Arm's Length Standard
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OECD releases new edition of transfer pricing guidelines

The Organization for Economic Cooperation and Development (OECD) on 10 July released the 2017 edition of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. The transfer pricing guidelines

provide guidance on the application of the arm's length principle and serve as a framework for the consideration of all transfer prices between associated enterprises.
URL: http://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm

The last edition of the transfer pricing guidelines was released in 2010. The guidelines were amended in 2016 to reflect updates stemming from the 2015 base erosion and profit shifting (BEPS) project.

The 2017 transfer pricing guidelines incorporate the BEPS framework and include the following:

- Substantial revisions introduced in the BEPS final reports on Actions 8-10, *Aligning Transfer Pricing Outcomes with Value Creation*, and Action 13, *Transfer Pricing Documentation and Country-by-Country Reporting*. These amendments revise guidance in Chapters I, II, V, VI, VII, VIII, and IX of the transfer pricing guidelines.
- Revised guidance on safe harbors in Chapter IV.
- Revised recommendation of the OECD Council on the Determination of Transfer Pricing between Associated Enterprises, which reflects the relevance to tackle BEPS, and invites non-OECD members to adhere to the recommendation.
- Consistency changes throughout the transfer pricing guidelines.

Some of the BEPS work streams have not been finalized in the 2017 transfer pricing guidelines, including the guidance on hard-to-value-intangibles and the attribution of profits to a permanent establishment.

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IRS's determination to cancel Eaton's APAs was abuse of discretion

The US Tax Court on July 26 held, in *Eaton Corp. v. Commissioner*,[1] that the determination by the Internal Revenue Service to cancel Eaton Corporation's and its US subsidiaries' (Eaton) advance pricing agreements (APAs) was an abuse of discretion. The Tax Court also held that Eaton did not transfer intangibles subject to Internal Revenue Code section 367(d) and that Eaton's bonus payments to Tractech Holdings, Inc. executives represented employee compensation and were deductible under section 162(a).

Background

Eaton and the IRS entered into two unilateral APAs: APA1, which covered Eaton's tax years 2001 through 2005, pursuant to Rev. Proc. 96-53[2] and APA2, which covered Eaton's tax years 2006 through 2010, pursuant to Rev. Proc. 2004-40.[3]

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[1] T.C. Memo. 2017-147, T.C., No. 5576-12, 7/26/17.
[2] Rev. Proc. 96-53, 1996-2 C.B. 375.
[3] Rev. Proc. 2004-40, 2004-2, C.B. 50.

During the tax years at issue, Eaton licensed intangible property to its Caribbean subsidiaries operating in Puerto Rico and the Dominican Republic (referred to in the opinion as the “Island plants”) to manufacture breaker products,[4] which were then sold to Eaton’s US assembly plants, and Eaton’s US distribution department. Eaton’s US plants manufactured a number of the component parts used by the Island plants to assemble the finished breaker products, which as noted below, was not a covered transaction for APA1 or APA2.

APA1 covered three intercompany transactions: the sale of breaker products from the Island plants to Eaton, Eaton’s license of intangible property to the Island plants, which the Island plants used to manufacture the breaker products, and the Island plants’ cost sharing payments to Eaton. APA2 covered only the sale of breaker products from the Island plants to Eaton.

In early 2010, Eaton discovered that it had made a number of errors in its computations of the transfer pricing method (TPM) pursuant to APA1 and APA2,[5] and advised the IRS of such errors. Eaton subsequently corrected these errors, and filed amended APA annual reports[6] and amended Federal income tax returns.

In 2011, the IRS cancelled APA1, effective January 1, 2005, and APA2, effective January 1, 2006, and advised Eaton in a cancellation letter that “these cancellations are based on numerous grounds, including the failure of a critical assumption, misrepresentation, mistake as to a material fact, failure to state a material fact, failure to file a timely annual report, or lack of good faith compliance with the terms and conditions of the APA.”

The IRS subsequently proposed transfer pricing adjustments under IRC section 482 for Eaton’s tax years 2005 and 2006, based on a different TPM than had been agreed upon in the APAs. As an alternative position, the IRS determined that Eaton transferred intangible property under IRC section 367(d) for Eaton’s tax year 2006. In addition, the IRS determined that Eaton was not entitled to a deduction under IRC section 162(a) in respect of certain bonus payments paid to Tractech executives in exchange for their release of claims related to any stock options, after Eaton entered into a stock purchase agreement to acquire Tractech. The IRS maintained that such payments should have been capitalized under IRC section 263.

The IRS issued Eaton a deficiency notice for approximately $127 million in taxes and penalties, arising from an income reallocation of approximately $369 million.

Scope and standard of review

The Tax Court previously held in *Eaton Corp. & Subs. V. Commissioner*, 140 T.C. 410, 417 (2013), that the standard of review is whether it was an abuse of discretion for the IRS to cancel Eaton’s APAs. The IRS must show that it abided by the self-imposed limitations set forth in Rev. Proc. 96-53 for APA1 and Rev. Proc. 2004-40 for APA2, and Eaton must show that the IRS’s canceling the APAs was arbitrary, capricious, or without sound basis in fact.

Rev. Proc. 96-53 provides that an APA can be cancelled if the IRS determines there was a misrepresentation, mistake as to a material fact, failure to state a material fact, or lack of good-faith compliance with the terms and conditions of the APA (but not fraud, malfeasance, or disregard) in connection with the request for the APA, or in any subsequent submissions (including the annual report).[7] Material facts are facts that, if known by the IRS, would have resulted in a significantly different APA or no APA at all.[8] Rev. Proc. 2004-40 provides that an APA can be cancelled due to the failure of a critical assumption or due to the taxpayer’s misrepresentation, mistake as to a material fact, failure to state a material fact, failure to file a timely annual report, or lack of good faith compliance with the terms and conditions of the APA.[9] Material facts include facts that, if known by the IRS, could have reasonably resulted in an APA with significantly different terms and conditions. In regards to annual reports, the IRS will consider facts as material if,

[4] Being, circuit breaker and electrical control products.
[5] A number of the errors made by Eaton related to computational errors in determining the appropriate revenues and expenses attributable to the APA Covered Transactions; allocating revenue and expenses between covered and non-covered transactions.
[6] APA1 and APA2 required that Eaton file an annual report for each APA year, which demonstrated compliance with the APA’s terms and conditions.
[7] Rev. Proc. 96-53, sec. 11.06(1).
[8] *Id.*
[9] Rev. Proc. 2004-40, sec. 10.06(1).

for example, knowledge of the facts would have resulted in a materially different allocation of income, deductions, or credits than reported in the annual report or the failure to meet a critical assumption.[10]

Tax Court's decision: APAs

The Tax Court's opinion noted that the IRS's arguments in support of the cancellation of the APAs fell into two categories: (1) misrepresentations, mistakes as to a material fact, and failures to state a material fact during the APA negotiations, and (2) implementation and compliance with the APAs.

APA negotiations: The Tax Court reviewed nine areas of the APA negotiations in terms of misrepresentations, mistakes as to a material fact, or failures to state a material fact to determine if it was an abuse of discretion for the IRS to cancel the APAs. The Tax Court concluded that none of the nine areas addressed during the APA negotiations was a ground for cancellation, and that canceling the APAs on grounds related to the APA negotiations was arbitrary. The Tax Court found that it did not see any additional material facts, mistakes of material facts, or misrepresentations that would have resulted in a significantly different APA or no APA at all. In reaching this conclusion, the Tax Court made a number of findings in its opinion, including:

- For any fact to be material, it needs to result in a significantly different APA or no APA at all. Because the TPM is the essential part of the APA, for a fact to be material, it should have an impact on the TPM.
- Either a mistake as to a material fact or a failure to state a material fact is a ground for cancellation.
- While the revenue procedures do not explain what constitutes a misrepresentation, the court looked to the Merriam-Webster's Collegiate Dictionary, which defines "misrepresent" as "to give false or misleading representation of usually with an intent to deceive or be unfair." The court noted that throughout the APA negotiations, Eaton had one position regarding the TPMs of the covered transactions, and it provided information to support this position. The IRS had ample opportunity to raise additional questions, question Eaton's position, come up with its own position, or not agree to the APAs, which it did not do, and the court concluded that a different viewpoint is not the same as a misrepresentation, which needed to be false or misleading, usually with the intent to deceive, and relate to the terms of the APA.
- The cancellation of an APA is a rare occurrence and should be done only when there are valid reasons that are consistent with the revenue procedures.
- A taxpayer should not be expected to provide information that is not requested and that the taxpayer reasonably believes is unnecessary. The IRS contended that it was not aware that Eaton's US assembly business earned low operating profits or incurred losses, and that it needed additional information pertaining to certain transactions, which were not covered transactions in APA1 or APA2. Eaton contended that whether the businesses outside the scope of the APA performed well or poorly had no bearing on the arm's length price for the breaker products, that the APA TPM applied only to the distribution functions, and that the entire business was not part of the covered transaction. The Tax Court found that the IRS had information regarding Eaton's other businesses and could have inquired about how the other businesses affected the proposed TPMs before agreeing to the APAs.

Implementation and compliance with the terms of the APAs: Rev. Proc. 96-53 and Rev. Proc. 2004-40 require that a taxpayer file an annual report for each taxable year covered by the APA, describing the taxpayer's actual operations for the year and demonstrating compliance with the terms and conditions of the APA. An APA may be canceled for lack of good faith compliance with the terms and conditions of the APA.[11]

The IRS contended that Eaton did not comply in good faith with the terms and conditions of the APAs and failed to satisfy the annual report requirements. Eaton argued that it did not fail to comply with the terms and conditions of the APA and that its implementation errors were all computational errors that did not warrant cancellation and instead it should have been allowed to correct them.

The Tax Court rejected the IRS's arguments and concluded that Eaton made good-faith efforts to comply with the terms of the APAs.

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[10] *Id.*
[11] See Rev. Proc. 96-53, section 11.06(1) and Rev. Proc. 2004-40, section 10.06(1).

In reaching this conclusion, the Tax Court looked at each of the seven errors made by Eaton individually, and in the aggregate. Eaton argued that an error is not material if the impact had a 5 percent or less impact, which the IRS disagreed with, noting that Eaton relied on an accounting rule, and that safe harbors for accounting purposes do not create safe harbors for tax purposes. The Tax Court noted that the revenue procedures do not contain a bright-line test on whether an error is material on the basis of its size and that a 5 percent test should not be used to determine if Eaton's error warranted cancellation of the APAs; however, the size of the error may be considered, and how the error occurred should also be reviewed. The Tax Court also considered whether the impact of the errors resulted in a tax advantage to Eaton, noting that not all of the errors were in Eaton's favor.

The Tax Court concluded that Eaton's errors were computational or related to inadvertence, that they were not material, that they would not have resulted in a significantly or materially different APA, that they did not constitute a material change in the facts on which the decision to enter into the APA was made by the IRS or change the TPM or the factors that were considered during the APA process, and that they should have been addressed through appropriate adjustments, which Eaton did through the filing of the amended APA annual reports.

The Tax Court also reviewed Eaton's specific compliance with the terms of the APAs, as the IRS contended that there was a lack of compliance in the following areas: (1) book-tax differences, (2) Forms 1120 and compliance with the APAs, (3) Canadian adjustments, and (4) VISTA data. Eaton argued that it was in compliance with the terms of the APAs in these areas, and the Tax Court agreed, concluding that these four areas were not grounds for cancellation.

The Tax Court further reviewed whether there was a failure of a critical assumption, as raised by the IRS in its cancellation letter to Eaton. The cancellation letter did not specify which critical assumption had been breached, and the Tax Court found that it did not believe a critical assumption had been violated.

The final statements contained in the opinion note that the IRS had ample opportunity to walk away from the APA negotiations for both APA1 and APA2, and that while Eaton made numerous mistakes, these were inadvertent, and the IRS should not be able to use these errors as grounds for switching to a different TPM that was contemplated during the APA1 and APA2 negotiations. The Tax Court held that the cancellation of the APAs by the IRS was arbitrary and unreasonable, and did not sustain the IRS's determination to cancel the APAs.

Tax Court's decision: Other matters

The Tax Court also reviewed the IRS's alternative position and held that Eaton did not transfer intangibles subject to IRC section 367(d), stating that the IRS "did not specifically identify any intangible or explain the exact value of any intangibles that should be covered by section 367(d)."
Finally, the court held that Eaton's bonus payments to Tractech executives represented employee compensation and were deductible pursuant to section 162(a).

Observations

Updated guidance on APAs issued by the IRS in 2015 may address a number of concerns raised by the IRS throughout this case, which is also consistent with recent developments at the OECD level.[12] Unlike the prior APA procedure, Rev. Proc. 2015-41 places a strong emphasis on presenting the entire value chain in relation to the covered transactions.[13] Accordingly, a complete APA request now must include "covered issue diagrams," which are relevant tax, legal, and management structures and the value chain relating to the covered issues. In addition, Rev. Proc. 2015-41 notes that the IRS may require, as a condition of continuing with the APA process, that the taxpayer expand the proposed scope of its APA to cover what the revenue procedure refers to "interrelated matters" to reach a resolution that is in the interest of principled, effective, and efficient tax administration.

It is anticipated that the IRS Advance Pricing and Mutual Agreement (APMA) Program will continue to focus on reviewing and understanding the entire value chain in relation to proposed covered transactions in APAs and reviewing

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[12] On August 12, 2015, the IRS released Rev. Proc. 2015-41, which provides updated procedures governing APAs, and is effective for all APAs filed on or after December 30, 2015. Rev. Proc. 2015-41 updates and supersedes Rev. Proc. 2006-9, which updated and superseded Rev. Proc. 2004-40.
[13] Proposed covered transactions are referred to as proposed covered issues in Rev. Proc. 2015-41.

interrelated matters to determine the potential impact on APAs. In addition, the IRS APMA Program may increase its review of taxpayers' APA annual reports for compliance with the APA.

Overall, the Tax Court's decision should help alleviate companies' potential concerns after the cancellation of Eaton's APAs, and may shed some light on standards to apply in the future.

The IRS has 90 days from the date the Tax Court formally enters its decision to appeal the decision.

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UK country-by-country reporting notification deadline approaches

The first country-by-country (CbC) reporting notifications required to be made to the UK tax authorities are due by 1 September 2017.

This deadline applies to all reporting periods that end on or before 1 September 2017. After 1 September 2017, the standard UK notification date is the end of the CbC reporting period.

A few examples regarding the application of these rules follow.

- **Example 1:** A group with a 31 December year end must notify by 1 September 2017 in respect of the year to 31 December 2016 (and by 31 December 2017 in respect of the year to 31 December 2017).
- **Example 2:** A group with a 31 March year end must notify by 1 September 2017 in respect of the year to 31 March 2017 (and by 31 March 2018 in respect of the year to 31 March 2018).
- **Example 3:** A group with a 30 June year end must notify by 1 September 2017 in respect of the year to 30 June 2017 (and by 30 June 2018 in respect of the year to 30 June 2018).
- **Example 4:** A group with a 30 September year end must notify by 30 September 2017 in respect of the year to 30 September 2017 (and by 30 September 2018 in respect of the year to 30 September 2018).

All multinational groups that meet the threshold for CbC reporting that have a UK resident constituent entity or a UK permanent establishment will need to provide at least one notification. There is optional administrative simplification in cases when multiple notifications are due.

UK notification obligations vary depending on the location of the ultimate parent entity. For UK-parented groups, the responsibility lies with the UK ultimate parent entity. For non-UK-parented groups with a UK presence, the notification obligations fall on the top UK entities (or top entities with UK permanent establishments).

In accordance with UK regulations, the notification for each period must include:

- The identification of the group entity (including the unique taxpayer reference or equivalent) that will file the country-by-country report and where it will file it; and
- Names and unique taxpayer references of all of the group's entities that are resident in the UK, are UK permanent establishments, or are UK partnerships.

There is no specific form for notifications, but the UK tax authorities have stated a preference for the notification to be on a spreadsheet. Notifications should be sent to a dedicated mailbox: notification.cbcrfiling@hmrc.gsi.gov.uk.
URL: mailto:notification.cbcrfiling@hmrc.gsi.gov.uk

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Singapore proposes mandatory transfer pricing documentation requirement and penalties

Singapore's Ministry of Finance (MoF) recently conducted a public consultation on the draft Income Tax (Amendment) Bill 2017, which includes major legislative changes to introduce a mandatory transfer pricing documentation requirement as well as penalties for noncompliance.

The key proposed legislative changes concerning transfer pricing are summarized as follows.

Introduction of mandatory transfer pricing documentation requirement and penalties for noncompliance

The existing Singapore transfer pricing guidelines require taxpayers to "prepare and keep contemporaneous records" as "part of the record-keeping requirement for tax," which is generally taken to refer to Sections 65, 65A, and 65B of the Singapore Income Tax Act (SITA).

Currently, all taxpayers must prepare transfer pricing documentation unless they meet certain safe harbor thresholds for exemption from preparing documentation. Generally, under these safe harbor thresholds, documentation is not required when the value of the transaction does not exceed SGD 15 million for intercompany sales/purchases of goods/loans; and SGD 1 million for all other categories of related-party transactions, such as service income/expense.

There is currently no specific penalty for failure to prepare transfer pricing documentation. If a taxpayer fails to submit adequate documentation on time upon request by the Inland Revenue Authority of Singapore (IRAS), it may be subject to a general offense penalty under Section 94(2) of the SITA, which may involve a fine not exceeding SGD 1,000 or a jail term not exceeding six months in default of such payment.

The bill proposes the introduction of a new Section 34F in the SITA to legislate specifically the requirement to maintain contemporaneous and adequate transfer pricing documentation. The requirement to prepare the documentation no later than the filing deadline of the tax return and the submission of the documentation to the IRAS within 30 days of a request by IRAS are also affirmed and codified in the new legislation. The proposed legislation also specifically requires taxpayers to retain the documentation for five years.

To reduce the compliance burden on smaller businesses, the requirement to prepare transfer pricing documentation would apply only to businesses with turnover exceeding SGD 10 million. This SGD 10 million turnover serves as an additional safe harbor to the existing thresholds. To illustrate, assume a company has only one related-party transaction (service income from a related party). The determination of documentation requirements would be as follows:

	Service Income From Related Party	Gross Revenue	TP Documentation Required?
Currently	More than SGD 1 million	Less than SGD 10 million	Yes, because the current TPD exemption safe harbor threshold is exceeded
Proposed	More than SGD 1 million	Less than SGD 10 million	No

In addition, the following would be deemed offenses, and a specific fine of up to SGD 10,000 may be imposed for each offense:

- Failure to prepare contemporaneous and adequate transfer pricing documentation;
- Failure to submit transfer pricing documentation within 30 days of request;
- Failure to retain transfer pricing documentation for five years; and
- Submission of false or misleading transfer pricing documentation.

The above amendments would take effect from year of assessment (YA) 2019.

Clarification of existing powers to enforce the arm's length principle

The existing Section 34D of the SITA currently empowers the IRAS to make a tax adjustment if the taxpayer's taxable profit is understated due to non-arm's-length related-party transactions.

Section 34D will be significantly expanded to clarify that the determination of the arm's length principle would also consider arm's length "circumstances," that is, whether third parties would reasonably enter into similar transactions/arrangements. The proposed legislation would allow the IRAS to disregard the form of actual commercial or financial relations between related parties when the substance of the transaction is inconsistent with the form of the transaction, and for the IRAS to make necessary adjustments.

Interestingly, a specific provision is proposed to treat any income adjustment to be "accruing in or derived from Singapore or received in Singapore from outside Singapore," effectively deeming that the income adjustment would be considered Singapore-source, or foreign-source but received in Singapore.

This provision is likely to impact cross-border loans, in the event the Singapore lender does not charge any interest or charges interest at a below-arm's-length rate. Currently, adjustments made on such loans may not result in actual increase in Singapore tax, as the imputed interest is likely to be treated as foreign-source income that is not remitted into Singapore (and therefore, is not subject to tax in Singapore until it is remitted into Singapore). With the change, any such adjustment will be taxable in Singapore.

Introduction of surcharge on transfer pricing adjustments

A new Section 34E will be inserted to introduce a surcharge on any transfer pricing adjustment made.

When the IRAS has made a transfer pricing adjustment under Section 34D to increase the amount of income/reduce the amount of deduction or allowance/reduce the amount of loss, a surcharge equal to 5 percent of the amount of increase in income or reduction in deduction, allowance, or losses will be imposed.

The legislation provides discretion for the IRAS to not impose the surcharge "for any good cause." No details have been provided on the circumstances that would merit such exception, but we believe the discretion is likely to be exercised based on whether contemporaneous transfer pricing documentation has been prepared, and the taxpayer's demonstration of its overall compliance with the various requirements discussed above.

The surcharge will apply from YA 2019.

Lifting of time bar for MAP cases

Section 74 will be amended to lift the statutory time limit of four years for the IRAS to raise additional assessments for cases under the mutual agreement procedure (MAP) process to provide taxpayers with certainty that the outcome of the MAP agreed with the relevant foreign competent authority can be given full effect by the IRAS.

Transfer pricing documentation required to support claim of error or mistake

Section 93A will be amended to clarify that any claim of transfer pricing error or mistake made in the tax return by the taxpayer must be supported by contemporaneous and adequate transfer pricing documentation.

Observations

The MoF states that the above proposed amendments seek to “strengthen the TP regime” of Singapore.

Together with the numerous changes made by the IRAS in recent years to enhance the Singapore transfer pricing guidelines, the proposed changes are in line and part of the IRAS’ overall and continuing effort and focus on transfer pricing compliance in Singapore, and to achieve greater alignment with the transfer pricing action items under the OECD’s base erosion and profit shifting (BEPS) initiative.

With mandatory transfer pricing documentation requirement now legislated, and the introduction of significant penalties (fines and surcharges), the IRAS is sending a clear signal that it is moving from a guidance-based approach to a formal transfer pricing regime whereby it will seek to enforce compliance, including through the imposition of penalties.

Therefore, companies should ensure that they have proper and contemporaneous transfer pricing documentation. More importantly, with the stakes for noncompliance raised considerably under these proposed changes, companies should ensure that they devote appropriate attention and processes to address related-party transactions and compliance with the new requirements.

Companies with loans to overseas parties should reevaluate these transactions and prepare the necessary documentation to avoid potential adjustments made by the IRAS, which would likely lead to double taxation on a group basis.

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Greece implements country-by-country reporting requirement

The Greek Parliament on 28 July voted to approve the adoption of EU Directive 2016/881 regarding the mandatory automatic exchange of tax-related information into Greek legislation. This directive amends the previous Directive 2011/16, which had been incorporated into Greek law by L.4170/2013.

The new law adds Article 9AA to L.4170/2013, which provides the scope and requirements for the compilation and filing of the country-by-country (CbC) report in Greece by multinational enterprises.

The most significant provisions of the new law are outlined below.

The obligation for annual filing of the CbC report arises for multinational enterprise (MNE) groups for fiscal years beginning from 1 January 2016 onwards, provided the group’s total consolidated revenues exceeded EUR 750 million in the fiscal year preceding the reporting fiscal year.

The CbC report must be submitted within 12 months from the last day of the reporting fiscal year. The entity required to file the CbC report is the ultimate parent entity of an MNE group that has tax residence in Greece (or any other surrogate entity in Greece).

Greece, as a competent authority receiving CbC reports, undertakes the obligation to share those reports via the mechanism of automatic exchange of information within 15 months from the last day of the reporting fiscal year, with any jurisdiction in which one or more constituent entities of each group are incorporated (according to the information provided in the CbC report). Especially for the first year of application – the fiscal year beginning from 1 January 2016 – the exchange of information will be completed within 18 months from the last day of the reporting year.

The CbC report must include the following information, which will be provided and exchanged using standard tables:

1. Aggregated data relating to revenue, profit (loss) before income tax, income tax paid, income tax due, share capital, accumulated profits, number of employees, and tangible assets other than cash or cash equivalents for each jurisdiction the group operates in.
2. Identification documents for the jurisdiction where each constituent entity has its tax residence, and in case the latter differs from the jurisdiction of tax residence, the jurisdiction under which this constituent entity is organized and the nature of its primary business or businesses.

The source of information for the CbC report – which may be financial statements, statutory financial statements, and internal management accounts – should be used in a consistent way, the same data sources year on year. There is no requirement that differences in accounting standards from jurisdiction to jurisdiction must be adjusted. It is also not necessary to reconcile differences in revenue, profits, and taxes between the CbC report and the consolidated financial statements.

The penalty for failure to submit the CbC report is EUR 20,000, while in cases of late submission or inaccurate disclosure the penalty is EUR 10,000.

Any constituent entity that is a tax resident of Greece and does not submit the CbC report is obligated to notify the Greek tax authorities of the identity and tax residence of the reporting entity no later than the last day of the reporting fiscal year. For the first year of application, the deadline is extended to the last day of submission of the CbC report.

The information contained in the CbC report will be shared between jurisdictions through the mechanism of automatic exchange of information, and it will be used by the authorities to evaluate possible areas of concern in relation to the pricing of intragroup transactions and other risks associated with erosion of the tax base and profit shifting. The law explicitly provides that price adjustments of intragroup transactions will not be based on information provided by the CbC report.

However, the Greek law states that the information in the CbC report may be used as the basis for further scrutiny regarding the group's pricing arrangements or other tax issues in the context of a tax audit; hence, appropriate adjustments of a constituent entity's taxable income may occur. This statement is not included in BEPS Action 13 or in the OECD transfer pricing guidelines,

Practical issues

To summarize the deadlines that must be taken into account for the first year of application of the CbC reporting requirement, a relevant example is presented below.

An MNE group with a parent entity in Greece and two subsidiaries, one of which is a Greek tax resident, has a fiscal year starting on 1 January 2016 and ending on 31 December 2016. The Greek parent entity must submit the CbC report for the year 2016 by 31 December 2017 with information on the group's income, tax, and business activities per jurisdiction. The same deadline applies for the notification that the Greek subsidiary must make to the Greek tax authorities regarding the reporting entity of the CbC report for fiscal year 2016 and for fiscal year 2017.

The information included in the aforementioned CbC report must be communicated by the Greek tax authorities to the EU member states by 31 August 2018.

The Independent Authority of Public Revenues is expected to provide details regarding the submission process soon.

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OECD releases third discussion draft on transactional profit splits

The Organisation for Economic Co-operation and Development (OECD) on June 22 released two non-consensus discussion draft documents concerning the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (TPG).[14] These documents are part of the base erosion and profit shifting (BEPS) project, which began in 2013.

The first discussion draft, which deals with work in relation to BEPS Action 7, contains additional guidance on the attribution of profits to permanent establishments (PEs). The second discussion draft, which deals with BEPS Actions 8 through 10, provides proposed revised guidance on the application of the transactional profit split method.

Actions 8 through 10 of the BEPS Action Plan focus on ensuring that transfer pricing outcomes are in line with value creation. In particular, Actions 8-10 invited clarification of the application of the transactional profit split method in the context of global value chains. The June 22 discussion draft is the third round of non-consensus discussion drafts relating to profit splits issued by the OECD – two earlier drafts were released on December 16, 2014, and July 4, 2016. Comments were submitted by stakeholders on each of the prior discussion drafts, and those comments were published on February 10, 2015, and September 8, 2016, respectively. This revised document replaces the discussion draft released in July of 2016. Interested parties are invited to send comments on this discussion draft by September 15, 2017.

The more significant unresolved issues from the July 4, 2016, guidance that came out of the public consultations held at the OECD are as follows:

- **Value chain analysis:** Whether to keep the guidance concerning a value chain analysis; and, if so, whether to include such guidance in Chapter II of the TPG, which discusses the selection of the most appropriate transfer pricing method, or whether to include it in Chapter I of the TPG, which discusses the concept of the "accurate delineation of the actual transaction" within a multinational enterprise (MNE);
- **Parallel and sequential integration:** Whether to keep the distinction between parallel and sequential integration of an MNE as a useful tool for tax administrations and taxpayers to inform the selection of the profit split as the most appropriate method;
- **Split of actual *versus* anticipated profits:** Whether the guidance on when the split of actual profits would be the most appropriate method in comparison with those circumstances in which the split of anticipated profits would be the most appropriate method could be further clarified and simplified;
- **Unique and valuable contributions:** Whether a profit split requires that both participants make unique and valuable contributions to the transaction; and
- **Acceptable profit split keys and application:** Whether to clarify or simplify the guidance on which profits to split (*e.g.*, contribution margin, gross margin, or operating margin) and which keys to apply on such profits.

The profit split discussion draft begins to address these unresolved issues, and generally results in simplified guidance compared to the July 4, 2016, non-consensus draft.

[14] All references herein to the OECD TPG are references to the 2010 version of the TPG, as modified by the BEPS final reports on Actions 8-10 and Action 15, published October 5, 2015, and adopted into the TPG in May 2016.

The profit split discussion draft does not mention the concept of "value chain analysis." Likewise, the importance of the notion of sequential versus parallel integration as a useful tool to evaluate the appropriateness of a transactional profit split receives little to no attention. Instead, the profit split discussion draft focuses squarely on the question of how the "risk control" framework of the revised Chapter I of the TPG might apply in the context of (i) the selection of the transactional profit split as the most appropriate transfer pricing method, and (ii) the application of a profit split key that may reasonably result in an arm's length outcome.

Some of the other important guidance in the July 4, 2016, non-consensus draft remains in the June 22 discussion draft. This includes the requirement that profit split keys be verifiable and based on internal accounting data or on measurable market data. According to the profit split discussion draft, management representations of where value is created in the MNE generally will not meet this requirement because such representations typically are difficult for a tax administration to verify (i.e., audit) because of their intrinsically subjective nature.

Written comments regarding the profit split discussion draft are due September 15, 2017, and a public consultation will be held at the OECD in November 2017.

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OECD releases new discussion draft on attribution of profits to PEs

The Organisation for Economic Co-operation and Development (OECD) on June 22 released two non-consensus discussion draft documents concerning the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (TPG). These documents are part of the base erosion and profit shifting (BEPS) project, which began in 2013.

The first discussion draft, which deals with work in relation to BEPS Action 7, contains additional guidance on the attribution of profits to permanent establishments (PEs). The second discussion draft, which deals with BEPS Actions 8-10, provides proposed revised guidance on the application of the transactional profit split method.

Action 7 of the BEPS Action Plan (Preventing the Artificial Avoidance of Permanent Establishment Status) mandated the development of additional guidance on the issue of attribution of profits to PEs, in particular for PEs outside the financial sector. Under this mandate, the OECD released in July 2016 a discussion draft for public comment and held a hearing in October 2016. After considering the comments received and the positions of countries, the OECD released this new discussion draft, which replaces the discussion draft issued in 2016.

The new discussion draft sets out high-level general principles for the attribution of profits to PEs in the circumstances addressed by Action 7 of the BEPS Action Plan. According to the OECD, countries agree that these principles are relevant and applicable in attributing profits to PEs.

In particular, the new discussion draft provides guidance with respect to the following:

- PEs arising from article 5, paragraph 5 of the OECD model treaty, including examples of a *commissionnaire* structure for the sale of goods, an online advertising sales structure, and a procurement structure.
- PEs created as a result of the changes to article 5, paragraph 4, including an example on the attribution of profits to PEs arising from the anti-fragmentation rule included in new paragraph 4.1 of article 5.

It is noteworthy that, unlike the discussion draft issued in 2016, this discussion draft does not contain numerical examples. The OECD indicated that this is to avoid drawing conclusions from this guidance on the level of profitability of the intermediary or the PE. The profits of the intermediary and the PEs should be determined under the relevant articles in the applicable tax treaty (*i.e.* Article 7 and, when applicable, Article 9) based on the specific facts and circumstances of the case.

The new discussion draft encourages administrative simplification for taxing profits of a dependent agent PE (DAPE) through combined allocation to the dependent agent enterprise that creates the DAPE. This encouragement does not repeal the OECD's original analysis of the "single taxpayer approach" in the 2008/2010 Authorized OECD Approach (AOA) Report or alter its conclusions that such approach is fundamentally incorrect under the OECD treaty. It also does not require host-PE countries to ignore their taxing rights over two separate enterprises, nor does it change the taxing rights of the home country where the host-PE country provides administrative accommodation permitting allocation solely to a dependent agency enterprise. However, the nod provided to administrative convenience is intended to address practical application of a host-PE country's tax base and encourage mutual accommodation when segregating ownership and service-based profits makes little economic difference.

The attribution of profits illustrations in the discussion draft address more common conditions of non-financial enterprises where a residual reward to capital risk may more often be substantially reduced in relation to the service-based profit remuneration owed to the dependent agent. However, the discussion draft does not amend or provide any additional guidance for the "role of capital" in the context of residual rewards to a financial enterprise's capital at risk over that already provided in the 2008/2010 AOA Report in Part III, Section C-2(iv). Accordingly, at this time, there may remain a divergence between the quantum of profits that should be expected to be available for attribution to a DAPE in non-financial enterprise fact patterns compared to financial enterprise cases where rewards to capital may commonly be materially higher. The OECD announced at their annual Washington, D.C. conference on June 6, 2017 that additional guidance on the transfer pricing treatment of financial transactions is planned for release later this summer.

Interested parties are invited to send comments solely on the proposed guidance in this discussion draft on the attribution of profits to PEs by September 15, 2017. Comments are expressly not invited on the 2016 discussion draft and on the PE definitions agreed in Action 7 that were published in the 2015 Final Report, "Preventing the Artificial Avoidance of Permanent Establishment Status."

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Kazakhstan releases draft legislation on country-by-country reporting requirements

Kazakhstan's State Revenue Committee has released draft amendments to the local transfer pricing law governing country-by-country reporting (CbCR) requirements for multinational enterprises (MNEs) operating in Kazakhstan.

Core changes

The amendments in question establish a three-tiered documentation requirement (CbCR, master file, and local file) as per OECD Action 13, which addresses base erosion and profit shifting; establish base requirements for the submission of three-tiered documentation; and specify the parties responsible for fulfilling these requirements.

Who is affected?

The amendments will affect the following MNE group entities ("constituent entities"), included in MNE group consolidated financial statements, or would be if equity interests in that MNE group business unit were traded on a public securities exchange:

- The MNE's ultimate parent company, which is a resident of Kazakhstan;
- The MNE's surrogate parent entity of the international group, which has been appointed by the MNE group as a sole substitute for the ultimate parent entity;
- Kazakhstan residents that are constituent entities; and
- Nonresidents of Kazakhstan that are constituent entities and that operate in Kazakhstan through a permanent establishment.

Base filing requirements

CbCR filing requirement would enter into force retroactively starting from 1 January 2016. As such, MNE groups with aggregate annual income (for the financial year prior to the reporting year) of no less than 110 million times the monthly calculation index (MCI) (approximately USD 780 million) would be required to file a CbC report.

The local file and master file filing requirements would enter into force starting from 1 January 2019, if a constituent entity's aggregate annual income (for the financial year prior to the reporting year) is no less than 10 million times the MCI (approximately USD 70 million).

Notification requirements

Effective 1 January 2018, constituent entities must notify the tax authorities of their participation in a multinational group no later than 183 calendar days after the fiscal year reporting deadline.

Failure to notify the authorities of participation in a multinational group for master file, local file, and CbCR requirements or failure to submit accurate information may be subject to a penalty of 100 MCI (approximately USD 8000) for small entities, 200 MCI (approximately USD 7000) for medium-sized entities, and 350 MCI (approximately USD 30,000) for large entities.

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Israeli government wins transfer pricing case on sale of IP

The Israeli Center District Court on 6 June ruled in favor of the Israeli Tax Authority (ITA) in a precedent-setting transfer pricing ruling on the sale of intellectual property to a related party that occurred subsequently to the acquisition of the shares of the IP's owner.

In November 2006, Microsoft Corp. acquired 100 percent of the shares of an Israeli start-up, Gteko Ltd., for a purchase price of approx. USD 90 million (the first transaction). Shortly after, Gteko's employees were transferred to Microsoft Israel, a subsidiary of Microsoft Corp., and the parties – Gteko and Microsoft Israel – signed a cost plus agreement for the provision of personnel services.

In July 2007, Microsoft acquired Gteko's IP for a purchase price of USD 26.6 million (the second transaction). The purchase price was based on an accounting purchase price allocation prepared by a third party.

The difference between the purchase price in the first transaction and that in the second transaction is the essence of the dispute between the ITA and Gteko.

The ITA argued that the second transaction – the sale of IP from Gteko to Microsoft – was given a false title and in fact constituted the sale of the entire business operation of Gteko to Microsoft; thus, consideration should be accordingly higher. Also important to mention is that the shares transaction occurred only six months before the IP transaction.

The ITA based its arguments on section 85A of the Israeli Tax Ordinance, which sets out the transfer pricing rules in the Israeli tax regime. Section 85A follows international transfer pricing principles, according to which a transaction between related parties must be at arm's length, that is, at the same price had the parties to the transaction not been related to each other.

Gteko's main argument was that the consideration paid in the first transaction did not represent the IP's market value. According to Gteko, the first transaction included other components that were not part of the second transaction, mainly a component of "synergy" – the positional added value Microsoft will have in integrating Gteko's business in its operations. This "synergy" is not an asset of Gteko, and it cannot sell it.

District Court decision

The District Court ruled in *Getko Ltd vs. Kfar Saba Assessing Officer* that according to transfer pricing principles and the evidence presented to the court, in nature, the sale of the IP was practically the sale of all of Gteko's business operation and thus the consideration must be adjusted, bringing it to a total of approx. USD 80 million.

The court ruled as follows:

- Transfer pricing rules must be examined in a broad manner and the IP transaction must be analyzed by its nature and not its title. Supporting its position with the OECD/G20 BEPS *Guidance on Transfer Pricing Aspects of Intangibles*, the court explained that a "functional" analysis must be conducted, and according to this analysis the IP transaction is in fact much broader than described by the parties in the IP sale agreement, and included most of Gteko's business operation.
- Based on the OECD guidance, the synergy component should not be naturalized when evaluating the market value of a transferred asset. Gteko's argument that it does not own the synergy is irrelevant in this case, as the synergy clearly affected the value of the (other) assets in the transaction, and thus must be taken into consideration when evaluating the market value of a transferred asset, whether the synergy is considered an "asset" owned by the seller or not considered an "asset" at all.
- The transfer of Gteko's employees to Microsoft is itself a significant "function" that must be taken into consideration when analyzing this transaction, and the combination of the IP transfer with the transfer of the employees virtually drained Gteko's of its business operation completely.
- All evidence, including the IP sale agreement that specifically mentioned that Gteko's would terminate its business operations pursuant to the sale of the IP, and the fact that Gteko, which was a profitable company, had become an empty shell and ceased its operations, point to the conclusion that the second transaction (the IP sale) included all of Gteko's business operation.

Comments

The *Gteko* decision provides the first substantive judicial guidance in Israel regarding the valuation of IP in a transaction between related parties, and the use of the "functional" method to reassess transactions between related parties.

The court rejected the transfer pricing approach that involved determining the value of the transaction that actually occurred, and instead suggested that the law allowed the tax authority to determine pricing based on a transaction that reflected how a company in the taxpayer's position would achieve the same commercial goals on arm's length terms.

This reasoning applied by the court is consistent with the current OECD BEPS principles, and may be indicative of how future courts will rule when the OECD transfer pricing guidelines are relevant to local transfer pricing legislation (that is, considering whether an independent party, acting in its own best interests, would have entered into a transaction under similar terms and conditions). In addition, though not mentioned, actions 8-10 of the BEPS action plan were surely a source of influence in the court's decision, thus marking the introduction of the BEPS guidance to the Israeli courts.

This is the first-ever court ruling in Israel that deals specifically with transfer pricing issues in the common practice of the sale of IP between related parties in the high-tech industry.

Given the significant amount of tax involved and the importance of the issue, Gteko may decide to appeal the District Court's decision to the Supreme Court of Israel.

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Malaysia introduces master file requirement, other BEPS recommendations

Malaysia's Inland Revenue Board (IRB) has released the first set of revisions to the Malaysian Transfer Pricing Guidelines 2012, to align with BEPS Actions 8-10 and Action 13 recommendations.

The revisions pertain to guidance on the arm's length principle and documentation, dedicate separate new chapters to intangibles and commodity transactions, and provide Malaysia-specific examples on interpretation. The key takeaways from the revised version of the guidelines, effective July 15, are summarized below.

Chapter II: Arm's length principle

The revisions to chapter II reaffirm the adoption of the arm's length principle to determine the pricing of controlled transactions.

The revised chapter emphasizes achieving transfer pricing outcomes that are consistent with value creation; that is, a mere contractual assumption of risk or provision of capital may not warrant above-normal returns.

Under the revised guidelines, contractual arrangements should reflect economic reality, and contractual allocations of risks are to be respected only when supported by actual decision-making.

Among the salient points in the revised chapter on the arm's length principle are the following:

- Capital provision that lacks functionality will generate at most a risk-free return, so that no premium returns will be allocated to "cash-box" entities.
- IRB will disregard transactions that are commercially irrational.
- Emphasis will be placed on the accurate delineation of transactions and "options realistically available."
- Correlation of functional analysis with value creation (group-wide) – a more detailed analysis will be required going forward, focusing on both parties to the controlled transaction. One-sided functional analysis would not work.
- Reaffirmation of preference for local tested party (and consequently local comparables).
- The Berry ratio is recognized as a profit level indicator, and specific circumstances for its application are provided.
- Contractual agreements provide the starting point for delineation of controlled transactions. Emphasis is on conduct over contract, and the written contractual terms may be supplemented based on evidence of the actual commercial/financial relations.
- Any increase in economically significant functions performed should be compensated by an increase in profitability.
- Acknowledgement of OECD concepts of "control over risk" and "financial capacity to assume risk."
- Control over the activity of a local affiliate can increase permanent establishment risk for the controlling entity, subject to the relevant double tax agreement.
- The form of remuneration would not be sufficient to dictate the assumption/allocation of risks between affiliates.
- Recognition of working capital adjustments that enhance comparability; however, these would not be automatically accepted by IRB.

Chapter VIII: Intangibles

The revised guidelines include a definition of "intangibles" that is consistent with the OECD guidance.

Government licenses and contractual rights qualify as intangibles under certain circumstances. Examples include (among others):

- Production-sharing contracts;
- License for broadcasting or license for Network Facilities Provider and Network Service Provider;
- Power purchase agreement; and
- Contract to supply pharmaceutical products to government hospitals.

Exclusive rights in intangibles are themselves intangibles.

The revised guidelines recognize the DEMPE concept, as well as legal ownership of intangibles, consistent with the OECD guidance.

A taxpayer paying a royalty for the use or transfer of intangibles must provide evidence for:

- Underlying intangible;
- Processes that utilize the intangible;
- Benefits obtained;
- Economically significant risks associated with DEMPE of the intangibles; and
- Withholding tax payments.

Economically significant activities in connection with intangibles are defined to include:

- Research and development activities that lead to customization/enhancement of existing products or new products;
- Activities that lead to improvement in manufacturing processes;
- Advertising, marketing, and promotional activities that lead to creation/enhancement of marketing intangibles; and
- Managing customer relationship, localization of products/advertisements, or marketing surveys including collection of local data.

When a local entity performs any of the above functions, the costs incurred should not be merely reimbursed to the local entity without any profit element. A local entity carrying out such core functions would generally control the strategic operational decisions regarding its activities, and should be entitled to more than a routine low cost plus remuneration for its performance and control of the core functions. It is highly unlikely to separate the performance and the control of a function under such circumstances.

Under the revised guidelines, when a local entity contributes to the enhancement of an intangible, the local entity is considered as having "economic ownership" of the intangible, irrespective of the legal ownership of that intangible.

Characterization as a risk-insulated contract R&D service provider would not be sustained merely on grounds of strategic decisions and overall direction from a foreign entity.

In determining the arm's length price for controlled transactions involving intangibles, if it is difficult to find comparable uncontrolled transactions, the profit split method or *ex ante* valuation techniques may be used.

The revised guidance recognizes the concept of hard-to-value intangibles in connection with under/over estimation of anticipated profits (entitlement to difference between *ex ante* and *ex post* returns).

Routine or limited risk distributor characterization (and consequent nominal profit) of a local entity that performs significant advertising, marketing, and promotional (AMP) functions and bears associated costs/risks that lead to the creation of local marketing intangibles, would not be sustained. Such intangibles would attract more than a routine return; in fact, the AMP function should be remunerated for its effort with or without the creation of local marketing intangibles. A marketer-distributor is expected to generate a higher margin, which may be in the form of:

- A reduction in purchase price;
- A reduction in royalty rate; or
- A share of profits associated with the enhanced value of the marketing intangibles.

The method of compensation for the AMP functions must be identifiable, quantifiable, and easily verifiable. A statement that merely mentions that the extra return was embedded in the purchase price is not acceptable evidence that the AMP functions are appropriately compensated.

When a limited-risk distributor performs marketing activities on behalf of the principal, even though those activities may not create marketing intangibles, the distributor should be compensated by way of a service fee for the marketing function, in addition to an arm's length margin for its distribution functions. The absence of an agreement covering such service fee arrangement would not prevent application of the arm's length principle under those circumstances.

Cost-plus compensation will not reflect the anticipated value of the intangibles created or the contribution of the research team. Therefore, a local contract R&D service provider should be remunerated based on the accurate delineation of the transaction. An analysis of the value contributed by the entity to the overall group operations should be provided.

When a local entity creates a unique intangible as a result of its R&D activities, and the legal ownership is transferred to a foreign entity without appropriate compensation, the remuneration for that transfer should be based on a share of the profits from the future exploitation of the intangible, in addition to an arm's length compensation for the R&D activities.

When a contract manufacturer makes enhancements to processes and the legal ownership is assumed by another group member, the contract manufacturer should be entitled to a return on the enhancements if they are transferred to or shared with other related entities. If the enhancements are self-exploited by the local entity, an increase in margin should be reflected.

If it is possible and appropriate to separate services/tangible good transactions from transfers of intangibles/rights in intangibles, the price of a package contract should be disaggregated; this applies by analogy to a situation whereby an arrangement of services and intangibles transferred in combination is so unique that sufficient reliable comparables are not available.

Continued payment of a royalty (indefinitely) by a local manufacturer, even after it has gained the necessary experience in due course, would be challenged by the tax authorities.

When a local company, using the technical know-how of a foreign affiliate, has incurred significant expenditures to customize such know-how and to enhance its value through its own R&D efforts, the cost of such R&D activities should be considered when determining the arm's length royalty for the original know-how or patents. Under those circumstances, if the local company continues to pay a royalty to the foreign affiliate owner of the original intangible, it must provide a justification that the original intangible continues to provide value over time. Also, the local company may be entitled to a return on the exploitation of the locally created or enhanced intangibles by other related companies.

The IRB would disallow a royalty payment if it is not demonstrated that the royalty currently paid is for newly developed or enhanced intangibles, especially when the original intangibles have become obsolete over the years.

Chapter X: Commodity transactions

Under the revised guidelines, "commodities" are defined to include physical products for which a quoted price is used as a reference by independent parties in the industry to set prices in uncontrolled transactions. "Quoted price" is defined as the price of the commodity in the relevant period obtained in a domestic or an international commodity exchange market.

The revised guidelines recognize the comparable uncontrolled price method as the most appropriate method in general.

Taxpayers are required to provide evidence of price setting policy as part of their transfer pricing documentation.

When there is a difference between a contract and conduct with regard to the “pricing date” (the specific time and date selected by the parties to determine the price for a commodity transaction), the IRB would have discretion to determine the “pricing date.”

Chapter XI: Documentation

The revisions reaffirm the requirement to prepare contemporaneous documentation, notwithstanding the exclusion in Paragraph 3 of the transfer pricing guidelines.

“Material changes” warranting an update of transfer pricing documentation are defined to include changes in operational and/or economic conditions that have a bearing on controlled transactions.

The revisions provide examples of “operational conditions”:

- Changes in shareholding;
- Changes in business model and structure;
- Changes in business activities;
- Changes in financial/financing structure;
- Changes in transfer pricing policy; and
- Merger or acquisition.

In addition, the revisions provide examples of “economic conditions”:

- Foreign exchange;
- Economic downturn; and
- Natural disaster.

Under the revised guidelines, comparable searches must be refreshed every three years, provided operational conditions remain the same. However, financial data and suitability of the existing comparables should be reviewed and updated annually.

Additional items are required as part of transfer pricing documentation (some in line with OECD local file guidance), such as management structure, detailed information on pricing policies, specific reference to risk analysis framework for functional analysis, information on involvement of a local entity in business restructuring or intangibles transfer, reconciliation between transfer pricing computations and financial statements, etc.

The newly introduced master file requirement applies to taxpayers required to prepare a country-by-country report under the Income Tax (Country-by-Country Reporting) Rules 2016. The requirement applies to a multinational enterprise (MNE) group when the parent prepares the master file. The master file is to be submitted together with transfer pricing documentation, upon request. The contents of the master file are largely consistent with the OECD guidance.

Penalty rates would continue to be as listed in the TP Audit Framework.

The revised guidelines elaborate on the penalty provisions:

- Information provided as part of transfer pricing documentation would be considered incorrect and attract a penalty under section 113(2)(b) of ITA [100 percent of tax undercharged], when the facts presented in documentation are different from actual conduct.
- Other circumstances that may lead to a penalty include:
    - Differences between form and substance; for instance, if a contract and conduct are different;
    - Comparables selected by the taxpayer do not meet all of the economically relevant characteristics or comparability factors;
    - Inaccurate or misleading explanation of function, assets, and risk.

Penalties will not be imposed when transfer pricing documentation is submitted within 30 days upon request, and the documentation fulfils the requirements of the transfer pricing rules and the revised transfer pricing guidelines.

Way forward for taxpayers

It is important for taxpayers to identify any potential areas of risk or gaps in their intragroup pricing policies, actual practices, and transfer pricing documentation, and make desired changes or build adequate defensible positions for audits. The revisions to the transfer pricing guidelines reflect the IRB's current stance on transfer pricing enforcement and the approach to be adopted in transfer pricing audits moving forward. With greater clarity on the requirements, it is imperative that the IRB enforce a higher degree of compliance as reflected in the penalty elaborations.

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IRS launches country-by-country reporting web pages

The IRS recently launched several new webpages providing information about country-by-country (CbC) reporting on irs.gov. These pages provide background information on CbC reporting and other useful resources. The main IRS CbC reporting page provides links to CbC information for US MNEs, CbC reporting guidance and resources, CbC frequently asked questions (FAQs), the IRS CbC newsletter, and several other related items.
URL: https://www.irs.gov/businesses/country-by-country-reporting

Here are some highlights of recent IRS updates.

Final versions of Form 8975, Schedule A (Form 8975), and Instructions

The IRS has issued final versions of Form 8975, *Country-by-Country Report*, Schedule A, *Tax Jurisdiction and Constituent Entity Information*, and the accompanying instructions. The IRS CbC reporting guidance webpage includes the final versions of the forms and instructions.
URL: https://www.irs.gov/businesses/country-by-country-reporting-guidance

The final versions of Form 8975 and Schedule A are essentially identical to the draft versions. The final instructions are substantially the same as the draft instructions; however, a few updates have been made, as outlined below:

- The description of "applicable financial statement" has been moved to a reorganized definitions section. The language of the definition is identical to the language regarding the applicable financial statement that was included in the "When to File" section of the draft instructions.
- The description of "reporting period" has been moved to a reorganized definitions section. The language of the definition is identical to the language regarding the reporting period that was included in the "When to File" section of the draft instructions.
- Information on paper filing has been added to the "Where to File" section of the instructions.
- Information on filing multiple Schedules A for a single tax jurisdiction has been moved to an earlier point in the instructions.
- The instructions for entering information on Lines 1a and 1b have been corrected. In the draft instructions, the instructions for entering Lines 1a and 1b were reversed.

IRS CbC FAQs

The IRS has issued CbC FAQs on its CbC reporting website. The FAQs currently include 14 questions and answers, separated into four categories: General Questions, Data Format and Structure, Exchange of Information, and Reporting Requirements.

Of note are Questions 4.4 and 4.5. Question 4.4 addresses how US limited liability companies (LLCs) should be reported on Form 8975. The IRS provides that in general, US LLCs that do not elect to be treated as corporations for federal income tax purposes are treated as being "stateless." As such, the financial and employee information of these "stateless" LLCs should be included on a Schedule A (Form 8975) for stateless entities. However, if a US LLC does not elect to be treated as a corporation for federal income tax purposes and is wholly and directly owned by a business entity that is organized in and has its tax jurisdiction of residence in the United States, then the LLC will be considered a US business entity with its tax jurisdiction of residence in the United States. If that US LLC wholly and directly owns another US LLC, the other LLC will also be considered a US business entity that has its tax jurisdiction of residence in the United States.

If a US LLC meets the above criteria and is treated as having its tax jurisdiction of residence in the United States, it will be listed as a Constituent Entity on Schedule A (Form 8975) for the United States. The LLC's financial and employee information should be aggregated with that of other US constituent entities of the US MNE group, and should not be reflected on the Schedule A for stateless entities.

Question 4.5 addresses what circumstances would subject the foreign subsidiaries of a US MNE group to a local filing requirement in a foreign tax jurisdiction. The IRS provides that a US MNE group's foreign subsidiaries cannot be subject to a local filing requirement unless one of two situations occurs: (1) the United States has an instrument in place that allows for automatic exchange of information with the foreign jurisdiction but has not entered into a CbC competent authority agreement (CAA) by the end of 12 months following the end of the fiscal reporting year of the US MNE group, or (2) the United States has had a systemic failure. A systemic failure on the part of the United States would occur when either: (1) there is a CAA in place, but the United States suspends automatic exchange for reasons other than those in accordance with the terms of the CAA, or (2) the United States persistently fails to automatically exchange CbC reports. Additionally, the foreign jurisdiction cannot require local filing if it does not meet the OECD standards of confidentiality, consistency, and appropriate use.

The IRS also provides that if a US MNE group determines that it does not need to file a CbC report because it does not meet the revenue threshold under the US Treasury regulations, the foreign jurisdiction cannot require local filing merely because the US MNE group exceeds the revenue threshold in the foreign jurisdiction.

The IRS will update the CbC FAQ webpage as additional information and guidance become available. The webpage includes a link that allows for the submission of comments and questions to the IRS CbC reporting mailbox. The IRS plans to review the submitted comments and questions and make updates to the FAQs as necessary.
URL: https://www.irs.gov/irspup/businesses/corporations/country-by-country-faqs

IRS CbC reporting newsletter

The IRS will periodically send out a CbC reporting newsletter, which will include information on the latest IRS news and guidance related to CbC reporting. This webpage includes instructions on how to register for the newsletter.
URL: https://www.irs.gov/businesses/subscribe-to-the-country-by-country-reporting-newsletter

Competent authority agreements for exchange of CbC reports

The United States continues to expand its network of bilateral competent authority arrangements (CAAs) for the exchange of CbC reports, and has now finalized 12 such agreements. The agreements are listed on an IRS webpage, "CbC Reporting Jurisdiction Status Table."
URL: https://www.irs.gov/businesses/country-by-country-reporting-jurisdiction-status-table

The United States has signed CAAs for the exchange of CbC reports with the following countries:

- Australia – 8/1/2017
- Belgium – 7/20/2017
- Brazil – 7/2-/2017
- Canada – 6/7/2017
- Denmark – 6/21/2017
- Estonia – 7/26/2017
- Guernsey – 6/22/2017
- Iceland – 5/5/2017
- Ireland – 6/15/2017
- Isle of Man – 7/20/2017

- Jamaica – 7/20/2017
- Latvia – 6/21/2017
- Malta – 7/20/2017
- Netherlands – 4/11/2017
- New Zealand – 5/11/2017
- Norway – 4/26/2017
- Republic of Korea – 6/22/2017
- Slovakia – 6/21/2017
- South Africa – 5/26/2017

At the time of this writing, all agreements had been published, except those with Australia, Canada, Jamaica, and Malta. Typically, CAAs like these are published in full by the IRS and the treaty or TIEA partner, as long as both competent authorities agree to do so.

For more information on the initial CbC CAAs, including a detailed discussion of the US-Netherlands CbC CAA, see Global Transfer Pricing Alert 2017-025, May 30, 2017. To date, all CbC CAAs published by the IRS have been substantially similar to the US Model CbC CAA for DTCs.
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-17-025-30-may-2017.pdf

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OECD releases additional implementation guidance on CbC reporting

The OECD on 18 July released additional guidance on the implementation of the country-by-country (CbC) reporting requirement introduced in the BEPS Action 13 final report. This guidance consolidates and expands all of the additional implementation guidance issued by the OECD since the release of the Action 13 Report. Also included is the additional implementation guidance issued on: (i) 29 June 2016; (ii) 5 December 2016; and (iii) 6 April 2017.[15] Because the 18 July release includes all of the information found in the prior three releases, when consulting OECD additional guidance on the Action 13 Report, it will only be necessary to refer to the 18 July guidance going forward.

To assist jurisdictions with the introduction of consistent domestic rules, the additional guidance addresses two specific issues:

- Whether aggregated data or consolidated data for each jurisdiction is to be reported in Table 1 of the CbC report; and
- How to treat an entity owned and/or operated by two or more unrelated multinational enterprise groups (MNE groups).

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[15] For prior coverage, see Global TP Alerts 2016-023, 2016-038, and *Arm's Length Standard*, June 2017.
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-16-023-1-july-2016.pdf
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-16-038-6-december-2016.pdf
URL: http://newsletters.usdbriefs.com/2017/Tax/ALS/170612_13.html

The 18 July implementation document also updates the list of countries that have indicated they will allow parent surrogate filing (*i.e.*, voluntary filing in the parent jurisdiction) but provides no substantive changes to this area of guidance as compared to the 6 April implementation document.

Aggregate *versus* consolidated data (new)

The 18 July guidance addresses whether the CbC financial data should be presented on an aggregated or consolidated basis for different group entities in a single jurisdiction. This issue may be of particular importance in reporting related-party revenue and total revenue. It arises, for example, under the following circumstances: Assume USP is the parent of a US consolidated group. Further assume that USP owns consolidated US subsidiaries A and B. Finally, assume that A takes out a loan of $100 from B and pays B $5 in interest on that loan. If data were reported on an aggregated basis, then the $5 of interest would have to be reported as related-party revenue on the CbC report. If, however, data were reported on a consolidated basis, then, because of intragroup eliminations, the $5 interest payment would not need to be reported as related-party revenues.

The 18 July implementation guidance states that reporting should be done on an aggregate basis. The guidance does provide, however, that jurisdictions may create an exception to this and allow reporting on a consolidated basis, just as long as: (i) consolidated data is reported for each jurisdiction on the CbC report; and (ii) consolidation must be used consistently across the years. Reporting entities are also required to provide an explanatory note on the CbC report if consolidated data is used. Importantly, however, this is applicable only to jurisdictions that have "a system of taxation for corporate groups which includes consolidated reporting for tax purposes, *and the consolidation eliminates intra-group transactions at the level of individual line items*." (Emphasis added.) Inclusive Framework members that plan to adopt this exception are expected to implement this guidance as soon as possible, taking into account their specific domestic circumstances.

It appears that the United States will not provide such an exception. The US CbC regulations clearly provide that jurisdictional-level financial data should be "aggregated." *See* Treas. Reg. §1.6038-4(d)(2). Although US Treasury officials had previously stated that the CbC report allows for flexibility with respect to intracountry eliminations, the final regulations did not adopt this rule.[16] Further, the US tax consolidation rules do not eliminate intragroup transactions at the line item level. We expect the IRS to update its CbC FAQ page in the near future to clarify its position on this issue.

Entities owned and / or operated by more than one unrelated MNE group (new)

According to the 18 July implementation guidance, if an entity is owned and/or operated by more than one unrelated MNE group, the treatment of that entity for CbC reporting purposes should be determined under the accounting rules applicable to each of the unrelated MNE groups separately.

If, therefore, the applicable accounting rules require an entity to be consolidated into the consolidated financial statements of an MNE group, then the entity would be considered a constituent entity of that group under Article 1.4 of the model legislation. In addition, when pro rata consolidation is applied to an entity in an MNE group in preparing the group's consolidated financial statements, jurisdictions may allow a pro rata share of the entity's total revenue to be taken into account for the purpose of applying the EUR 750 million threshold. Finally, jurisdictions may also allow an MNE group to include a pro rata share of the entity's financial data in its CbC report, in line with the information included in the MNE group's consolidated financial statements, instead of the full amount of this financial data.

These rules appear to be consistent with prior guidance regarding reporting of minority shares in accordance with certain local GAAP. The rules do not appear to have an impact on US MNEs, however, because pro-rata reporting is not applicable under US rules.

Parent surrogate filing (updated)

When surrogate filing (including parent surrogate filing) is available, it will mean that there are no local filing obligations for the particular MNE in any jurisdiction that otherwise would require local filing in which the MNE has a

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[16] *See, e.g.*, "U.S. Treasury Officials: New OECD Guidance Allows for Flexibility on Reporting Template," Kevin A. Bell, Bloomberg BNA Accounting Policy & Practice Report, 4/24/2015.

constituent entity (herein referred to as the local jurisdiction). This is subject to certain conditions, as listed in the OECD guidance.

The 18 July implementation document provides updates regarding some of the countries that have indicated they will allow parent surrogate filing (that is, voluntary filing in the parent jurisdiction). The original list of countries from the June 2016 guidance was supplemented in the December 2016 guidance and the April 2017 guidance, and our prior alerts[17] noted those changes. This list of jurisdictions is dynamic and may continue to be updated periodically by the OECD.
URL: http://www.oecd.org/tax/automatic-exchange/country-specific-information-on-country-by-country-reporting-implementation.htm

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France publishes list of partner countries for automatic exchange of CbC information

A ministerial order presenting the list of countries with which France will exchange country-by-country (CbC) reporting information automatically and bilaterally was published July 8 in France's official journal.

For fiscal years that begin on or after January 1, 2016, the list includes:

- All European Union member states (following the enactment of Council Directive 2016/881 of May 25, 2016)
- Australia
- Brazil
- Canada
- Chile
- China
- Indonesia
- Mexico
- New Zealand
- Norway
- South Africa
- South Korea
- United Kingdom's overseas territories: Bermuda, Guernsey, and Jersey

India and Japan are also on the list, but only for fiscal years that begin on or after April 1, 2016.

[17] Global TP Alert 2016-38 and *Arm's Length Standard*, June 2017.
URL: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-transfer-pricing-alert-16-038-6-december-2016.pdf
URL: http://newsletters.usdbriefs.com/2017/Tax/ALS/170612_13.html

The list is expected to grow by the end of the fiscal year, as long as new countries sign the multilateral competent authority agreement (MCAA) and fulfill the conditions to exchange information with France. Of note, France is also currently in open discussions with the United States to enter into a bilateral automatic exchange agreement for the exchange of CbC information.

France has enacted CbC reporting requirements for fiscal years that begin on or after January 1, 2016. The CbC report must be filed within 12 months following the fiscal year end, either in France or in one of the countries listed above. Failure to file the CbC report exposes French entities that are members of a multinational group to a penalty up to EUR 100,000.

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