider to address the issue of stock-based compensation in the context of a CSA in their tax returns?

Generally speaking, taxpayers within the Ninth Circuit must include the value of stock options in their calculations of intangible development costs in CSAs. Taxpayers outside the Ninth Circuit have a more complex analysis to undertake. On one hand, these taxpayers may want to argue that they can continue to treat the Tax Court's 2015 opinion as authority (and therefore not include the value of stock options in their CSAs). On the other hand, the *Altera* decisions are not the only authorities to be taken into account when developing a tax return position, and taxpayers considering not sharing the costs of stock-based compensation under their CSAs should consider other authorities, including the legislative history of the pertinent provisions and other relevant cases.

In addition, the section 1.482-9 intercompany services regulations issued in 2009 reiterate the requirement to include stock-based compensation expenses in the calculation of services costs. Taxpayers who decide not to include stock-based compensation in their cost sharing calculations must prepare detailed and specific documentation supporting their position.

Planning

After years of litigation, the treatment of stock-based compensation for transfer pricing purposes continues to be undeniably complex, and multinational entities that enter into CSAs should carefully examine the whole body of guidance that exists on this issue.

Grow Into a Proactive Approach to Transfer Pricing

Tax departments often start the new fiscal year with good intentions, which in the practical world get pushed from quarter to quarter until year-end has arrived again. Rather than be discouraged, companies can use the past to understand what is achievable and help prioritize the right-size improvement projects for the business.

Some common year-end transfer pricing challenges include:

Large transfer pricing adjustments. Many companies use transfer pricing adjustments as a mechanism to ensure they achieve the desired transfer pricing policy. However, if these adjustments are material, they can have both a tax and indirect tax impact, leading to further issues and risk.

Developing a multiperiod transfer pricing monitoring process that tracks profitability throughout the year to help reduce significant transfer pricing year-end adjustments. Such monitoring can also be used to provide insight into whether underlying intercompany pricing changes are needed as a proactive approach to limit the number and magnitude of year-end adjustments.

Lack of transparency in calculations. Transfer pricing calculations are typically built in Excel, by one person and over many years. This leads to workbooks that lack a sufficient audit trail with hard-coded data that undermines the reviewer's ability to validate the calculations. This in turn leads to lack of confidence in the calculations performed. Add to this key person dependency and companies may be faced with not only year-end issues but a risk that at any point throughout the year there could be a significant knowledge gap should the key person leave the company.

Identifying a material transaction or set of transactions and performing a detailed review of the calculation workbook can help a company pinpoint where existing workbooks are deficient. Examples could include: a lack of version control; hard-coded amounts with no audit trail, limited or no key assumptions documented, and an overall incoherent calculation process. Companies can choose to tackle one, some, or all of the issues identified based on timing and resources. The project doesn't need to be large, but it can be impactful by making small changes.

Data constraints. The underlying mechanics of most transfer pricing calculations are not complex; however, difficulties arise when it comes to the variety of data needed (revenues, segmented legal entity P&Ls, headcount, R&D spend) and challenges associated with accessing that data can lead to short-cuts being taken and unvalidated assumptions being applied.

Defining a transfer pricing data-focused project allows companies to consider the data needed, investigate the form and availability of data, identify new data sources, and help providers of transfer pricing data 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 find new data sources through these projects and the interaction with the providers of the data can form valuable connections when it comes to all parties understanding their role in the overall transfer pricing calculation process.

Learning is key to the adoption of a proactive approach to transfer pricing -- surviving a year-end process provides clarity on the areas that may be in need of improvement. These observations should be captured and converted into small improvement projects as soon as possible after year-end. Companies can't tackle everything at once, but by prioritizing key projects, developing a timeline with identified resources, and obtaining stakeholder buy-in quickly, companies have a good chance of improving the next year-end experience.

Proactive tax planning and seamless tax compliance are essential components of financial success. At FustCharles, we are dedicated to providing year-round support, ensuring you stay informed about emerging opportunities, evolving tax laws, and optimal strategies. Our commitment is to guide you towards the most advantageous course of action aligned with your objectives, ultimately contributing to your business's financial well-being.

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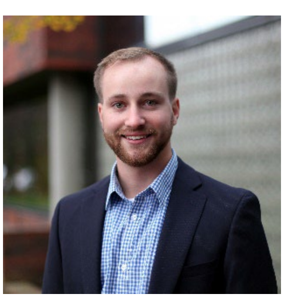

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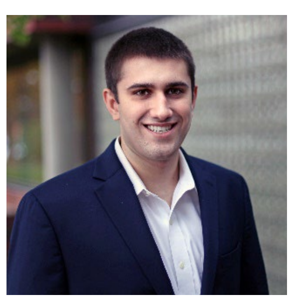

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