June 1, 2017

UIA-NYSBA INTERNATIONAL SECTION
CORPORATE MERGERS AND ACQUISITIONS
Thursday, June 8 & Friday, June 9, 2017

Transaction Structure and Tax Issues

Thursday, June 8, 2017 from 12:00 pm – 1:15 pm

Certain M&A Tax Issues under BEPS relating to a U.S. Target

James R. Shorter, Jr.
Shorter Law Offices
New York
jshorter@shorterlaw.net

I. BEPS: the Background.[1]

1. The OECD was formed in 1960 by the signing of a multilateral treaty.[2] Since its founding, the OECD has grown to include 34 members from around the world.[3] In general the OECD, acting through its Council, may make decisions that are binding on all members, and make recommendations and to enter into bilateral agreements with members, nonmembers, and international organizations, but to the extent that the OECD makes a decision rather than a recommendation of action, such decisions must be made by mutual agreement, unless the members have previously agreed unanimously to a different standard.[4] The U.S. did not agree to accept such decisions as binding on it.[5]
2. As G20 and various policymakers worked toward greater transparency in tax administration, concerns about the operation of and effects of tax on cross-border activities were voiced. These concerns related to the difficulty of taxing corporations engaged in cross-border activities, a perceived increase in base erosion and profit shifting, and a risk that double taxation may arise if governments acted unilaterally to protect their respective corporate tax revenue bases, and resulting uncertainty for taxpayers with cross-border operations. At the G20 Leaders Summit in

---

[1] This background discussion is based on a report by the Staff of the U.S. Joint Committee on Taxation, "Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project" (JCX-139-15), November 30, 2015 (hereinafter referred to as the "JCT BEPS Report").
[2] Convention on the Organization for Economic Cooperation and Development, signed December 14, 1960 at Paris, (entered into force on September 30, 1961) ("OECD Convention").
[3] JCT BEPS Report at 3.
[4] Id.
[5] When the OECD Convention was pending with the U.S. Senate for advice and consent, concerns were raised about the extent to which membership in such an organization could limit legislative authority or expand or limit the executive branch powers. Based on assurances offered by both the Eisenhower and Kennedy Administrations, the resolution for ratification included a statement of the Senate understanding of the OECD Convention that "...nothing in the Convention, or the advice and consent of the Senate of the ratification thereof, confers any power on the Executive to bind the United States in substantive matters beyond what the Executive now has, or to bind the United States without compliance with applicable procedures imposed by domestic law, or confers any power on the Congress to take action in fields previously beyond the authority of Congress, or limits Congress in the exercise of any power it now has." Cong. Record, Senate, March 16, 1961, 87 Congress Vol. 107, page 4154; JCT BEPS Report at 6.

June 2012, world leaders expressed the "need to prevent base erosion and profit shifting" and voiced support for the work being done in that area by the OECD.[6]

3. Undertaken at the request of the G20 leaders, the work to address BEPS is based on the 2013 G20/OECD BEPS action plan,[7] which identified 15 "Action Items" to combat international tax avoidance:

   Action 1: Addressing the Tax Challenges of the Digital Economy

   Action 2: Neutralizing the Effects of Hybrid Mismatch Arrangements

   Action 3: Designing Effective Controlled Foreign Company Rules

   Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

   Action 5: Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance

   Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

   Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status

   Actions 8-10: Aligning Transfer Pricing Outcomes with Value Creation

   Action 11: Measuring and Monitoring BEPS

   Action 12: Mandatory Disclosure Regime

   Action 13: Transfer Pricing Documentation and Country-by-Country Reporting

   Action 14: Making Dispute Resolution Mechanisms More Effective

   Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

4. The rationale for the Action Plan from the OECD's perspective is that taxpayers need to trust the fairness of their tax system and this cannot be achieved where loopholes in international rules as well as lack of cooperation allow tax strategies that divorce the location of the profits (and taxation of those profits) from the location of the activities.[8]

5. General Concepts under BEPS:

   a. Taxes shall be levied and paid in the “right place”- means a focus on "Permanent Establishment issues",[9] "intercompany transactions" and "taxation where the value is created".

   b. "Double non-taxation" of income is not acceptable.

   c. Nor is tax deduction in more than one country of the same expense (i.e., ban double dip schemes).

---

[6] JCT BEPS Report at 8. It should be noted that countries may seek to attract foreign direct investment by establishing favorable tax regimes. In 1998, the OECD published a report titled Harmful Tax Competition: An Emerging Global Issue. That OECD initiative was not successful at the time.

[7] JCT BEPS Report at 9. See, OECD, Action Plan on Base Erosion and Profit Shifting, July 19, 2013, available at http://www.oecd.org/tax/action-plan-on-base-erosion-and-profit-shifting-9789264202719-en.htm

[8] OECD Secretary-General Report to the G20 Finance and Central Bank Governors (September 2015) (hereinafter referred to as, "OECD 9/2015 Report") at 9.

[9] A Permanent Establishment ("PE"), as used in Tax Treaties, is a nexus concept. Is there enough connection to a jurisdiction to make it appropriate for that jurisdiction to tax the profits which are properly allocated to that jurisdiction? The BEPS reports seek to make it easier to find that such nexus exists.

d. "Tax arbitrage" shall be prohibited – i.e. so called "hybrid instruments" must be abolished.

6. Although traditionally the OECD's tax projects are undertaken by the OECD member countries, more than 60 countries participated in formulating the final BEPS reports.[10]

7. The U.S. supported the BEPS project in part because of pressure/headlines in connection with the issue of multinational tax avoidance. This pressure resulted in, for example, enactment of FATCA in 2010.

   a. As negotiations progressed it appeared that the U.S. was becoming a reluctant participant. BEPS presented challenges, because with respect to some of the action items, the interests of the U.S. and of other countries diverged. Such divergence arose in, e.g., the Digital Economy Action Item, which reflected a revenue grab by certain jurisdictions at the expense of the U.S tax base.[11]

   b. Additionally, the U.S. publicly opposed "loose and vague rules like a permanent establishment standard that no taxpayer could really interpret or a 'main purpose' test in treaties that seemed to the U.S. tax administration like they were going to invite more conflict and potential overreaching on the part of countries."[12]

8. With the change of U.S. administrations, one question is whether the Trump administration will continue U.S. participation in BEPS. For the present, it appears that it will.[13] However, such continued participation does not mean that the U.S. will agree to implement all of the Action

---

[10] Regional tax organizations, including the African Tax Administration Forum, Centre de rencontre des administrations fiscales and the Centro Interamericano de Administraciones Tributarias, and international organizations such as the International Monetary Fund, World Bank and the UN participated in the BEPS project. See David Ernick, Can the OECD Remain an International Tax Standard-Setting Organization? Tax Management International Journal (December 2016). The author believes that by expanding participation in the BEPS project, "it remains to be seen whether the OECD's future tax work will reflect consensus around uniform, consistent international tax rules or whether it will end up simply cataloguing divergent country views." This approach appears to reflect the OECD's desire to expand its sphere of influence far beyond its 35 member countries. However, such expansion "seems like a recipe for never being able to reach consensus, if consensus is defined as agreement around a uniform rule" and a likely result is more of the "menu of options" approach which the OECD resorted to in the final BEPS reports and ambiguous rules which allow countries to implement divergent positions in their domestic rules. The OECD's desire "to expand participation in the OECD's tax work must be balanced against the detrimental effects that it has on the ability to achieve consensus and standardization." Id.

[11] For example, in an interview with BNA Robert Stack, former Deputy Assistant Treasury Secretary for International Tax Affairs, stated, "I was the chair of the task force [on the digital economy], and it quickly became clear to me that other countries wanted to write the rules in such a way to get more income from our companies who had high revenues in their jurisdictions, and ultimately, that was the U.S. tax base." Bloomberg BNA Tax Management Transfer Pricing Report, Vol. 25, No. 21 (March 9, 2017) (hereinafter "Stack Interview") at 2.

[12] See Stack Interview at 1-2. Another view is that the Obama administration initially supported the BEPS project because it thought that it would reinforce its own efforts to tax the foreign income of U.S. multinationals, but as the project progressed, it became aware that several BEPS Actions would have a greater impact on U.S. multinationals than on European multinationals, "but by then the train had left the OECD station. The Obama administration was unwilling to stop a project it had a hand in launching and for which it felt mixed affection." See, Gary Hufbauer, Euijin Jung, Tyler Moran, and Martin Vieiro, "The OECD's "Action Plan" to Raise Taxes on Multinational Corporations", Peterson Institute for International Economics Working Paper 15-14 (September 2015) (hereinafter referred to as "Peterson") at 4-5.

[13] BNA reported that at a conference on March 9, 2017 Theodore Setzer, IRS Assistant Deputy Commissioner (International) stated that the IRS is active in the international dialogue, because it is critically important for the U.S. to be an active voice at the OECD Forums on Tax Administration and at the OECD working parties. He also emphasized the need to continue with the projects despite the difficulty of achieving agreement with a large number of the parties. Bloomberg BNA Tax Management Transfer Pricing Report, Vol. 25, No. 22 (March 23, 2017).

Items. Some of them are contrary to longstanding U.S. treaty policy, such as the Permanent Establishment ("PE") changes, revised transfer pricing rules, principle purpose test, or entering into the multinational treaty instrument. In this respect the Trump administration may continue the approach of the previous administration.

9. The JCT BEPS Report provides a brief summary of each of the BEPS Actions. These summaries are not comprehensive, but provide an overview of the final reports for each of the BEPS actions, including a description of the main discussion points, any recommendations made by the OECD, and next steps anticipated by the OECD.[14]

II. BEPS and M&A in the context of a U.S. Target

1. Scope of the Issues.
   - A. In connection with a cross-border acquisition, the principal impact of BEPS arises in the post-acquisition operations of the U.S. Target, particularly in its transactions with members of the Acquirer's international group.
     - i. This is not to say that the structure of the acquisition does not potentially involve one of the BEPS Action Items; for example:
       - a. Action 2: Neutralizing the Effects of Hybrid Mismatch Arrangements;
       - b. Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments in connection with the debt/equity structure of the acquisition transaction; and
       - c. Action 6: Preventing Treaty Abuse[15]
   - B. In the context of the acquisition of a U.S. Target by a foreign Acquirer certain BEPS Action Items are worth noting. These are:
     - i. Action 6: Preventing Treaty Abuse
     - ii. Actions 8-10: Aligning Transfer Pricing Outcomes with Value Creation —Transfer pricing — intangibles (Action 8); Transfer pricing — risk and capital (Action 9); and Transfer pricing — high-risk transactions (Action 10)
     - iii. Action 13: Transfer Pricing Documentation and Country-by-Country Reporting
     - iv. Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

2. <u>Preventing Treaty Abuse (Action 6)</u>
   - A. <u>Issue</u>: Actions 6 takes aim at abuse of treaties.
     - i. Generally, if the Acquirer is able to qualify for benefits under a Tax Treaty between the U.S. and the Acquirer's tax jurisdiction,[16] there would be reduced withholding taxes on payments of interest, dividends and royalties by the U.S. Target, as well as other potential benefits.

[14] JCT BEPS Report at 11-32.
[15] Action 6 is discussed below in connection with the U.S. release of its 2016 Model Income Tax Treaty.
[16] Among other requirements, the Acquirer would need to qualify under the "limitation of benefits" (LOB) provision of the Treaty.

ii. The panel discussion discussed tax and non-tax considerations relating to Acquirers from Switzerland, France and Spain. These jurisdictions currently have Income Tax Treaties with the U.S.[17]

iii. The impact, if any, of Action 6 might occur in connection with a future amendment or replacement of these treaties, or with respect to negotiation of treaties applicable to acquirers of U.S. targets in other jurisdictions.

B. Action 6 - Changes to the OECD Model Tax Convention to prevent treaty abuse. The OECD issued its Final Report, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances,[18] on October 5, 2015.[19]

i. Action 6 identifies treaty abuse, and in particular treaty shopping, as one of the most important sources of BEPS concerns.

ii. The goal of Action 6 is to develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. It proposes anti-treaty shopping provisions and specific treaty rules to address other forms of treaty abuse and ensure that tax treaties do not inadvertently prevent the application of domestic anti-abuse rules. These rules offer a certain degree of flexibility in the implementation of the standards, recognizing that these provisions need to be adapted to each country's specific circumstances and the circumstances regarding negotiation of bilateral treaties.[20]

iii. These new treaty anti-abuse rules first address treaty shopping, which involves strategies through which a person who is not a resident of a particular country attempts to obtain benefits that a tax treaty concluded by that country grants to residents of that country.[21]

iv. To deal with these strategies:

a. Tax Treaties should contain a clear statement that the tax treaty parties intend to avoid creating opportunities for non-taxation (so-called "double non-taxation") or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements.[22]

b. Key concepts for acronym lovers: PPT and LOB.

1. The OECD Model Tax Convention will include a limitation-on-benefits ("LOB") rule, which is a specific anti-abuse rule that limits the availability of treaty benefits to entities that meet certain conditions. Such conditions are based on the legal nature, ownership in, and general activities of the

[17] These treaties entered into force: Switzerland (December 19, 1997); France (December 30, 1995); Spain (November 21, 1990).
[18] Hereinafter, this is referred to as the "Action 6 Final Report".
[19] http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm
[20] The need to provide such flexibility is addressed in Action 6 Final Report at 14, ¶6.
[21] Action 6 Final Report at 9.
[22] Id.

entity, and seek to ensure that there is a sufficient link between the entity and the residence country under the Treaty.[23]

2. To the extent that other forms of treaty abuse are not covered by the LOB rule, a more general anti-abuse rule ("GAR") based on the principal purposes of transactions or arrangements (the "*principal purposes test*" or "PPT" rule) will be included in the OECD Model Tax Convention. If one of the principal purposes of transactions or arrangements is to obtain treaty benefits, these benefits would be denied unless it is established that granting these benefits would be in accordance with the object and purpose of the provisions of the treaty.[24]

c. To address tax avoidance strategies that seek to circumvent provisions of domestic tax laws, domestic anti-abuse rules are needed, and the report includes changes to the OECD Model Tax Convention to ensure that treaties do not inadvertently prevent application of such domestic anti-abuse rules.[25]

d. A new rule will include a "savings clause" covering the principle that treaties do not restrict a State's right to tax its own residents (subject to certain exceptions).[26]

e. Changes to the Commentary of the OECD Model Tax Convention will clarify that treaties do not prevent the application of so-called "departure" or "exit" taxes, under which liability to tax on some types of income that has accrued for the benefit of a resident (whether an individual or a legal person) is triggered in the event that the resident ceases to be a resident of that country.[27]

f. Changes to the OECD Model Tax Convention would be amended to include the minimum level of protection against treaty abuse, including treaty shopping, as this minimum level of protection is necessary to effectively address BEPS.[28]

C. Prevention of Treaty Abuse from the U.S. perspective - the Revised 2016 U.S. Model Income Tax Convention. On February 17, 2016 the Treasury Department released a revised 2016 U.S. Model Income Tax Convention (herein referred to as the "2016 U.S. Model"), which is the baseline text that Treasury uses when it negotiates tax treaties.[29]

i. With regard to BEPS, the 2016 U.S. Model:

[23] Id. Such LOB provisions currently are found in treaties concluded by a few countries (notably, the U.S.) and have proven to be effective in preventing many treaty shopping strategies.
[24] Id.
[25] Action 6 Final Report at 10.
[26] Id. U.S. Tax Treaties include a savings clause. See, e.g., *Letourneau v. Commissioner*, 103 CCH TCM 1229 (2012); 2012RIA TC Memo ¶2012-045.
[27] Action 6 Final Report at 10. See, for example, Code§ 877A, which provides in general that all property of a "covered expatriate" is treated as sold on the day before the expatriation date for its fair market value. In general, a "covered expatriate" is (i) a U.S. citizen who gives up U.S. citizenship or a long-term U.S. resident who gives up his resident status and (ii) who meets certain tests.
[28] Action 6 Final Report at 14, ¶5.
[29] The 2016 U.S. Model is published at:
https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf
The U.S. Model was last updated by the 2006 Model. The "Preamble", which among other things highlights the significant features of the 2016 U.S. Model is published at:
https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Preamble-US%20Model-2016.pdf

a. Would deny treaty benefits for payments of interest, royalties, and certain guarantee fees between related parties if the beneficial owner of the payment benefits from a "special tax regime" ("STR") with respect to the payment.[30]

    1. These STR rules seek to protect against treaty abuse by denying treaty benefits on deductible payments of highly mobile income that are made to related persons that enjoy low or no taxation with respect to that income under a preferential tax regime.[31]

    2. There is an exception for preferential regimes that are generally expected to result in a rate of taxation that is at least: (i) 15%, or (ii) 60% of the general statutory rate of company tax in the source country, whichever is lower. In general, the rate of taxation would be calculated based on the income tax principles of the country that has implemented the STR in question.[32]

b. The 2016 U.S. Model incorporates certain BEPS recommendations for the first time:

    1. It provides a revised preamble that makes clear the purpose of the treaty is the elimination of double taxation without creating opportunities for non-taxation or reduced taxation reduced taxation through tax evasion or avoidance.[33]

    2. It includes a rule to protect against contract-splitting abuses of the twelve-month PE threshold for building sites or construction or installation projects.[34]

    3. It provides a rule intended to protect against contract-splitting abuses of the twelve-month permanent establishment threshold for building sites or construction or installation projects.[35]

    4. It provides a 12 month ownership requirement for the 5% withholding rate for direct dividends and a 12 month residence requirement to prevent companies from circumventing the ownership period as well as to allow the payee company to take into account certain prior ownership.[36]

c. The 2016 U.S. Model has not adopted the other BEPS recommendations regarding the permanent establishment threshold, notably the revised rules related to dependent and independent agents and the exemption for preparatory and auxiliary activities.[37]

---

[30] Preamble at 2. The STR provisions seek to mitigate instances of double non-taxation, whereby a taxpayer uses provisions in the tax treaty, combined with STRs, to pay no or very low tax in either country. However, the new provisions also reflect the U.S. preference "for addressing BEPS concerns through changes to objective rules that apply on a prospective basis, rather than introducing subjective standards that could call into question agreed treaty benefits or applying wholly new concepts to prior years". Id.
[31] Preamble at 1.
[32] Preamble at 3.
[33] Preamble at 8-9.
[34] Preamble at 9.
[35] Id.
[36] Id.
[37] Id..

ii. Many of the 2016 U.S. Model updates include technical improvements developed in the context of bilateral tax treaty negotiations and do not represent substantive changes to the 2006 Model. In addition, it includes a number of new provisions intended to more clearly implement the Treasury Department's longstanding policy that tax treaties should eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. In addition, new Article 28 (Subsequent Changes in Law) obligates the treaty partners to consult with a view to amending the treaty as necessary when changes in the domestic law of a treaty partner draw into question the treaty's original balance of negotiated benefits and the need for the treaty to reduce double taxation.[38]

iii. The 2016 U.S. Model includes a number of technical improvements and certain policy changes to the longstanding LOB provisions of Article 22, which is intended to prevent so-called "treaty shopping" by third-country residents that are not intended beneficiaries of the treaty.[39] U.S. tax treaties have since the 1990s contained robust LOB provisions and rules that determine when treaty benefits should be available for payments through fiscally transparent entities.[40] Thus, LOB provisions are in most U.S. Tax treaties, with the exception of the older treaties. [41]

iv. The U.S. prefers the objective LOB approach over the subjective PPT.

v. As of May 26, 2017, the Treasury has not released a "Technical Explanation" of the 2016 U.S. Model, which it originally said would be released in the spring of 2016.

vi. It has been reported that the US Delegate to the Action 6 Working Party has made a proposal to exclude from treaty relief entities benefitting from a "special tax regime" (i.e., regimes resulting in a low effective tax rate), with certain exceptions such as pension funds, charities, etc.

3. <u>Aligning Transfer Pricing Outcomes with Value Creation: Transfer pricing — intangibles (Action 8); Transfer pricing — risk and capital (Action 9); and Transfer pricing — high-risk transactions (Action 10).</u>

A. <u>Issue</u>. Aligning transfer pricing outcomes with value creation (i.e., the allocation of profit aligns with the activities that create value); treatment of intangibles; risks and capital considerations; and so-called "other high-risk transactions."

i. Potentially, these BEPS Action Items will affect the post-acquisition intercompany transactions of the Acquirer's international group of companies. However, as noted below, the U.S. generally should be expected to continue following its current transfer pricing rules, and objects to certain aspects of the BEPS proposals.[42]

---

[38] Preamble at 1.
[39] Id.
[40] Preamble at 8.
[41] The Preamble at 4 states "A fundamental pillar of U.S. tax treaty policy for over two decades has been to include objective LOB rules to prevent a practice known as "treaty shopping," in which an investor from a third country routes investment into the United States through a company resident in a treaty partner that does not have sufficient nexus to that country with respect to the treaty-benefitted income."
[42] For example, the U.S. adheres to the arm's length standard and is not likely to follow the possible OECD introduction of special measures either within or beyond the arm's length principle.

B. In September 2015 the OECD Secretary General stated that "[t]he existing transfer pricing rules have been called into question by some as they are too often used and abused to locate profits, in particular from intangible assets, in low tax jurisdictions where no activity takes place. In spite of their high technical character, the changes that will be introduced to the existing Transfer Pricing Guidelines will be expected to have a sea change impact on the behavior of taxpayers, in particular on so-called “cash box” entities which house significant profits in low or no tax jurisdictions, but have few personnel and minimal or no economic activity."[43]

C. The March 2014 Discussion Draft states that "[t]he BEPS work on transfer pricing is intended to address BEPS issues that commonly arise among companies active in the digital economy as well as other taxpayers. Many of the structures involve separating business functions between different legal entities in the group, treating some of those entities as low-risk / low-profit entities, and others as high-risk / high-profit ones, making certain that the high risk /high-profit entities do not conduct activities that trigger taxation in high tax jurisdictions. Taken together, the overall objective of the transfer pricing actions is to bring the allocation of income within a multinational group of companies more directly in line with the location of the economic activity that gives rise to that income. This objective is pursued by focusing on key issues such as (i) intangibles, (ii) business risks, (iii) characterization of transactions, (iv) base erosion payments, and (v) global value chains and profit splits."[44]

D. Transfer Pricing involves three BEPS Actions.

   i. Action 8 considers transfer pricing issues relating to transactions involving intangibles, because misallocation of the profits generated by valuable intangibles has contributed to base erosion and profit shifting.

   ii. Action 9 considers contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond with the activities actually carried out; in addition, Action 9 addresses the level of returns to funding provided by a capital-rich multinational group member, where those returns do not correspond to the level of activity undertaken by the funding company.

   iii. Action 10 focuses on other high-risk areas, including the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterization), the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the multinational group, and neutralizing the use of certain types of payments between members of the multinational group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation.

---

[43] OECD 9/2015 Report" at 9.

[44] March 2014 Discussion Draft at 51 (¶ 160).

E. The OECD issued its Final Report, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports,[45] on Oct 5, 2015.[46]

i. Background regarding transfer pricing. The arm's length principle is used by countries as the cornerstone of transfer pricing rules. It is embedded in treaties and appears as Article 9(1) of the OECD and UN Model Tax Conventions.[47]

1. The arm's length principle requires that transactions between associated enterprises are priced as if the enterprises were independent, operating at arm's length and engaging in comparable transactions under similar conditions and economic circumstances. Where the conditions of the transaction are different from those between third parties in comparable circumstances, adjustments to the profits may be needed for tax purposes.
2. The arm's length principle has proven useful as a practical and balanced standard for both tax administrations and taxpayers to evaluate transfer prices.
3. However, with its perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance is vulnerable to manipulation, which can lead to outcomes which do not correspond to the "value created" by the underlying economic activity carried out by the members of a multinational group.
4. Therefore, the BEPS Action Plan requires clarification and strengthening of the guidance, and, possibly, introduction of *special measures either within or beyond the arm's length principle*.[48]

ii. Scope and methodology. The revised guidance requires:

1. Consider the "actual transaction" between the associated enterprises by analyzing the contractual relations between the parties in combination with the conduct of the parties.

   a. Such actual conduct will control, and supplement or replace the contractual arrangements, if the contracts are incomplete or are not supported by the conduct of the parties. This would mean that the terms of the contract allocations of risk will not be honored if such conduct differs from the contractual terms.

   b. Pricing methods will be applied to prevent the allocation of profits to locations where no contributions are made to these profits, which will lead to the allocation of profits to the enterprises that conduct the corresponding business activities.

   c. Importance of commercial rationality. If the transaction between associated enterprises "lacks commercial rationality," the guidance continues to authorize the disregarding of the arrangement for transfer pricing purposes.[49]

---

[45] Hereinafter, this is referred to as the "Transfer Pricing Final Report".
[46] http://www.oecd.org/tax/transfer-pricing/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm
[47] A shared interpretation of the principle by many of those countries is set out in the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter: "Transfer Pricing Guidelines"), first published in 1979, and most recently updated in 2010.
[48] Transfer Pricing Final Report at 9.

d. The Summary notes that:

   1. Ordinarily the actual arrangements should be priced in accordance with the existing Transfer Pricing Guidelines. **However, the revisions reinforce the need to be able to disregard transactions when the exceptional circumstances of commercial irrationality apply.**

   2. **The mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognized**.

   3. Instead, the key question is **whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances**. [50]

2. Focus on Actual Risks. Risks are defined as the effect of uncertainty on the objectives of the business.

   a. In all of a company's operations, uncertainty exists, and risk is assumed. No profit seeking business takes on risk associated with commercial opportunities without expecting a positive return. This economic notion that higher risks warrant higher anticipated returns made multinational groups pursue tax planning strategies based on contractual re-allocations of risks, sometimes without any change in the business operations.

   b. To address this, risks **contractually assumed by a party** (i) that **cannot in fact exercise meaningful and specifically defined control** over the risks, or (ii) **lacks the financial capacity to assume the risks**, will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks.[51]

3. Attention to intangibles. Legal ownership of intangibles by itself does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible.

   a. The group companies performing important functions, controlling economically significant risks and contributing assets, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return reflecting the value of their contributions.[52]

   b. Specific guidance will ensure that the analysis is not weakened by:

      1. Information asymmetries between the tax administration and the taxpayer in relation to hard-to-value intangibles, or

      2. Using special contractual relationships, such as a cost contribution arrangement. [53]

---

[49] Transfer Pricing Final Report at 10.
[50] Transfer Pricing Final Report at 14, Summary, Revisions to Section D of Chapter I of the Transfer Pricing Guidelines. Detailed Guidance is provided in the following pages at 15-50.
[51] Transfer Pricing Final Report at 10.
[52] Transfer Pricing Final Report at 10.
[53] Transfer Pricing Final Report at 10.

4. Profits might not be allocated to a so-called "cash box". A capital-rich member of the group without any other relevant economic activities ("cash box") will not be entitled to any excess profits, if it provides funding but performs few activities, and does not in fact control the financial risks associated with its funding.[54] It will not be allocated the profits associated with the financial risks and will be entitled only to a risk-free return, or less if (for example) the transaction is not commercially rational and therefore the guidance on nonrecognition applies.[55] This will be coordinated with other BEPS Action Plans to discourage the use of cash boxes in BEPS strategies.[56]

5. Allocation of profits to the most important economic activities. The synergistic benefits of operating as a group will be allocated to the members contributing to such synergistic benefits.[57]

   a. The Report provides for further study of the" transactional profit split method," to lead to detailed guidance on the ways in which this method can be applied to align transfer pricing outcomes with value creation, including in the circumstances of integrated global value chains.[58]

6. The Transfer Pricing Final Report asserts that Actions 8-10 "better align" transfer pricing outcomes with value creation of the multinational group, and by curtailing the role of "cash boxes" in BEPS planning, the goals set by the BEPS Action Plan in relation to the development of transfer pricing rules has been achieved **without the need to develop special measures "outside the arm's length principle."**[59]

7. One criticism of the proposed rules relates to the unwarranted extension by taxing authorities of the concept that BEPS transfer pricing rules seek to "better align" transfer pricing outcomes with "value creation".[60] The question is whether value creation, like beauty, is in the eyes of the beholding tax authorities. The BEPS Actions relating to the Digital Economy and Permanent Establishment suggest an approach to more easily align value creation to the market existing in the source jurisdiction. One commentator noted that: "The point that hasn't really been debated is the question of where "value" is created. Some of the interpretations of the TPG [transfer pricing guidelines] which have the effect of allocating more

[54] For example, if it just provides the money when asked to do so, without any assessment of whether the party receiving the money is creditworthy.
[55] Transfer Pricing Final Report at 11.
[56] The return to the cash box may be subject to the interest deductibility rules of Action 4; it may be difficult to structure the payments to the country where the cash box is tax-resident in a way that avoids withholding taxes, due to the guidance on preventing treaty abuse (Action 6); and a cash box with limited or no economic activities is likely to be the target of CFC rules (Action 3). Transfer Pricing Final Report at 11.
[57] For example, discounts that are generated because of the volume of goods ordered by a combination of group companies will need to be allocated to these group companies. Transfer Pricing Final Report at 11.
[58] Transfer Pricing Final Report at 11.
[59] Transfer Pricing Final Report at 12.
[60] The Transfer Pricing Final Report at 9 notes that "existing international standards for transfer pricing rules can be misapplied so that they result in outcomes in which the allocation of profits is not aligned with the economic activity that produced the profits. The work under Actions 8-10 of the BEPS Action Plan has targeted this issue, to ensure that transfer pricing outcomes are aligned with value creation."

income to the destination state are based on *the tax policy assertion that value is created by the simple existence of the market*. In the nexus area, that policy view is inspiring governments to seek to impose new nexus standards on income derived from sales into their market. The new standards usually are justified on the basis that they are needed to capture a “fair share” of tax arising from the transactions."[61]

a. Will transfer pricing standards under the OECD approach result in a similar effort to attribute intangible income to the market countries? This is an important issue, which to some extent is an outgrowth of the attempt to "loosen" permanent establishment standards. profit attribution. If you are viewing a branch, as opposed to two subsidiaries, the questions about the circumstance in which intangible income is attributed to a branch are more difficult than the case of relationships between two legal entities with contracts. A consideration is this big, intangible pot of money which hangs over everything, so certain countries want to attribute more income to themselves and their markets, and that creates a tension on the OECD process.[62]

b. One observation on the OECD negotiations on transfer pricing is: "As a U.S. practitioner, when you read the [OECD] papers that are done in transfer pricing, they don’t fit perfectly the U.S. transfer pricing lawyer’s view of exactly how the U.S. arm’s-length standard works. And the reason for that is, it’s a horse—you know that expression, a camel is a horse built by a committee? You’ve got 80 or 90 countries around a table trying to parse and explain these things, so it would shock us all if the words came out exactly as the U.S. [transfer pricing regulations] came out."[63] He notes that the U.S. representatives are "trying to get as close as we can to what we can all agree is the arm’s-length standard."[64]

c. A brief review of current U.S. transfer pricing standards is included in Appendix A.

8. Arm's length principle or formulary apportionment? Another concern with the OECD approach to transfer pricing is whether there is an actual commitment to continued use of the arm's length principle*, or instead a movement by tax administrators to use formulary apportionment*.

a. This concern has been raised in connection with the data required by CbC (country by country) reporting. Comments were made that data requested would not be useful for transfer pricing risk assessment if the transfer pricing rules were to continue to be based on the arm's length principle.

b. In this regard PWC noted its concerns that "the level of detail currently required in the CbC template could encourage tax authorities to pursue

[61] Gary D. Sprague, "Nexus Rules and Theories of Market-Based Taxation in the BEPS Project (and Beyond)", Tax Management International Journal (January 2017) (Emphasis added). He points to the revisions of Art. 5 of the OECD Model Treaty relating to creation of nexus by activities of a dependent person in the market country relating to the conclusion of contracts, and the narrowing of the preparatory or auxiliary exception to establishment of a PE.
[62] See Stack Interview at 6.
[63] Stack Interview at 7.
[64] Id.

challenges that have more in common with a formulary apportionment approach, despite the OECD's comments that such an approach is not intended to replace the arm's-length standard. The CbC template asks for country by country reporting of taxpayers' payroll, property, and sales, which are the same factors commonly used to allocate income under a formulary apportionment system."[65]

> "Consequently, it seems likely that CbC reporting will lead to more transfer pricing controversies, as foreign countries use the information from such reporting to target the profits of U.S. companies, while the United States would consider that any potential transfer pricing adjustments from outbound intangibles transfers should accrue to its benefit."[66]

9. A transfer pricing related issue from the U.S. perspective concerns the European Union's application of its own version of transfer pricing rules under the EU's State Aid investigations which has targeted certain EU Member State rulings benefiting U.S. multinationals.

    a. <u>EU State Aid Investigations of Transfer Pricing Rulings</u>. On June 11, 2014 the European Commission announced that it was investigating whether decisions by tax authorities regarding transfer pricing arrangements on corporate taxation of Apple (Ireland) Starbucks (Netherlands) and Fiat Finance and Trade (Luxembourg) comply with the EU rules on state aid.[67] The press release noted that tax rulings confirm transfer pricing arrangements,[68] and that transfer pricing influences the allocation of taxable profit between subsidiaries of a group located in different countries. If tax authorities insist on a remuneration of a subsidiary or a branch on market terms, reflecting normal conditions of competition, this would not constitute state aid. However, if market terms are not used, it could imply a more favorable treatment of the company compared to the treatment other taxpayers would normally receive, which might constitute state aid.

        1. Tellingly, it stated that "[a] number of multinational companies are using tax planning strategies to reduce their global tax burden, by taking advantage of the technicalities of tax systems, and substantially reducing their tax liabilities. This aggressive tax planning practice erodes the tax bases of Member States, which are already financially constrained."[69]

    b. Subsequently, the Commission announced that Ireland granted undue tax benefits to Apple, which violated EU state aid rules by allowing Apple to pay substantially less tax than other businesses. Accordingly, Ireland is required to recover the illegal aid from Apple.[70]

---

65 See David Ernick, "How Will Country-by-Country Reporting Assist in Transfer Pricing Risk Assessment?", 45 Tax Mgmt. Int'l J. 350 (June 10, 2016).
66 Id.
67 European Commission press release (June 11, 2014) at http://europa.eu/rapid/press-release_IP-14-663_en.htm
68 "Transfer pricing refers to the prices charged for commercial transactions between various parts of the same group of companies, in particular prices set for goods sold or services provided by one subsidiary of a corporate group to another subsidiary of the same group." Id.
69 Id.
70 European Commission press release (August 30, 2016) at http://europa.eu/rapid/press-release_IP-16-2923_en.htm

1. The recovery of illegal state aid is retroactive - Ireland must now recover the unpaid taxes in Ireland from Apple for the years 2003 to 2014 of up to €13 billion, plus interest.
2. The Irish tax treatment enabled Apple to avoid taxation on almost all profits generated by sales of Apple products in the entire EU Single Market, because Apple recorded all sales in Ireland rather than in the countries where the products were sold.[71]
3. The amount of unpaid taxes to be recovered by Ireland would be reduced if other countries were to require Apple to pay more taxes on the profits recorded by ASI and AOE for this period, or if the U.S. requires a transfer pricing adjustment to require larger payments to the U.S. parent company for this period to finance research and development efforts.

c. U.S. Foreign Tax Credits ("FTC") on such retroactive taxes is a big issue for the U.S. Treasury Department.

1. If the Apple subsidiaries are required to pay the full amount of such unpaid taxes, the U.S. would stand to lose \$14.5 billion in tax revenue if Apple were able to claim the FTC on such taxes.[72]
2. In general, if a U.S. corporation repatriates profits from a foreign subsidiary, it is entitled to an "indirect" FTC for creditable foreign income taxes "deemed to have been paid" on the repatriated income.[73]
3. Accordingly, profits from the subsidiaries would have to be distributed to Apple to entitle Apple to the indirect FTC.

d. The U.S. Treasury Department White Paper. The Treasury took the unusual step of issuing a "White Paper" highly critical of the EU commission's decision.[74] The following points were raised:

1. The Commission's approach is new and departs from prior EU Case Law and Commission Decisions.

(a) In general, the Commission advanced several previously unarticulated theories to justify its view that generally available tax rulings may constitute impermissible State aid in particular cases, claiming "selectivity" and in doing so equating selectivity with "benefit".[75] It

---

It stated that such treatment allowed Apple to pay an effective corporate tax rate of 1 per cent on its European profits in 2003 down to 0.005 per cent in 2014.

[71] Only a fraction of the profits of Apple Sales International ("ASI") were allocated to its Irish branch and subject to tax in Ireland. The remaining vast majority of profits were allocated to the "head office" (which the Commission stated was not based in any country and did not have any employees or own premises), where they remained untaxed. Consequently, only a small percentage of ASI's profits were taxed in Ireland, and the rest was taxed nowhere. A similar arrangement applied to Apple Operations Europe ("AOE"). The Commission determined that the tax rulings endorsed an artificial internal allocation of profits within the two Apple subsidiaries, without any factual or economic justification. Id.

[72] See 178 BNA DTR I-1 (Issue No. 178, 09/14/16)

[73] See Code § 902.

[74] U.S. Treasury Department, "The European Commission's Recent State Aid Investigations of Transfer Pricing Rulings" (August 24, 2016) ("White Paper"). This White Paper provides additional detail regarding the principal concerns expressed in Treasury Secretary Lew's letter to Commission President Jean-Claude Juncker on February 11, 2016 regarding the Commission's recent State aid investigations.

[75] Generally, the test previously required a showing of both selectivity and benefit.

found selectivity in Ireland's transfer pricing rulings because standalone companies (which therefore do not have transactions with affiliates) could not obtain (nor need) a transfer pricing ruling. Such a change, which second-guesses Member State income tax determinations, was an unforeseeable departure from the status quo.

2. The Commission should not seek retroactive recoveries under its new approach.[76]

   (a) Such retroactivity is inconsistent with EU legal principles.

   (b) U.S. companies have been receiving transfer pricing rulings from EU Member States for decades and had no reason to doubt their legality.[77]

   (c) Retroactive recoveries are counter to efforts taken by the international community to improve tax certainty. The G20 has highlighted the "benefits of tax certainty to promote investment and trade," while asking the OECD and International Monetary Fund to continue working on the issue of tax certainty. This work will play an important role to make sure that efforts to combat BEPS do not unnecessarily impede cross-border investment and trade. In this case the Commission's retroactive application of large recoveries related to past conduct creates significant uncertainty for companies. This approach is in tension with the G20's efforts to emphasize tax certainty and sets an undesirable precedent that could lead to other tax authorities, particularly those in developing countries that look to the EU as a model, to seek large and punitive retroactive recoveries from both U.S. and EU companies.[78]

3. The Commission's new approach uses an EU-only arm's length principle which undermines the international consensus on transfer pricing standards, calls into question the ability of Member States to honor their bilateral tax treaties, and undermines the progress made under the BEPS project.

   (a) The Transfer Pricing Guidelines of the OECD ("TP Guidelines") are widely used by tax authorities to apply the "arm's length principle" consistently.

   (b) The OECD and G20 members' work has improved protections against base erosion and profit shifting. In general, under the OECD/G20 BEPS project, the OECD and G20 members updated the OECD TP Guidelines to strengthen the ability of tax administrations to combat base erosion and profit shifting arising from transfer pricing that is inconsistent with the arm's length principle. This was a consensus-based multilateral approach to help ensure consistency in both the

[76] These recoveries can be significant - recovery may cover up to ten prior years, with interest for the period from the grant of the illegal aid until the aid is recovered.

[77] "[T]he longstanding inaction by the Commission—in addition to the fact that the Commission provided no hints of its new approach in previous guidance—warrants the Commission declining to impose retroactive recoveries." White Paper at 16.

[78] White Paper at 16-17.

interpretation of the arm's length principle and in its practical application by taxpayers and tax authorities throughout the world.[79]

(c) The Commission is now applying a different arm's length principle that it says is derived from EU treaty law. As a result, whether a tax ruling is consistent with the OECD TP Guidelines will now be determined, in the first instance, by a non-tax agency that generally is not tasked with applying the Guidelines and was not involved in their development. "This approach raises concerns because the Guidelines are not designed to reach formulaically precise results; rather, they describe a framework of analysis and methodologies that are highly dependent on each case's facts."[80]

(d) "Various statements by the Commission invite speculation as to whether the Commission's view of the arm's length standard depends on the relative tax rates of the countries on either side of a transaction. For example, the Deputy Director-General of DG COMP has stated that '[i]f multinationals are able to adjust their transfer pricing to shift profits to low-or no-tax countries, or otherwise avoid paying taxes due, then they can operate in the internal market without paying the taxation that their competitors are subject to.' "[81]

(e) In other words, the Commission is applying a result oriented approach which seeks to ensure that profits are allocated to tax jurisdictions within the EU.[82]

(f) Such approach undermines the international consensus on transfer pricing standards and the on the obligation to attempt to resolve transfer pricing disputes through the mutual agreement procedures ("MAP") found in bilateral tax treaties.[83] Under MAP, the OECD TP Guidelines are used to determine an arm's length price, based on a neutral interpretation of the arm's length principle that applies fairly and consistently without regard to a country's particular circumstances, including whether it is a high-or low tax jurisdiction. In many cases an agreement is reached by jurisdictions on the interpretation of facts and the application of the most reliable transfer pricing method, so that profits are shared in a fair and reasonable manner, or they agree to another dispute resolution mechanism such as arbitration.

---

[79] See White Paper at 19.
[80] White Paper at 20. Because transfer pricing is highly dependent on the underlying facts and circumstances, tax authorities generally have entire departments whose sole responsibility is to examine transfer pricing issues.
[81] White Paper at 21.
[82] The White Paper points out that the Commission stated in its *Fiat* decision that, "[E]ven applying the most appropriate method may constitute State aid if used with 'overly favourable parameters.' These instructions appear to be premised on the notion that *as long as the taxpayer has left sufficient income in the Member State to be taxed, then the TFEU's 'general principle of equal treatment in taxation' is satisfied*. Yet such outcome-determinative reasoning is inconsistent with the logic of the arm's length principle, which is neutral as to which jurisdiction ends up with the income as long as the allocation is generally consistent with what unrelated companies otherwise would pay." Id. at 22. (Emphasis added; footnotes omitted).
[83] The White Paper notes that Action 14 of the BEPS project reflects an agreement that MAP "is of fundamental importance to the proper application and interpretation of tax treaties." Id. at 22.

(g) By seeking to impose standards which depart from the OECD TP guidelines and MAP the Commission's approach in the State Aid Cases restricts the ability of Member States to honor their bilateral tax treaties with the U.S. and other trading partners.[84] In addition, it undermines the progress made under the OECD/G20 BEPS project.[85]

4. Treasury action on FTC splitters. As a consequence of the potential loss of U.S. tax revenues from significant FTCs from the above "state aid" back tax impositions, Notice 2016-52[86] indicates that in many cases U.S. multinationals will find it more difficult to obtain full FTC relief for such foreign tax assessments.[87] As noted above, U.S. companies can reduce their U.S. taxes by the value of the FTCs they claim for taxes paid abroad on foreign profits, and such profits are not subject to U.S. tax until they are brought into the U.S., or are repatriated.

(a) The new rule will prevent companies faced with back tax bills from "splitting", a strategy that allows companies to bring FTCs into the U.S. without repatriating the income from which they were derived. In general, certain foreign income taxes paid by a § 902 corporation after the taxable year to which the taxes relate are taken into account by adjusting "pools of post-1986 foreign income taxes" in the taxable year in which the taxes are paid, rather than accounting for the taxes in the prior taxable year to which the taxes relate.[88]

(b) The Treasury Department and the IRS are aware that, in anticipation of a large foreign-initiated adjustment that relates to a prior taxable year, a taxpayer may take steps to separate the additional payment of foreign income tax from the income to which it relates.

(c) The Notice states that such foreign-initiated adjustments may arise under European Union (EU) State aid law, to the extent EU State aid payments result in creditable foreign taxes.[89]

---

[84] Id. at 22-23.
[85] Id. at 24-25.
[86] 2016-40 IRB 425 (9/15/16). This notice indicates that Treasury and IRS plan to issue regulations under Code § 909 to address the separation of related income from foreign income taxes paid by a § 902 corporation. In general, a § 902 corporation, is a foreign corporation with respect to which one or more domestic corporations meets the ownership requirements of § 902 (a) or (b), which is 10% or more of its voting stock (at the first tier) and indirectly at least 5% of its voting stock up to the 6th tier (and below the third tier the foreign corporation must be a CFC).
[87] See James J. Tobin, "A New Splitter", Tax Management International Journal (November 2016).
[88] See § 905(c). Tobin notes that the Notice reflects Treasury's concern that the §905(c) rule could be used to separate additional foreign taxes paid as a result of a foreign-initiated audit assessment from the related income. His article describes the rules provided in the Notice. He believes that the Notice is "a rushed attempt to discourage U.S. multinationals from claiming a credit for foreign tax assessments without fully analyzing the collateral effects." He also hopes that Treasury continues to challenge foreign governments to refrain from pursuing overly aggressive foreign assessments, because "[t]here could eventually be a cost to the U.S. fisc and in any event it's the right thing to do."
[89] Before a payment is made pursuant to a foreign-initiated adjustment, a taxpayer may attempt to change its ownership structure or cause the § 902 corporation to make an extraordinary distribution so that the subsequent tax payment creates a high-tax pool of post-1986 undistributed earnings that can be used to generate substantial amounts of foreign taxes deemed paid, without repatriating and including in U.S. taxable income the earnings and profits to which the taxes relate. Notice 2016-52.

5. Future actions by Treasury. The Department is said to be "closely" reviewing the possibility of imposing retaliatory double taxes on European Union companies and individuals.[90]

e. Contract R&D arrangements. What to do about the "cash box."

1. "The Report takes an almost anti-capitalism tone. It indirectly addresses the age-old question as to whether capital or labor is the predominant factor in creating value by taking the view that labor is all-important. While ownership of IP and the provision of money to develop it are not entirely ignored, they take a distant backseat to "people functions" — camouflaged somewhat under the rubric of "control." Fundamentally, the Report fails to recognize that not everyone works for an equity-like return; that some important persons, even those who may make important decisions, might provide their services at arm's length for an essentially risk-free or low-risk return (like a salary) in exchange for the comfort of knowing that they are very likely to obtain that return."[91]

2. "Overall I found the Actions 8-10 report very troubling. By defining the portion of IP return that the company that is the legal owner is not entitled to, but leaving many open questions on which entities are entitled to that return or a portion of that return, the prospect of extended controversy around the world and high risk of double taxation seems a highly likely outcome. Lots of countries seeing a potential revenue prize to pursue. And I'd suggest the issue will be real for virtually all large multinationals and not just for the dwindling few that may have something that resembles a "cash-box." I encourage the OECD to continue its work in this area but with greater input from industry. Meeting the very ambitious timetable for the report could be said to be an achievement. But not when it produces an unworkable answer."[92]

---

[90] Code § 891 provides that "Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 1, 3, 11, 801, 831, 852, 871, and 881 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country ...." This approach also was suggested to Treasury in a letter from the Senate Finance Committee to Treasury Secretary Lew, dated January 15, 2016.

[91] Philip Morrison, "BEPS 2015 Final Report Regarding Transfer Pricing of Intangibles", Tax Management International Journal (April 2016).

[92] James J. Tobin "Intangible BEPS Risks", Tax Management International Journal (April 2016).

4. Automatic Sharing of Tax Data (Transfer Pricing Documentation and Country-by-Country Reporting) (Action 13)

   A. Issue. The BEPS Action Plan adopted in 2013 recognized that enhancing transparency for tax administrations by providing them with adequate information to assess high-level transfer pricing and other BEPS-related risks is a crucial aspect for tackling the BEPS problem.[93]

   B. OECD initiatives were to provide (a) revised standards for transfer pricing documentation and (b) a global Common Reporting Standard ("CRS") and an Automatic Exchange of Financial Account Information standard ("AEOI") for automatic sharing of tax data between governments to crack down on tax-avoidance strategies used by Multinationals. The Final Report on Action 13 includes a template for Country-by-Country Reporting of income, taxes paid and certain measures of economic activity ("CbC Reporting").

   C. Action 13 requires the development of "rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template".

   D. In 2014 the OECD developed the global CRS[94] for the AEOI, drawing on the work undertaken by the European Union and relating to the U.S. Foreign Accounts Tax Compliance Act ("FATCA").[95] The OECD is working with G20 countries and the Global Forum on Transparency and Exchange of Information for Tax Purposes to support jurisdictions with the tools and practical guidance necessary for globally consistent implementation. By doing so, they are working to minimize the compliance burdens for both governments and financial institutions.

   E. The OECD issued its Final Report, Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report,[96] on Oct 5, 2015.[97]

      i. The Action 13 Final Report described a three-tiered standardized approach to transfer pricing documentation,[98] consisting of:

         1. a "Master File" containing standardized information relevant for all MNE group members, grouped in five categories: a) the group's organizational

[93] See, BEPS Action 13: Country-by-Country Reporting Implementation Package (June 8, 2015) at 5.
[94] The September 2014 Report on Action 13 (the "September 2014 Report") provided a template for Multinational Enterprises ("MNEs") to report annually, and for each tax jurisdiction in which they do business, the information set out therein. This report is called the Country-by-Country Report ("CbC Report").
[95] OECD 9/2015 Report at 5, 13.
[96] Hereinafter, this is referred to as the "Action 13 Final Report".
[97] See http://www.oecd-ilibrary.org/docserver/download/2315381e.pdf?expires=1493952593&id=id&accname=guest&checksum=4F817B12145801FF09B6BB10D67D7B02
[98] See Action 13 Final Report at 14, ¶16.

structure; b) its business or businesses; c) its intangibles; d) its intercompany financial activities; and (e) its financial and tax positions;[99]

2. a "Local File" referring specifically to material transactions of the local taxpayer.[100] It should provide more detailed information relating to specific intercompany transactions, such as transfer pricing analysis relating to transactions between a local country affiliate and associated enterprises in different countries which are material in the context of the local country's tax system;[101] and

3. a CbC Report containing certain information relating to the global allocation of the MNE group's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.[102] The report also requires a listing of all the constituent entities for which financial information is reported, as well as the nature of the main business activities carried out by that entity.[103]

   (a) Such CbC Report would be filed annually by large MNEs for each tax jurisdiction in which they do business, and it would: (a) provide the amount of revenue, profit before income tax and income tax paid and accrued; (b) report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction; (c) identify each entity within the group doing business in a particular tax jurisdiction and provide an indication of the business activities engaged in by each entity.[104]

F. The standardized CbC Report was developed to provide a global picture of the operations of Multinationals to tax administrations. In March 2016 the OECD released its standardized electronic format for the exchange of CbC Reports between jurisdictions.[105] Such CbC Reports would be transmitted electronically between Competent Authorities in accordance with the CbC XML Schema format, to assist tax administrations in obtaining a complete understanding of the way in which Multinationals structure their operations, by providing them annually with key information on the global allocation of income and taxes paid, together with other indicators of the location of economic activity within that Multinational's group. It also will cover information about which entities do

---

[99] In general, this consists of "high-level" information regarding their global business operations and transfer pricing policies, which would be provided to relevant tax administrations. See Action 13 Final Report at 14, ¶¶18-19.

[100] In general, this "local file" consists of detailed transactional transfer pricing documentation specific to each country, which identifies material related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions. Action 13 Final Report at 9.

[101] Action 13 Final Report at 15, ¶22.

[102] See Action 13 Final Report at 14, ¶16 and at 16, ¶24. See also: BEPS Action 13 guidance on implementation of transfer pricing documentation and CbC reporting (Feb 6, 2015) at 3. See http://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf

[103] Action 13 Final Report at 16, ¶24.

[104] See Action 13 Final Report at 9.

[105] See http://www.oecd.org/tax/exchange-of-tax-information/oecd-releases-standardised-electronic-format-for-the-exchange-of-beps-country-by-country-reports.htm
See also http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/country-by-country-reporting.htm

business in a particular jurisdiction and the business activities engaged in by each entity engages.[106]

G. The information to be included in the CbC Report will be collected by the country of residence of the Reporting Entity for the Multinational's group, and exchanged under the relevant international exchange of information agreement. First exchanges of CbC Reports will start in 2018, with information on the year 2016.[107]

H. In addition, OECD developed an Exchange of Information on Request ("EOIR") Standard, and seeks to devise incentives to cause jurisdictions to comply with the international standard of EOIR.[108]

I. The OECD released a "high level snapshot" to information on the domestic legal frameworks for CbC reporting around the world. This table contains the information received from members and will be updated as members finalize their CbC reporting frameworks.[109] In addition, it released a list of signatories of the Multilateral Competent Authority Agreement on the exchange of CbC reports ("CbC MCAA")[110] The U.S. has not signed the CbC MCAA. The U.S. Treasury Department has issued forms of bi-lateral agreements that it proposes to enter into.[111] These were issued on April 6, 2017.

J. Confidentiality. This is a major concern for Multinationals.

   i. Action 13 Final Report provides that Tax administrations should take all reasonable steps to ensure that there is no public disclosure of confidential information (trade secrets, scientific secrets, etc.) and other commercially sensitive information contained in the documentation package (master file, local file and Country-by-Country Report).

   ii. Tax administrations also should assure taxpayers that information presented in transfer pricing documentation will remain confidential. In cases where disclosure is required in public court proceedings or judicial decisions, every effort should be made to ensure that confidentiality is maintained and that information is disclosed only to the extent needed.[112]

   iii. Nevertheless, there is some concern among multinationals that in certain jurisdictions such information could become public.

---

[106] Id.
[107] Id. Data reporting for 2016 was an issue for U.S. Multinationals, because Treas. Reg. § 1.6038-4 regarding CbC reporting generally were not applicable to 2016 tax returns. However, this was remedied by Rev. Proc. 2017-23, 2017-7 IRB 915, which described the filing process for filing Form 8975, Country-by-Country Report, and schedules by ultimate parent entities of U.S. multinational enterprise groups. This guidance applies for reporting periods beginning on or after January 1, 2016 but before applicability date of Treas. Reg. § 1.6038-4 (discussed below).
[108] See OECD 9/2015 Report at 15. Annex 1of the Report at 25-33 provides additional detail.
[109] The table is published at: http://www.oecd.org/tax/automatic-exchange/country-specific-information-on-country-by-country-reporting-implementation.htm
[110] This table includes signing dates and status as of January 26, 2017. See: http://www.oecd.org/ctp/exchange-of-tax-information/CbC-MCAA-Signatories.pdf
[111] There are two types of agreements. One is for jurisdictions with which the U.S. has entered into a Tax Treaty, and the other is for jurisdictions covered by a Tax Information Exchange Agreement (TIEA). See https://www.irs.gov/businesses/country-by-country-reporting-guidance
[112] Action 13 Final Report at 19.

K. U.S. implementation of CbC Reporting

i. Final Regulations. IRS and Treasury Department have issued final regulations that require annual CbC reporting by U.S. persons that are the ultimate parent entity of a multinational enterprise group that has annual revenue for the preceding annual accounting period of $850MM or more.[113]

1. The effective date of these regulations is June 30, 2016.[114] Because of such effective date, data reporting generally was not applicable to 2016 tax returns for calendar year taxpayers. However, this was remedied by Rev. Proc. 2017-23,[115] which described the filing process for filing Form 8975, Country-by-Country Report, and schedules by ultimate parent entities of U.S. multinational enterprise groups. This guidance applies for reporting periods beginning on or after January 1, 2016 but before applicability date of Treas. Reg. § 1.6038-4.[116]

2. It has been noted that the OECD structure for reporting CbC information provides that reporting on the complete template is made to the tax authority of the multinational group's parent's country, which then shares it under treaty exchange protocols. Thus, the above procedure for 2016 reporting solves a particular issue for U.S. Multinationals.

(i) If the U.S., did not require or permit the CbC report for 2016 calendar year taxpayers or make it available to the tax authorities of the subsidiary's country, such tax authorities could request the CbC template from the local subsidiary. However, submission of such information directly by the subsidiary to its tax authorities would cause the information to lose confidentiality protection. In contrast with such result, a treaty exchange between the U.S. and such tax jurisdiction provides confidentiality protection.[117]

ii. In general, under the regulations, the ultimate parent entity of a U.S. multinational group is a U.S. business entity that:

1. owns directly or indirectly, a sufficient interest in one or more other business entities, at least one of which is organized or tax resident outside the U.S., such that the U.S. business entity is required to consolidate the accounts of the other entities with its own accounts for financial reporting purposes under U.S. GAAP, or that would be required to do so if equity interests in the U.S. business entity were publicly traded on a U.S. securities exchange; and

2. is not owned directly or indirectly by another business entity that consolidates the accounts of such U.S. business entity with its own

[113] See Treas. Reg. §1.6038-4 (Information returns required of certain United States persons with respect to such person's U.S. multinational enterprise group); T.D. 9773, 81 FR 42482-42491 (June 30, 2016).
[114] Treas. Reg. §1.6038-4(k).
[115] 2017-7 I.R.B. 915.
[116] The Treasury Department is working to ensure that foreign jurisdictions implementing CbC reporting requirements will not require U.S. multinational groups to file a CbC report with the foreign jurisdiction if the U.S. multinational group files a CbC report with the IRS and the CbC report is exchanged with such foreign jurisdiction pursuant to a competent authority arrangement. T.D. 9773.
[117] See James J. Tobin "Country-by-Country Finals", Tax Management International Journal (September 2016). http://www.bna.com/countrybycountry-finals-n73014447266/

accounts under GAAP in the other business entity's tax jurisdiction of residence, or would be so required if equity interests in the other business entity were traded on a public securities exchange in its tax jurisdiction of residence.[118]

iii. CbC reports filed with the IRS and exchanged pursuant to a competent authority arrangement benefit from the confidentiality requirements, data safeguards, and appropriate use restrictions in the competent authority arrangement.[119]

1. If a foreign tax jurisdiction fails to meet these requirements set forth in the competent authority arrangement, the U.S. will pause exchanges of all reports with that tax jurisdiction.

2. If such tax jurisdiction has adopted CbC reporting rules that are consistent with the 2015 Final Report for Action 13, the tax jurisdiction will not be able to require any constituent entity of the U.S. multinational group in the tax jurisdiction to file a CbC report.

3. The ability of the U.S. to pause exchange creates an additional incentive for foreign tax jurisdictions to uphold the confidentiality requirements, data safeguards, and appropriate use restrictions in the competent authority arrangement.[120]

iv. However, multinationals should consider the possibility that such information would not remain confidential.

1. The EU may become a problem with respect to confidentiality. One commentator noted that an EU proposal released in April 2016 would, if approved, require public filing of the CbC information, and that information shared with many countries around the world might find its way into the public domain (despite the possibility that the U.S. would pause exchange of information with a country that fails to preserve confidentiality). Thus, multinationals should plan for the information to become public and likely misinterpreted. Thus the CbC template should be prepared (and information disclosed) with this possibility in mind.[121]

v. The CbC report is a tax return, and the information furnished to the IRS on the CbC report is return information subject to the confidentiality protections provided under Code §6103.[122]

vi. Master File/Local File.

1. This is not covered by the regulations.

2. The U.S. already has transfer pricing documentation regulations which provide the principal and background documents that must be maintained to satisfy the contemporaneous documentation requirement of the transfer pricing regulations.

---

[118] Treas. Reg. §1.6038-4(b).
[119] T.D. 9773.
[120] Id.
[121] See James J. Tobin, "Country-by-Country Finals", Tax Management International Journal (September 2016). See http://www.bna.com/countrybycountry-finals-n73014447266/
[122] T.D. 9773.

3. Currently, it isn't certain if the U.S. will require the master file and local file described under Action 13.
4. An IRS official indicated the IRS has not taken the OECDs proposal for the master and local files "off the table. "
5. During the December 1, 2015 BEPS hearings, U.S. lawmakers indicated the master file, which includes specifics regarding supply chains, service agreements and other sensitive information, and which can be directly collected by jurisdictions, has raised concern by taxpayers over confidentiality issues.

vii. Reporting of so-called "stateless income".

1. It has been noted that the OECD and IRS final CbC reporting rules define the term in a way that is counterintuitive and will require U.S. MNEs to report significant amounts of "stateless income" that in fact is subject to tax and thus not "stateless" under any reasonable definition of that term. [123]

(a) the aggregate information for all "constituent entities" are required to be reported for each jurisdiction in which an MNE operates, corresponding to purported "indicators of economic activity", which are to be reported for each tax jurisdiction in which constituent entities of an MNE group is resident. For this purpose, a business entity is treated as resident in a tax jurisdiction if, "under the laws of that tax jurisdiction, the business entity is "liable to tax" therein based on place of management, place of organization, or another similar criterion."[124]

(b) A business entity without any tax jurisdiction of residence is reported separately as a stateless entity, which is defined simply as "business entities treated as transparent for tax purposes in the jurisdiction in which organized". Thus, an entity treated as a partnership in such jurisdiction is reported as a "stateless entity" and all of its income is reported as "stateless income."[125] This produces a strange result where, e.g., the partnership's income is taxed (proportionately) in the jurisdictions where its partners are resident, and yet is reported separately in the CbC report as "stateless income". In effect, there is "double counting" of such income in the CbC data (once in the partners' tax jurisdiction(s) and second in the "stateless" category).[126]

[123] David Ernick, "Will Country-by-Country Reporting Help Identify 'Stateless Income'?", 36 Tax Mgt Weekly Rpt [BNA] 635 (05/29/2017). The author notes "Much like describing a country as a "tax haven," the term "stateless income" can be asserted any time the user of the term considers that a country imposes an insufficient level of taxation on income within its jurisdiction. Characterization of income as "stateless" is thus inextricably intertwined with arguments against tax competition."
[124] Id.
[125] Id.
[126] The author notes that such reporting is an intentional feature of CbC reporting, and not a design flaw. He notes that "[e]xamples like this raise serious questions as to whether there are any legitimate tax policy concerns for imposing CbC reporting requirements on a broad swath of the business community, along with the expensive and time-consuming compliance burden it entails." Id.

(c) Accordingly, so far no explanation has been provided as to how CbC reporting assists in assessing transfer pricing risk under the arm's-length standard.[127]

5. Developing a Multilateral Instrument to Modify Bilateral Tax Treaties (Treaty Implementation) (Action 15)

A. Issue. Issues relating to implementation by multilateral treaty, including respective views of the panel members' countries regarding the process of negotiating a multinational treaty, possible local obstacles to implementation, and disagreement over certain provisions, etc.

B. The OECD issued its Final Report, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report,[128] on Oct 5, 2015.[129]

C. Action15 - Developing a Multilateral Instrument to Modify Bilateral Tax Treaties.

1. Tax treaties are based on a set of common principles designed to eliminate double taxation that may occur in the case of cross-border trade and investments.

a. The interaction of domestic tax systems can lead to overlaps in the exercise of taxing rights that can result in double taxation. For example, if an item of income is earned in one jurisdiction (the "source jurisdiction") by a resident of another jurisdiction (the "residence jurisdiction"), both jurisdictions may tax that income under their domestic laws.

b. International treaties to address double taxation, many of which originated with principles developed by the League of Nations in the 1920s, aim to address these overlaps so as to minimize trade distortions and impediments to sustainable economic growth. There are more than 3,000 bilateral tax treaties, based on model tax conventions, including model tax conventions developed by the OECD and the UN.[130]

c. Some features of the current bilateral tax treaty system facilitate base erosion and profit shifting and need to be addressed. The sheer number of bilateral treaties makes updating the current tax treaty network highly burdensome. Consequently, governments have agreed to explore the feasibility of a multilateral instrument that would have the same effects as a simultaneous renegotiation of thousands of bilateral tax treaties.[131] Participation in the development of the multilateral instrument is voluntary and does not entail any commitments to sign such instrument once it has been finalized.[132]

D. U.S. view regarding Action 15

1. It was reported that the U.S. agreed to participate in multilateral tax treaty negotiations under BEPS Action 15 because it is the best way for the U.S. to advance its interests in mandatory binding arbitration as the optimal method for

[127] Id.
[128] Hereinafter, this is referred to as the "Action 15 Final Report".
[129] http://dx.doi.org/10.1787/9789264241688-en
[130] See Action 15 Final Report at 9 and 15.
[131] Action 15 Final Report at 9.
[132] Action 15 Final Report at 10.

resolving disputes and improving tax administration. Treasury would consult as appropriate with Congress as the process moves along.[133]

Appendix A

A brief review of current U.S. transfer pricing standards

1. In General. The purpose of the U.S. transfer pricing regime is to ensure the proper recognition of income generated by transactions between entities owned or controlled directly or indirectly by the same interests (hereinafter referred to as "controlled taxpayers") and to prevent the avoidance of taxes with respect to such transactions. Without such rules a corporation, for example, could allocate the bulk of the profits from the sale of goods in Country X to an entity formed in a tax haven jurisdiction and recognize minimal taxable profit in the U.S.

2. Thus, Internal Revenue Code (the "Code") § 482 grants the IRS broad discretion to allocate income, deductions, credits and allowances between entities engaged in controlled transactions, if the IRS determines that such steps are necessary in order to clearly reflect the allocation of income between the respective entities or to prevent the avoidance of taxes with respect to such transactions. The goal is to place controlled taxpayers on "tax parity" with uncontrolled taxpayers by determining the true taxable income of the controlled taxpayer.[134]

(a) The standard employed in determining the income of the controlled taxpayers is that of uncontrolled taxpayers dealing at arm's length with each other.[135] Therefore, transfer prices between such entities (e.g. in the case of any services or licenses of technology provided by them) must be set so that they approximate a transaction that would be entered into by similarly situated independent parties. Even if controlled taxpayers enter into a joint venture with unrelated third parties, Code § 482 might still apply, depending on factors including ownership and management.[136]

(b) The regulations set forth general principles and guidelines to be followed under section 482.[137]

---

[133] BNA International Tax Monitor, October 05, 2015

[134] Treas. Reg. § 1.482-1(a)(1).

[135] Treas. Reg. §1.482-1(b)(1).

[136] Control includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted. Treas. Reg. § 1.482-1(i)(4).

[137] Treas. Reg. § 1.482-2 provides rules for the determination of the true taxable income of controlled taxpayers in specific situations, including controlled transactions involving loans or advances or the use of tangible property. Treas. Reg. §§ 1.482-3 through 1.482-6 provide rules for the determination of the true taxable income of controlled taxpayers in cases involving the transfer of property. Temp. Treas. Reg. § 1.482-7T sets forth the cost sharing provisions applicable to taxable years beginning on or after January 5, 2009. Treas. Reg. § 1.482-8 provides examples illustrating the application of the best method rule. Finally, Treas. Reg. §1.482-9 provides rules for the determination of the true taxable income of controlled taxpayers in cases involving the performance of services.

(c) No strict priority of methods exists for determining what constitutes the arm's length result of a controlled transaction.[138] Rather, the arm's length result of a controlled transaction is determined using the method that provides the most reliable result given the specific facts of the transaction.[139] The "**best method**" is determined based on two primary factors: (i) the degree of comparability between the controlled and any uncontrolled transactions[140] and (ii) the quality of the data and assumptions used in the analysis.[141]

3. <u>Specific Situations</u>. The analysis employed for measuring the income generated in an uncontrolled transaction will vary depending upon the transaction. Thus, the Regulations provide for determining arms length prices or rates for (i) loans (Treas. Reg. § 1.482-2(a)), (ii) the rendering of services (Treas. Reg. §§ 1.482-2(b) and 1.482-9),[142] (iii) use of tangible property pursuant to a lease or other arrangement (Treas. Reg. § 1.482-2(c)) and (iv) transfers of tangible and intangible property (Treas. Reg. § 1.482-2(d)).[143] Any sale or licensing of technology between controlled taxpayers therefore would be analyzed under methods different from those applicable to a sale of supplies or equipment.

(a) <u>Services</u>. The arm's length amount charged in a controlled services transaction must be determined under one of the following methods: the services cost method, the comparable uncontrolled services price method, the gross services margin method, the cost of services plus method, the comparable profits method, the profit split method, and methods other than the foregoing ("**unspecified methods**").[144]

---

[138] The IRS released a so-called International Practice Unit ("IPU") which is intended to provide internal guidance in connection with transfer pricing audits. According to this IPU, when reviewing the transfer pricing for controlled transactions, it is important to determine how the U.S. parent selected a transfer pricing method to document that the prices charged to the CFC were arm's length. There are various pricing methods available, including the Comparable Uncontrolled Price (CUP), Resale Price Method, Cost Plus Method, Comparable Profits Method (CPM), and various Profit Split Methods. Although there is no hierarchy for these methods, the taxpayer must select the method that provides the most reliable measure of an arm's length result taking into consideration all the data available. This is known as the "best method rule." In addition, the taxpayer must be able to support the pricing method it selected. One way to determine whether the U.S. parent selected the best method is to review its Transfer Pricing Study, if the taxpayer prepared one. The Transfer Pricing Study is the documentation that a taxpayer prepares to show that its transfer pricing was conducted at arm's length.

[139] Treas. Reg. §1.482-1(c)(1) (the "**best method rule**").

[140] See Treas. Reg. § 1.482-1(d).

[141] Treas. Reg. §1.482-1(c)(2).

[142] These provisions are generally applicable for taxable years beginning after July 31, 2009, but a person may elect to apply them to any taxable year beginning after September 10, 2003 in accordance with the rules set forth in Treas. Reg. § 1.482-9(n)(2). Such election requires that all of the provisions of such sections be applied to such taxable year and all subsequent taxable years (earlier taxable years) of the taxpayer making the election. Treas. Reg. §1.482-9(n)(2)(i).

[143] See Treas. Reg. §1.482-3 for a list of methods to determine taxable income in connection with a transfer of tangible property and Treas. Reg. §1.482-4 for a list of methods to determine taxable income in connection with a transfer of intangible property.

[144] Treas. Reg. § 1.482-9(a). Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, including economically similar transactions structured as other than services transactions, and only enter into a particular transaction if none of the alternatives is preferable to it. Treas. Reg. §1.482-9(h).

(b) Property transfers. The arm's length amount charged in a controlled transfer of tangible property must be determined under one of the following methods: the comparable uncontrolled price method, the resale price method, the cost plus method, the comparable profits method (“**CPM**”), the profit split method, and unspecified methods.[145] In the case of a transfer of intangible property the arm's length amount charged must be determined under one of the following methods: the comparable uncontrolled transaction method, the CPM, the profit split method, and unspecified methods.[146]

4. Advance Pricing Agreements. The IRS has an Advance Pricing Agreement (“**APA**”) program to provide certainty to participating taxpayers in applying the best transfer pricing method (within the meaning of section 482 and related regulations) to particular subsequent transactions (“**Covered Transactions**”). The IRS developed the APA program to resolve highly factual transfer pricing issues in a principled, cooperative manner, and a taxpayer voluntarily participates in the APA program in exchange for the IRS limiting its discretion under Code § 482 to make transfer pricing adjustments.[147] The APA program is intended to supplement traditional administrative, judicial and treaty mechanisms.[148] A "bilateral" APA generally combines an agreement between a taxpayer and the IRS with an agreement between the U.S. and one or more foreign tax authorities on appropriate transfer pricing methods for such Covered Transactions.[149] Announcement 2013-17[150] notes that the most common types of related party transactions in 2012 APAs fell primarily into two categories (U.S. distributors and U.S. service providers), each of which represents approximately 30 percent of the total.[151] The 2011 APA Report also states that the CPM frequently is applied because reliable public data on comparable business activities of independent companies may be more readily available, and comparability of resources employed, functions, risks, and other relevant considerations is more likely to exist than comparability of product.[152] Announcement 2015-11[153] states that, consistent with prior years, the primary transfer pricing method used for transfers of both tangible and intangible property in APAs executed in 2014 was the Comparable Profits Method/Transactional Net Margin Method (CPM/TNMM),[154] and for services transactions, the majority of cases applied

---

[145] Treas. Reg. § 1.482-3(a).

[146] Treas. Reg. § 1.482-4(a).

[147] *See Eaton Corp. v. Commissioner*, 140 T.C. No. 18 (2013).

[148] *See Eaton Corp., supra*. Although an APA reflects an agreement between a taxpayer and the IRS regarding appropriate transfer pricing methods for Covered Transactions, the Tax Court has held that APAs are not enforceable contracts, and cancellation by the IRS is reviewable only under an abuse of discretion standard, which bears a high burden of proof by the taxpayer. *Id*.

[149] With such “bilateral” APAs, the taxpayer ordinarily is assured that the income associated with the Covered Transactions will not be subject to double taxation by the combination of the United States and the foreign jurisdictions. Announcement 2012-13, 2012-16 I.R.B. 805 (Report Concerning Advance Pricing Agreements for 2011 (“**2011 APA Report**”)).

[150] 2013-16 I.R.B. 911("**2012 APA Report**").

[151] 2012 APA Report at 9-10. No other single type of entity represents even ten percent of the total. Consistent with this result, more than 40 percent of the transactions covered in APAs executed in 2012 involved transfers of tangible goods, and close to 40 percent involved the provision of services. Most of the rest of the transactions involved the use of intangible property. *Id*. Similarly, the 2011 APA Report notes that the most common types of related party transactions in 2011 APAs involved U.S. distributors, manufacturers and service providers. 2011 APA Report, Table 18.

[152] 2011 APA Report at 26.

[153] 2015-15 IRB 883, 2015 USTR ¶86,183 ("**2015 APA Report**"). As in prior years, more than half of the APAs executed in 2014 involved transactions between non-U.S. parents and U.S. subsidiaries.

[154] 2015 APA Report at 9.

the CPM/TNMM or the services cost method.[155] Announcement 2017-3[156] updated such statistics for 2016. The IRS completed 86 APAs in 2016, of which 21 were unilateral, while 65 were bilateral, requiring approval from both the IRS and a foreign tax authority. The form of Model APA Agreement is set forth in the 2015 APA Report.[157]

5. <u>Ancillary effects of transfer pricing rules on Foreign Tax Credits</u>. Although transactions between a foreign branch or disregarded entity and its U.S. parent corporation (or an intermediate CFC) do not give rise to offsetting amounts of income or expense for U.S. tax purposes (because they are not separate entities for U.S. tax purposes, and such transactions are in effect disregarded), U.S. transfer pricing principles nevertheless could apply in determining whether non-arm's length transfer prices result in noncompulsory payments of foreign tax, to the extent foreign tax law includes similar arm's length principles.[158] Taxpayers must establish to the satisfaction of the IRS that they have properly minimized their creditable foreign tax liability by exhausting all effective and practical remedies (including resort to competent authority proceedings where available) to reduce, over time, their liability for foreign tax.[159]

---

[155] 2015 APA Report at 11. The services cost method evaluates the amount charged for certain services with reference to the total services costs.
[156] 2017-15 IRB 1077, 2017 USTR ¶86,162 ("**2016 APA Report**").
[157] 2016 APA Report, Appendix 1.
[158] Here, the issue is that through the use of a non-arm's length transfer price the U.S. taxpayer operating through a foreign branch, or disregarded entity, may report too much income to the foreign country, resulting in an overpayment of foreign income tax. Similarly, a CFC in one country that operates through a branch or disregarded entity in a foreign third country may report too much income and overpay its foreign taxes in either its home country or the third country. Under the noncompulsory payment rule of Treas. Reg. § 1.901-2(e)(5) a foreign tax is not considered "paid" for purposes of Code § 901 to the extent that the amount paid exceeds the amount of liability for tax under foreign law.
[159] See CCA 201349015 (12/6/2013).