

INTERPLAY BETWEEN PILLAR TWO AND TRANSFER PRICING

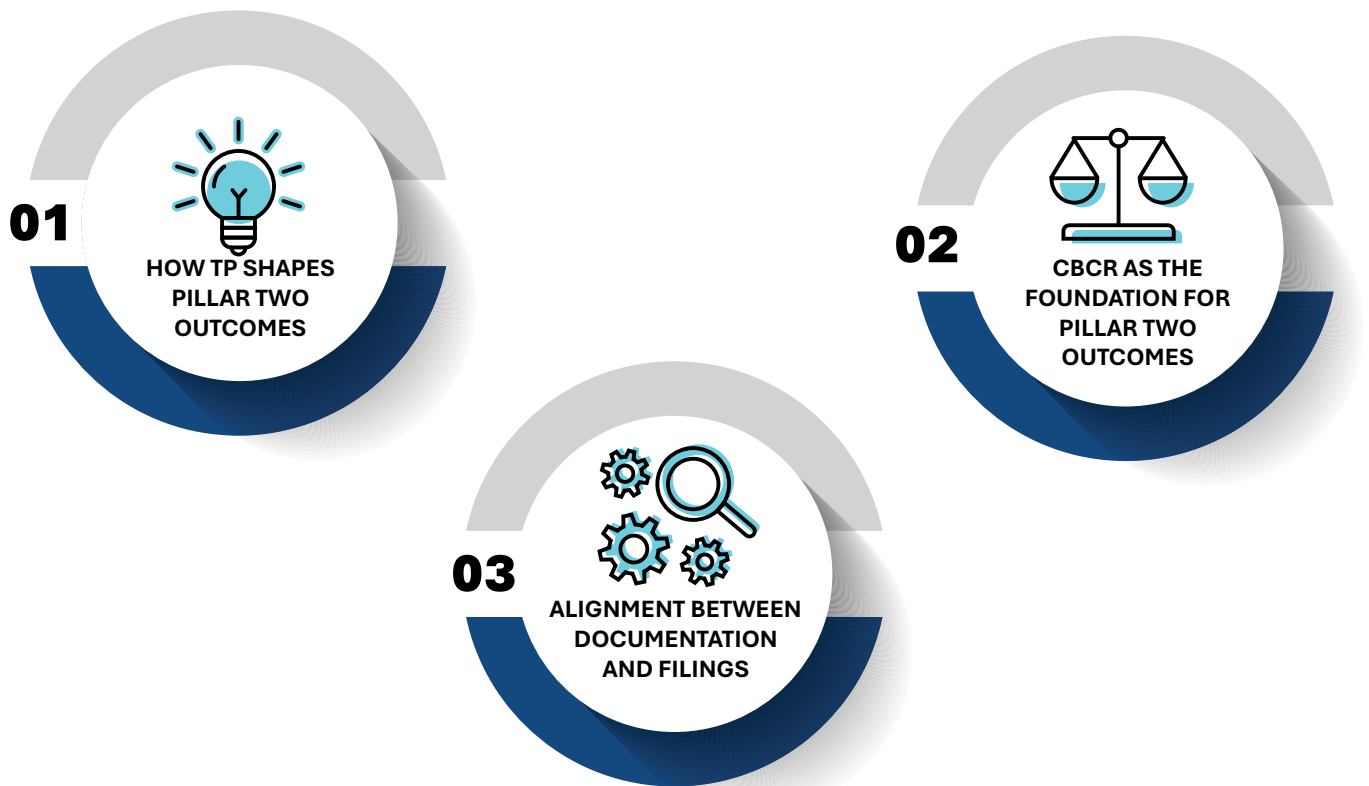
How TP drives the Global Minimum Tax outcomes



Historically, multi-jurisdictional tax strategies focused on allocating profits across jurisdictions. Transfer Pricing (TP) addressed this by aligning profits with value creation through functional and risk analysis.

Under the Global Minimum Tax regime, the focus has shifted from profit allocation to whether allocated profits are taxed sufficiently. Pillar Two does not create or reallocate profits; it only applies tax to profits allocated through TP. As a result, inaccuracies in the TP model can directly affect GloBE computations.

In this article, we will cover the following:



HOW TP SHAPES PILLAR TWO OUTCOMES

Impact of profit misalignment on top-up tax liability

Many groups approach Pillar Two by modelling the top-up tax based on the profits already reflected in their accounts. However, an important practical risk is often overlooked: are those profits themselves correct from a transfer pricing perspective?

If a constituent entity is not receiving an arm's length level of remuneration under the group's TP policy, its profit will be understated. At first glance, this appears to be only a traditional TP issue affecting the entity's local taxable income. In reality, the consequences are broader.

In this way, Pillar Two exposure can be a direct derivative of a TP error. Groups should therefore confirm that each entity's remuneration is at arm's length. Otherwise, the entire GloBE calculation may be built on a profit allocation that would not withstand TP scrutiny.



HOW TP SHAPES PILLAR TWO OUTCOMES (CONT.)

Illustrative simplified example:

Lets consider a simplified structure wherein ABC Co., in a covered jurisdiction, earns a cost plus 12% on its operating cost as a captive service provider. GloBE income of ABC Co. would be 1,000 (cost)*12% = 120 with local tax payout being 12 and consequently ETR of 10%. Assuming no carve-outs and no other adjustments, the top-up tax is calculated as $(15\%-10\%)*120 = 6$. At this stage, the analysis proceeds on the basis of the taxpayer's position that the transfer pricing model, being cost plus 12%, is arm's length and therefore appropriate. The entire GloBE calculation rests on that assumption.

But, what if cost plus 12% doesn't reflect adequate transfer pricing remuneration. What if tax authority adjusts the cost plus 12% to 13%. The authority increases the CE's taxable income: Correct arm's length remuneration = $1,000*13\% = 130$, thus additional income assessed = 10. Thus, revised top-up tax would be $(15\%-10\%)*130 = 7$.

The above would also require consideration of the impact of such and other adjustments, including any corresponding adjustments and the timing of their recognition.

The example is intentionally simplified. In practice, the analysis may be influenced by a range of additional factors, including corresponding adjustments, substance-based income exclusions and other Pillar Two mechanics. However, these complexities do not alter the fundamental dependency illustrated by the example: the top-up tax outcome remains directly contingent on the arm's length profit that should have been recognised in the relevant jurisdiction.

The central point is that the Pillar Two liability is inherently dependent on the amount of profit that should have been recognised in the relevant jurisdiction under an arm's length policy. Where the group applies an inadequate transfer pricing margin, the profit base used for GloBE purposes is correspondingly incorrect, resulting in incorrect calculation of the top-up tax as well.

HOW TP SHAPES PILLAR TWO OUTCOMES (CONT.)

Strategic insights

1. **Global TP alignment directly influences Pillar Two outcomes:** Misaligned TP models can drive top-up tax exposure and unintended tax leakage
2. **Concentration of high-value functions in low-tax jurisdictions:** Legacy structures with residual profits in low-tax entities should be reassessed for Pillar Two efficiency
3. **Substance alignment is critical across TP and Pillar Two:** SBIE claims must be supported by economic substance reflected in TP positions
4. **TP adjustments:** TP audit adjustments, APAs, or post-facto TP changes require careful evaluation of GloBE impact
5. **Key GloBE adjustments require a TP-informed review¹:**
 - Adjustments (Article 3.2.3 and 4.6.1)
 - Intra-group financing arrangements (Article 3.2.7)
 - Intra-group tax consolidation and eliminations – minority CEs (Article 3.2.8)
 - Intra-group transfer of assets and liabilities (Article 6.3.1)

What this means for the businesses?

- **TP can no longer be designed in Isolation: A hybrid approach is required -** balancing arm's length compliance, Pillar Two outcomes, and sustainable ETR
- **Re-evaluate legacy low-tax structures through a Pillar Two lens:** Low-tax legacy structures (say, IP and central treasury structures) should align with DEMPE, substance, and SBIE eligibility to mitigate top-up exposure
- **Align value creation with profit allocation:** Structures must reflect economic substance and functional reality to remain robust under both TP and Pillar Two
- **Invest in integrated TP and Pillar Two Technologies:** Seamless linkage between global ERP, operational TP, and GloBE computations is critical for accuracy and audit readiness

¹Articles are referenced from Commentary issued by the OECD on Global Anti-Base Erosion Model

CBCR AS THE FOUNDATION FOR PILLAR TWO OUTCOMES

Originally introduced as a transparency and risk-assessment tool, CbCR has now assumed a far more consequential role under BEPS Pillar Two. Through the Transitional CbCR Safe Harbour, CbCR data supported by Qualified Financial Statements can now directly influence whether detailed GloBE computations are immediately required.

This transitional relief represents more than administrative convenience. It delivers tangible strategic benefits:

- Eases immediate compliance pressure
- Creates valuable implementation runway, enabling MNEs to design robust data systems aligned with GloBE mechanics
- Reduces near-term exposure to top-up taxation in jurisdictions where Safe Harbour thresholds are satisfied

Yet, this relief is intentionally conditional. Only a “Qualified CbCR” can unlock Safe Harbour protection. So, the question is **What is a Qualified CbCR?**

CbCR prepared and filed using consistent, reliable and jurisdiction-wide Qualified Financial Statements (‘QFS’) is Qualified CbCR. QFS, specifically means:

- Accounts used to prepare the Consolidated Financial Statements of the UPE;
- Separate financial statements of each Constituent Entity prepared in accordance with an Acceptable/Authorised Financial Accounting Standard;
- For a Constituent Entity excluded from line-by-line consolidation solely due to size or materiality, the financial accounts used in preparing the MNE Group’s CbC Report

CBCR AS THE FOUNDATION FOR PILLAR TWO OUTCOMES

Structural convergence

At a computational level, several key inputs for Pillar Two calculations closely mirror data already captured under CbCR

Data embedded in CbCR	Inputs for Pillar II
Revenue	De minimis for Transitional Safe Harbour test
Profit before tax	Starting point for Jurisdictional GloBE income

Certain data filed in CbCR such as ‘Number of employees’ and ‘Tangible assets’, may be aligned further with Pillar II as per requisite inclusions and exclusions of Payroll carve-out and Substance carve-out respectively.

For MNE groups, CbCR discipline is fast becoming a prerequisite for Pillar Two readiness



CONSISTENCY ACROSS TAX DATASETS TO STRENGTHEN AUDIT DEFENCE

Tax administrations now have simultaneous visibility across multiple global tax datasets, each offering a different lens on how multinational profits are allocated and taxed.



Three critical data narratives must coherently align

- Transfer Pricing outcomes : functional characterisation, value creation and remuneration frameworks
- CbCR jurisdictional profiles : distribution of revenue, profits, taxes and economic substance indicators
- Pillar Two ETR computations: jurisdictional effective tax rates and resulting top-up tax exposures

Strategic way forward for MNE groups

Forward-looking tax governance will require MNEs to:

- Ensure narrative consistency between TP documentation, CbCR and Pillar Two disclosures
- Strengthen data governance and financial reporting discipline across jurisdictions
- Embed Pillar Two considerations into future TP policy design and operational decision-making

EMERGING PRACTICAL CHALLENGES AND KEY TAKEAWAYS

KEY TAKEAWAYS

- Embed ERP-integrated TP technology as a control framework
- Reassess legacy structures under a Pillar Two lens
- Evaluate TP adjustments in a Pillar Two environment
- Ensure defensible commercial rationale for restructuring
- Prepare for a new era of controversy and audit intensity

CHALLENGES

- TP adjustments and arm's length implementation for ETR optimization
- Timing alignment between statutory accounts, tax returns and GIR for TP adjustments
- Symmetry of amounts in the financial accounts of constituent entities
- Commercial rationale for any restructuring exercise



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