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Global Transfer Pricing

Arm's Length Standard

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OECD Releases Final BEPS Reports

The Organization for Economic Cooperation and Development (OECD) on October 5 released the final reports under the base erosion and profit shifting (BEPS) project it started two years ago to address perceived gaps in international tax rules. The final reports – one for each of the 15 items in the "Action Plan" released in 2013, except for the three transfer pricing actions, for which one report was issued – will be submitted to the G-20 finance ministers at their meeting in Lima, Peru, on October 8.

Key transfer pricing concepts in final reports

The 186-page final transfer pricing report and the 70-page documentation and country-by-country reporting report provide guidance on a multitude of transfer pricing topics. Some of the salient features include the following:

- **Global transfer pricing documentation and country-by-country reporting:** As expected, the OECD did not introduce any new guidance in the global documentation and CbC final report, which is simply a compilation of previously released deliverables.
- **Role of contracts:** The contractual arrangements between the parties is the starting place for the proper understanding (delineation) of a transaction. However, written contracts are unlikely to provide all the information necessary to perform a transfer pricing analysis. Therefore, the parties' actual conduct should be used to clarify or

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supplement the terms of the contract, or replace the contract if the contract is not supported by the conduct of the parties.

- **Risk:** To contractually assume risk, a party must exercise control over the risk and have the financial capacity to assume the risk. Although there is no bright line test to determine control over risk, the factors considered include: (1) performance of the decision to take risks; (2) the performance of responding to risks associated with the business opportunity; and (3) performance of risk mitigation activities. The guidance permits day-to-day risk mitigation activity to be outsourced as long as the party outsourcing the risk mitigation activity exercises control over the party doing the day-to-day risk mitigating activity. The guidance provides a six-step process to determine the entity incurring risk.
- **Intangibles:** The final report retains the 2014 guidance on categories of intangibles, transfer pricing methods, and important functions related to the development, enhancement, maintenance, protection, and exploitation of intangibles (the DEMPE functions). To be entitled to intangible returns associated with the DEMPE functions, the final report incorporates the control and funding requirements from the deliverable on risk, discussed above. The guidance states that the entity entitled to the profit or loss between projected and actual outcomes will be the entity exercising the control functions over the risks that caused the difference.
- **Funding and cash boxes:** An entity that does not control the financial risks associated with its funding will be entitled only to a risk-free return. An entity that does control the financial risks associated with the DEMPE functions will be entitled to a risk-adjusted return.
- **Recharacterization:** If a transaction lacks the commercial rationality of an arrangement that would have been agreed between unrelated parties, the guidance permits the nonrecognition of the transaction. The fact that a transaction is not observed between unrelated parties is not sufficient grounds for not recognizing the transaction.
- **Hard-to-value intangibles:** If the taxpayer cannot demonstrate that its pricing is based on a thorough analysis, the *ex post* outcome will be used as a presumptive evidence of the appropriateness of *ex ante* pricing arrangements. The OECD includes several exemptions to this rule based on unforeseeable events and adopts a five-year look-back rule with a 20 percent tolerance. They also allow taxpayers to bypass the provisions of this section by disclosing the underlying *ex ante* and *ex post* data and explaining why the variance was not anticipated.
- **Cost contribution arrangements:** The final report updates the CCA guidance to conform to the changes on contracts, risk, and intangibles discussed above. The guidance retains the requirement that ongoing contributions be valued at value rather cost unless the parties value the opportunity cost of the upfront commitment to contribute resources to the CCA.
- **Low-value-adding intragroup services:** To qualify for the safe harbor on low-value-adding intragroup services, taxpayers must document the cost pool and choose appropriate allocation keys. If the level of low-value-adding intragroup service fees exceeds a threshold determined by an individual country, tax administrations are able to require a full functional analysis and comparability analysis including the application of the benefits test to specific service charges.

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- **Dispute resolution:** Twenty nations – Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the UK and the US – have committed to provide for mandatory binding MAP arbitration in their bilateral tax treaties as a mechanism to guarantee that treaty-related disputes will be resolved within a specified time frame. Other countries have agreed to minimum standards and a peer review monitoring system.
- **Profit splits:** Final guidance on profit splits has been postponed until 2016 and 2017.

Deloitte Webcasts and Publications

The final reports and related materials, including *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10*, and *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13* are available on the OECD's website.
URL: http://www.oecd.org/tax/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm
URL: http://www.oecd.org/tax/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241480-en.htm

Deloitte Tax will conduct a series of webcasts to discuss all aspects of the OECD transfer pricing deliverables. To register, follow the links below:

Asia-Pacific:

- Base Erosion and Profit Shifting: The Final Reports (Part 1: Transfer Pricing), October 28, 11:00 AM HKT
  URL: https://event.on24.com/eventRegistration/prereg/register.jsp?clientid=1168&eventid=1060892&sessionid=1&key=A36D3CDED9EE22215FFC8C91AB96633E&id=us:em:na:als:eng:tax:101215
- Base Erosion and Profit Shifting: The Final Reports (Part 2: Non-Transfer Pricing), November 4, 2:00 PM HKT
  URL: https://event.on24.com/eventRegistration/prereg/register.jsp?clientid=1168&eventid=1060893&sessionid=1&key=E22DAFDCE200A5BCCACB1023C83F7636&id=us:em:na:als:eng:tax:101215
- BEPS: Implementation of Transfer Pricing Changes (Part 1: Australia, Japan, China, and Korea), November 26, 2:00 PM HKT
  URL: https://event.on24.com/eventRegistration/prereg/register.jsp?clientid=1168&eventid=1060901&sessionid=1&key=FFDA7BEE948033621FC99A5071EB3FA3&id=us:em:na:als:eng:tax:101215
- BEPS: Implementation of Transfer Pricing Changes (Part 2: India and Southeast Asia), December 8, 2:00 PM HKT
  URL: https://event.on24.com/eventRegistration/prereg/register.jsp?clientid=1168&eventid=1060895&sessionid=1&key=1EA2235235F6F136012F78F27C8666DF&id=us:em:na:als:eng:tax:101215

EMEA:

- G20/OECD – BEPS: Round-up of 2015 Deliverables, October 20, 1:00 PM BST
  URL: https://event.on24.com/eventRegistration/prereg/register.jsp?clientid=3731&eventid=1025266&sessionid=1&key=2A466B9D279AF71EA87E40B524CABFC7&id=us:em:na:als:eng:tax:101215

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- G20/OECD – BEPS: Transfer Pricing – Risk and Recharacterization, October 28, 2:00 PM GMT
  URL: https://event.on24.com/eventRegistration/prereg/register.jsp?clientid=3731&eventid=1028170&sessionid=1&key=844975FBEFF7CEC698F776566E28E6C6&id=us:em:na:als:eng:tax:101215
- G20/OECD – BEPS: Transfer Pricing of Intangibles, Hard-to-Value Intangibles and Cost Contribution Arrangements, November 12, 12:00 noon GMT
  URL: https://event.on24.com/eventRegistration/prereg/register.jsp?clientid=3731&eventid=1028174&sessionid=1&key=5592A5106D715B43B026E795E2DDFF59&id=us:em:na:als:eng:tax:101215

United States:

- BEPS Update: Release of the Final Package, October 9, 2:00 PM ET
  URL: http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/upcoming-webcasts.html?id=us:em:na:als:eng:tax:101215
- OECD Transfer Pricing Guidelines: After Crossing the Finish Line, What's Next?, October 27, 2:00 PM ET
  URL: http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/october/2015/dbriefs-OECD-transfer-pricing-guidelines-after-crossing-the-finish-line-whats-next.html?id=us:em:na:als:eng:tax:101215

Deloitte's transfer pricing practice is preparing a suite of 10 articles to explore in depth the changes brought about by the final BEPS report on transfer pricing and country-by-country reporting. To receive these articles when released, subscribe to our transfer pricing newsletter, *Arm's Length Standard* or visit the transfer pricing page on Deloitte.com.
URL: http://www2.deloitte.com/global/en/pages/tax/articles/arms-length-standard.html?id=us:em:na:als:eng:tax:101215
URL: http://www2.deloitte.com/global/en/pages/tax/solutions/transfer-pricing.html?id=us:em:na:als:eng:tax:101215

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China's SAT Issues Draft Guidance on Transfer Pricing Rules and BEPS Initiatives

China's State Administration of Taxation (SAT) on 17 September released a discussion draft of "Special Tax Adjustment Implementation Measures" that would comprehensively revise Circular 2, the existing guidance in this area.

Circular 2, issued in 2009, is China's primary transfer pricing guidance, and contains detailed rules on transfer pricing adjustments, cost sharing arrangements (CSAs), controlled foreign companies (CFCs), thin capitalization, and the general anti-avoidance rule (GAAR). The draft also incorporates a number of recommendations of the OECD in the context of the base erosion and profit shifting (BEPS) initiative, but does so taking into account China's unique economic environment and factors relevant to the revamping of Circular 2. The draft also

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includes new chapters addressing intangible assets, intragroup services transactions, and profit level monitoring.

The SAT is seeking public comments on the draft by 16 October 2015.

Summary of key points

- Transfer pricing contemporaneous documentation would consist of a master file and local report(s). Enterprises that meet certain criteria would be required to complete and submit the country-by-country (CbC) reporting form with their annual Enterprise Income Tax (EIT) return (Chapters 2 and 3).
- Taxpayers would be required to prepare a “special issue” report as part of their contemporaneous documentation if they engaged in related-party services transactions, implemented CSAs, or exceeded the prescribed thin capitalization ratio at any time during the year (Chapters 3, 7, 9, and 11).
- During the course of a special tax investigation, if the ultimate global holding company of the investigated enterprise is located outside China and that holding company did not provide a CbC report to its local tax authorities, or if the Chinese tax authorities are unable to effectively obtain the CbC report of the ultimate global holding company under an applicable automatic exchange of information agreement, the Chinese tax authorities would have the power to request that the investigated enterprise provide a CbC report. The tax authorities also would consider location-specific advantages (LSAs), such as location savings and market premium, when determining whether any additional profits should be attributed to the investigated enterprise (Chapters 5 and 6).
- The Chinese tax authorities would adopt a broader approach in monitoring the profit levels of taxpayers, and taxpayers would be assigned risk rankings. Taxpayers would not only have to comply with the contemporaneous documentation and related-party disclosure requirements, but also would need to monitor their day-to-day transfer pricing policy implementation and potentially their profit levels (Chapter 13).

The draft also provides a number of clarifications that taxpayers would welcomed:

- The value contribution method and asset valuation method would be formally introduced as examples of other acceptable transfer pricing methods, but the draft clearly affirms the importance of considering traditional transfer pricing methods (Chapter 4).
- The requirement that CSAs be pre-approved by the tax authorities would be abolished and changes would be made to post-CSA monitoring, which would provide flexibility for taxpayers that intend to implement CSAs (Chapter 9).
- The tax authorities should impose additional tax and/or refund overpaid tax, as appropriate, based on the outcome of a mutual agreement procedure (MAP) to eliminate any double taxation arising from a special tax adjustment. Although the draft sets out situations whereby MAP applications would be denied, it would provide flexibility for the SAT to ignore these criteria in situations in which it considers that the MAP would eliminate double taxation.

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Details of the draft

Chapter 2: Reporting of related-party transactions: The draft contains a number of clarifications relating to the recognition of associated relationships. For example, the draft would:

- Clarify the calculation for combining the shareholding percentage of two or more individuals who have a familial relationship;
- Provide a method for calculating the ratio of total debt owed by a party to the actual paid-in capital;
- Include licensing of trademarks as one of the determination factors for associated relationship;
- In the case of know-how licensing, distinguish between patented know-how and non-patented know-how; and
- Emphasize the meaning of "primary control" and "common interest," and provide an explanation of primary control, a clear definition of senior management personnel, and stipulate that a family relationship should be considered as one factor in determining whether an associated relationship exists. The draft also would clarify that a shareholding by the state or an association through the delegation of senior personnel by the state to a party would not give rise to an associated relationship.

These clarifications are designed to help the Chinese tax authorities make better practical determinations of the existence of associated relationships.

The draft would modify and provide additional clarifications of various types of related-party transactions. Transfers of financial assets, cash pooling arrangements, and equity transfers would be considered related-party transactions and "other types of transactions" would be added as a catch-all category.

The draft would require that the CbC form be submitted with the PRC Annual Related-Party Transactions Reporting Form in the annual EIT tax return. The draft also sets out the criteria for CbC reporting when a Chinese enterprise is the ultimate holding company of a multinational group and the group's annual consolidated revenue for the previous fiscal year exceeds RMB 5 billion (equivalent to the EUR 0.75 billion threshold established by the OECD), or when the enterprise's ultimate holding company is outside China and the China enterprise has been designated by the multinational group to prepare and submit the CbC report.

Chapter 3: Contemporaneous documentation: On the basis of the existing version of Circular 2, the draft draws on Action 13 of the BEPS Action Plan, and states that there would be three types of transfer pricing contemporaneous documentation: the master file, local report(s), and report(s) on special issues that would cover related-party services transactions, CSAs, and thin capitalization. This is consistent with the domestic initiative to focus on significant outbound service fee and royalty payments, as set out in guidance issued in 2014 and earlier this year (Circular 146 and Bulletin 16).

The requirement to prepare the contemporaneous documentation report, master file, and local report(s) would be subject to the same threshold as is found in the current version of Circular 2, that is, the report would be required when the "aggregate amount of related-party purchases

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and sales exceeds RMB 200 million" or "the aggregate amount of other related-party transactions exceeds RMB 40 million." However, the draft also would require enterprises with limited functions and that incur losses to prepare a master file and local report(s). The draft also would eliminate the requirement that the "foreign shareholding percentage be lower than 50% and that the related-party transactions only be between domestic associated parties" in Circular 2, so that an enterprise that only had related-party transactions with domestic related parties would not be required to prepare the documentation report.

The draft clearly indicates that if a taxpayer provides false or incomplete information that does not truly reflect the company's related-party transactions, the taxpayer would be considered to have failed to comply with the contemporaneous documentation requirement. This implies that the tax authorities may impose stricter requirements on the quality of documentation, as well as disclosure requirements.

Chapter 4: Transfer pricing methods: In addition to the five traditional transfer pricing methods listed in the existing version of Circular 2, the draft mentions other transfer pricing methods, including the value contribution allocation method and the asset valuation method. The value contribution allocation method typically would be used for transactions that lack comparable information but where each party's value creation and the group's consolidated profit can be reasonably determined. While the draft formally would introduce the use of the value contribution allocation method when appropriate, it clearly states that the SAT acknowledges the importance of the proper consideration of traditional transactional methods in the analysis. The draft stipulates that the asset valuation method consists of the cost method, the market method, and the income method, while indicating that when using the income method to evaluate intangible assets, the economic life of intangible assets should be reasonably determined.

The draft further explains and specifies classifications of types of related-party transactions, and adds new types of related-party transactions (such as financial assets and equity transfers) to expand the Chinese tax authorities' monitoring of various types of related-party transactions.

Chapter 5: Special tax audits and adjustments: Chapter 5 would expand transfer pricing audits, adjustment procedures, and the Chinese tax authorities' investigation rights as prescribed in the existing version of Circular 2 (that is, using electronic data as evidence, providing a CbC report for an investigated enterprise that should have a CbC report). The draft also states that transactions between domestic related parties temporarily would not be subject to these rules, and that the tax authorities intend to relax the management of domestic related-party transactions (as in the case of contemporaneous documentation).

The Chinese tax authorities would have the power during a transfer pricing audit to deny or refine the terms of related-party transactions. The draft emphasizes that regional special factors (such as location savings and market premium) should be taken into account, and would apply a reasonable basis to determine the additional profit that should be attributed to the audited enterprise as a result of such special factors during an audit. If the ultimate global holding company of the investigated enterprise is located outside China, and that company did not provide a CbC report to its local tax authority or the Chinese tax authorities are unable to effectively obtain the CbC report of the global ultimate holding company under an automatic

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exchange of information agreement, the Chinese tax authorities would be able to request that the China investigated enterprise provide the CbC report. This requirement is in line with Actions 9 and 13 of the BEPS Action Plan regarding the characterization of risk and capital, as well as the CbC report.

Based on SAT guidance issued in 2009 (Circular 363), the draft emphasizes that enterprises with limited functions and risks (such as toll manufacturing and contract manufacturing enterprises, and enterprises that carry out simple distribution or contract R&D activities) would be defined as enterprises that are not responsible for bearing any market and business risks associated with decision making, underutilization, sluggish sales, or R&D failures, and would be required to maintain reasonable levels of profit. In reference to the adjustment method to be used by a toll manufacturer for recharging the value of raw materials and equipment, the chapter indicates that a capital adjustment of up to 10 percent of the comparable companies' financial data would be permissible. This is the first time the Chinese tax authorities would officially formalize their practice regarding transfer pricing audits and adjustments for toll manufacturers.

The draft also mentions "secondary adjustments," which became a controversial issue after the SAT issued guidance in 2006 (Circular 901); it references the points made on the subject in the most recent OECD transfer pricing guidelines. However, the draft does not provide any details regarding secondary adjustments or their impact (for example, how accounting adjustments should be made and whether dividends arising from a secondary adjustment would qualify for benefits under an applicable tax treaty or tax credit). How the Chinese tax authorities address secondary adjustments in the future will need to be monitored.

The draft indicates that this chapter is temporarily not applicable to domestic transactions. The existing version of Circular 2 stipulates that, for transactions between domestic related parties with the same actual tax rate, no transfer pricing audit or adjustment is required in principle, provided the transaction does not directly or indirectly result in the overall reduction of tax revenue. However, transfer pricing adjustments of domestic related-party transactions still exist from a practical perspective (where the transactions involve both foreign and domestic related parties). Clarification on how the SAT would implement this principle in future transfer pricing audits and how a domestic corresponding adjustment would be made if one party is undergoing a transfer pricing audit will be required.

Chapter 6: Intangible assets (new chapter): The draft contains a new separate chapter on intangible assets that would include definitions, as well as the principles and factors to be taken into account in allocating returns to intangible assets, and the valuation methods to be used. In general, this chapter would incorporate the new developments in the OECD's BEPS Action Plan on intangibles, and at the same time, evidence the SAT's recent specific positions and practices.

According to the draft, intangibles may be categorized as technology-related, market-related, and other intangibles. Chapter 2 of the draft (Reporting and Filing of Related-Party Transactions) also specifically mentions that intangible assets would include land-use rights, goodwill, and going concern value. However, the draft does not include the controversial LSAs (such as location savings and market premium) in intangibles; instead, these factors would be

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considered with the group's other functions/risks/assets in the global business and the group synergy as value creation factors when determining the return on intangibles.

Regarding the allocation of return on intangibles, the draft emphasizes the principle of alignment with economic activities and value creation, which is consistent with the key themes of the BEPS Action Plan as it relates to transfer pricing. The draft also provides a detailed list of functions and risks related to intangible assets, and mentions that a company that merely funds the intangibles but does not assume any functions or risks should be entitled to a reasonable return only on the provision of funding. On this basis, it is expected that the Chinese tax authorities would further examine whether a local entity engages in any important functions related to intangible assets, and if so, they could challenge the traditional IP model whereby an offshore entity that only contributes funding is entitled to a residual return. On the other hand, the draft also states that the legal ownership of intangibles, without any contribution to the creation of the value of the intangibles, should not entitle the legal owner to a return on those intangibles. Whether a mere legal owner of intangibles would be entitled to any return in the future is unclear.

The draft mentions that intangible value may be quantified using the comparable uncontrolled price, profit split, and other reasonable methods (including the value contribution allocation method and the asset valuation method). This would be in line with the fact that in recent years the Chinese tax authorities seem to have been advocating for the use of the profit split method, and value contribution and asset valuation methods in transfer pricing controversies. The draft confirms the SAT's position on royalty payments, for example, the disallowance of a tax deduction for a royalty if the intangible assets concerned are incapable of providing the domestic taxpayer with any economic benefit, and requiring an adjustment of the royalty payment based on changes in the value of the intangibles, as well as changes in functions and risks.

Chapter 7: Intragroup services transactions (new chapter): The draft adds a chapter that specifically addresses issues related to the arm's length principle in the context of intragroup services transactions.

The draft sets out two conditions that would have to be satisfied when service fees are received from or paid to a related party: (1) the service would have provided economic benefits to the service recipient; and (2) the service fee would have to be charged at an arm's length price. When a taxpayer pays service fees to a related party but does not receive any economic benefits, the tax authorities would be able to impose a special tax adjustment by disallowing a deduction for the service fees in computing the taxpayer's taxable income. The authorities also would be able to adjust a taxpayer's profits using an appropriate transfer pricing method in cases when the service fees charged or paid to related parties do not satisfy the arm's length principle.

According to the draft, the following types of services would not be deemed to create an economic benefit: duplicative services; shareholder activities; services that give rise to additional benefits simply because of a taxpayer's association with the group; services for which compensation already has been received; services that are unnecessary or unrelated to the function and risk profile of the taxpayer; and services that cannot result in any direct or

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indirect economic benefit. These principles generally are consistent with the SAT's positions in Bulletin 16, as well as the general views of the OECD.

The draft would require that the fees for beneficial services charged between related parties be determined based on the reasonable costs incurred and that reflect arm's length profits. The service costs could be allocated using reasonable allocation factors, such as sales income, operating assets, headcount, staff salaries, facility utilization, data flow volume, and working hours. Although this chapter does not include a safe harbor rule for low-value-added services such as those contemplated in BEPS Action 10, it does provide clearer guidelines to taxpayers on how intragroup services transactions could comply with the arm's length principle.

The new chapter details the specific requirements for the preparation of the special issue file on intragroup services transactions. Specifically, taxpayers would be required to maintain and submit to the tax authorities their service contracts or other documents to demonstrate that the intercompany services are genuine. Taxpayers also would be required to describe in the special issue file how services costs were computed, how the transfer pricing method was selected, and the reasons for selecting a particular method, as well as the specific amount of service fees borne by related parties within the group. However, the draft does not specify whether there would be any exemption threshold for preparing the special issue file for intragroup services transactions.

Chapter 8: Advance pricing agreements: The draft would eliminate the APA application prerequisites stipulated in the existing version of Circular 2 and the threshold amount for annual related-party transactions (transaction amounts that exceed RMB 40 million). The elimination of these items would allow more taxpayers to apply for APAs. However, considering the SAT's limited resources to process and prioritize APA applications, an increase in the number of APA applications is not expected in the short term. The draft enumerates the "priorities" that would guide the SAT in accepting formal APA applications, and contains a list of the circumstances in which the tax authorities would be able to deny a taxpayer's APA application.

Priority factors would include a comprehensive consideration of the value-chain analysis and LSAs, and the reasonableness of the proposed transfer pricing policies and methodologies.

An APA application could be rejected in the following circumstances:

- When a formal transfer pricing audit is initiated before the application is submitted;
- When the weighted average profit level during the implementation period of a previous APA is lower than the median of the interquartile range when the taxpayer applies for renewal of the APA; and
- When the applicant fails to prepare contemporaneous transfer pricing documentation or submit annual related-party transaction filings in accordance with relevant laws or regulations.

In practice, some tax authorities may initiate transfer pricing investigations for prior years before they process an APA application to evaluate the applicant's transfer pricing risk exposure and compliance status. Therefore, taxpayers should reassess the feasibility of their

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APA applications and consider whether such applications would be likely to manage the risks of potential transfer pricing challenges.

The draft clearly states that taxpayers would be required to prepare an APA prefiling package and submit the package to the competent tax authorities and the SAT, along with a written letter of intent for an APA application. The contents of the prefiling package would have to be comprehensive and include factual information on the taxpayer and its related parties, a technical analysis of the transfer pricing policies and methodologies selected. The prefiling requirement generally is in line with prevailing practice under the existing version of Circular 2, whereby the Chinese tax authorities expect comprehensive documentation and analyses to be prepared by the applicant in the initial stage of an APA application. Accordingly, the draft would formalize prevailing practice to make it part of the requirements in APA applications.

The draft would clarify and detail how to roll back an APA for the same or similar related-party transactions to prior years. According to the draft, the rollback period for transfer pricing policies and methodologies determined in an APA could not exceed 10 years. The rollback period would be counted from the date the competent tax authorities issue the notice of a formal meeting to 1 June of the tax year following the tax year in which the related-party transaction(s) took place. The draft indicates that the rollback would be effected via special tax adjustments, in a manner similar to current tax authority practice. Taxpayers considering whether to apply for an APA should consider the potential impact of rolling the APA back to cover prior year related-party transactions.

Chapter 9: Cost sharing agreements: The draft reiterates and emphasizes the importance of the CSA participants owning the results of the arrangement and the cost-commensurate-with-benefit principle in sharing relevant costs, which also is consistent with the current OECD transfer pricing guidelines. However, the draft does not appear to have embraced the proposal in the discussion draft on Action 8 of the BEPS Action Plan as to cost sharing based on "economic value."

Although the draft does not contain detailed guidance or examples on how to determine reasonably anticipated benefits (RABs) and buy-in and buy-out payments, it underlines the importance of considering the "characteristics" of the relevant intangibles or services in selecting the parameters in a RAB analysis; these should not change in the absence of special circumstances. Therefore, the draft would impose greater technical requirements on taxpayers that are contemplating CSAs. Potentially affected taxpayers should consider the entire life cycle of CSAs before selecting and applying reasonable and consistent methodologies in their RAB analyses.

Specifically, the draft requires that the impact of LSAs on the determination of the cost pool being shared should be considered. Generally speaking, there could be such an impact when Chinese participants develop intangibles or provide services based on a much lower level of costs, compared with CSA counterparties located in developed countries, i.e., location savings. Again, this requirement may make the relevant technical analysis more challenging. Potentially affected taxpayers would need to consider whether LSAs exist, how to reflect their impact on the cost base, and the RAB analysis throughout the life cycle of the CSA. In addition, although the draft requires that the terms of a CSA include a balancing adjustment clause, there is no

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clarification whether such an adjustment is to be made based on *ex ante* or *ex post* cost information.

The draft would include changes from *ex ante* approval to *ex post* supervision, which is specified in the recently issued Bulletin 45. This change generally would be favorable to taxpayers seeking to enter into CSAs.

The draft sets out the relevant requirements for post-CSA monitoring, the prime focus of which is the functions and risks undertaken by CSA participants. The SAT's position is that any participant that lacks commercial and/or economic substance or that does not carry out any actual functions but only provides funding, should not be entitled to any benefits from the intangibles resulting from the CSA. Considered in conjunction with the clarification and definitions in Chapter 6 of the draft regarding the legal and economic ownership of intangibles, it is expected that the Chinese tax authorities would challenge any CSA participant that does not perform actual functions or that does not make actual and continuous contributions to the economic value of the relevant intangibles. From the perspective of implementation, the SAT is expected to further clarify and coordinate with the local tax authorities how to claim a deduction of relevant CSA costs and apply for relevant treatment in both a direct and an indirect tax context after CSAs are registered by taxpayers.

Chapter 10: Controlled foreign corporations: Chapter 10 of the draft provides additional guidance on CFCs based on the existing Circular 2. It would define "attributable income" (the part of the profits earned by the CFC that are attributable to resident shareholders) and would provide reference to the determination of the "attributable income." The draft also lists some typical instances in which certain income (such as proceeds from insurance coverage) of CFCs generally would be deemed to be "attributable income."

The draft explains some key controversial concepts on the determination of when a CFC would exist (for instance, definition of single resident shareholder, and calculation of the effective tax rate), which would provide general guidance and a legal basis for enforcement by the Chinese tax authorities. The draft also states explicitly that if a CFC is subject to a special tax adjustment audit, the tax authorities would have the right to request the Chinese resident shareholders to provide information on the CFC under their control.

Chapter 11: Thin capitalization: The draft provides more detailed rules in the thin capitalization chapter than are found in the existing version of Circular 2. For example, the draft indicates that related-party debt from cash pooling should be included in the related party debt-to-equity calculation. In practice, this requirement appears to have led to challenges, especially for taxpayers acting as the cash pool heads that centralize the borrowing/lending positions of the cash pool members. Even though some borrowings are not for the use of the head of the cash pool, such borrowings still are viewed as borrowings by the cash pool heads that increase the related-party debt-to-equity ratios. In addition, although existing Circular 2 indicates the ratio calculation referred to above is to be based on average monthly equity and related-party debt, the draft proposes that the calculation be made by reference to each occasion of investment in equity and related-party debt.

The draft also would expand the scope of interest expense that could be recognized. Some instances of this expanded scope (recharacterized interest expense due to special tax

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adjustments and foreign exchange gain/loss related to related-party debt) would seem to require further clarification.

The draft would require taxpayers wishing to claim interest expense deductions on related-party debt in excess of the standard related party debt-to-equity ratio to prepare contemporaneous documentation similar to what currently is required in Circular 2. However, the draft also would require the taxpayer to provide an additional item allowing the tax authorities to determine “whether an independent enterprise would be able and willing to accept the (related party) financing conditions, amount and interest rate.” If one looks at the components required in the contemporaneous documentation, it seems that when examining thin capitalization issues, the SAT still would focus more on the taxpayer’s credit rating and repayment ability and the pricing of intercompany financing by reference to the arm’s length principle.

Chapter 12: General anti-avoidance rule: Chapter 12 of the draft contains some minor changes to the GAAR. It would add a new measure to the effect that if an enterprise attempts to disguise a related-party transaction by way of an agency, a trust, or other arrangement, the Chinese tax authorities would be permitted to recharacterize the arrangement as a related-party transaction based on economic substance. Because the draft does not provide detailed guidelines on how this would be implemented, its potential impact remains to be seen.

Chapter 12 also defines the sequence of the application of special tax adjustment provisions, tax treaty provisions, and a GAAR audit.

Chapter 13: Profit level monitoring (new chapter): The draft would add a new chapter on profit level monitoring and establish a risk management-oriented approach to enhance the monitoring of taxpayers’ real-time profit levels, and to encourage cooperation and compliance.

The draft would require the local tax authorities to provide guidance to taxpayers that have a high compliance level and a low tax risk ranking. For taxpayers with low compliance levels and high tax risk rankings, the tax authorities would conduct special tax investigations. The tax authorities also would keep track of taxpayers that already have been subject to special tax adjustments and closely monitor their related-party transactions and profit levels. However, the draft would replace the five-year supervision period requirement with ongoing supervision, which demonstrates that the Chinese tax authorities are moving toward a holistic approach to the monitoring of related-party transactions. The draft would place more emphasis on establishing a broader mechanism for risk management to assess taxpayers’ risk ranking, as compared to the current practice of focusing on taxpayers that already have been subject to a special tax adjustment. Taxpayers should not only focus on the preparation of contemporaneous documentation and disclosure of related-party transactions, but also on ensuring that their day-to-day transfer pricing implementation is in accordance with the arm’s length standard.

The draft also would encourage taxpayers to make “self-adjustments” and report the adjustments to the tax authorities. However, the tax authorities would retain the right to conduct audits and impose special tax adjustments.

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Chapter 14: Corresponding adjustments and MAP: Chapter 14 of the draft would revamp the existing text in Circular 2, by making reference to guidance issued in 2013 (Bulletin 56) to improve the administration of the mutual agreement procedure (MAP) in relation to special tax adjustments. A MAP request could be initiated by a Chinese tax resident, the competent tax authorities of another contracting state, or under other situations when MAP is considered necessary.

The draft emphasizes that the tax authorities should impose additional tax and/or refund overpaid tax as appropriate, based on the outcome of a MAP to protect taxpayers from double taxation resulting from a special tax adjustment. These measures reflect the efforts of the SAT to enhance the MAP in the context of special tax adjustments.

The draft sets out the situations in which a MAP request would be denied, such as when the taxpayer failed to initiate the request within the time period specified in the relevant tax treaty or when the issue is not covered by the treaty. However, the draft would provide flexibility for the SAT to ignore these criteria if it considers that the MAP would prevent double taxation. Therefore, more Chinese companies investing overseas, as well as foreign companies doing business in China, would be able to consider the possibility of initiating a MAP as an alternative approach to resolve tax disputes and protect themselves from double taxation that arises from transfer pricing or other special tax adjustments.

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US Tax Court's *Altera* Decision Raises Broader Questions

The US Tax Court on July 27 held, in a unanimous 15-0 decision in *Altera Corp. v. Commissioner*, that a rule promulgated under the 1995 cost sharing regulations requiring participants in a qualified cost sharing arrangement (QCSA) to share stock-based compensation (SBC) costs related to the intangible development area (IDA) of the QCSA (i.e., Treas. Reg. § 1.482-7(d)(2)(2003), the "all costs rule") did not satisfy the reasoned decision-making standard, and is thus invalid, under the standards enunciated in *Motor Vehicle Mfrs. Ass'n of the US v. State Farm Mut. Auto Ins. Co.*, 463 US 29 (1983) and *Chevron USA., Inc. v. Natural Res. Def. Council, Inc.*, 467 US 837 (1984). In so holding, the *Altera* court found that, in promulgating the all costs rule, the Treasury and the IRS had failed to explain how it was consistent with the fundamental principle underlying the regulations promulgated under section 482 of the Internal Revenue Code (IRC), i.e., the arm's length standard (Treas. Reg. §1.482-1(b)(1)), given that all evidence proffered indicated that it was not.

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This decision raises serious issues about whether taxpayers should continue to include SBC costs as part of the total costs included not only for purposes of Treas. Reg. § 1.482-7, but also Treas. Reg. § 1.482-9. Taxpayers should consult with their local Deloitte Transfer Pricing and International Tax contacts to discuss the consequences of this decision on their QCSA and other transfer pricing policies.

Factual and Procedural Background

The taxpayer-petitioner in this case, Altera Corporation, develops, manufactures, and sells programmable logic devices (PLDs) and related hardware, software, and predefined design building blocks for use in programming the PLDs. On May 23, 1997, Altera US (the parent corporation, incorporated in Delaware) and Altera International (a subsidiary of Altera US, incorporated in the Cayman Islands), entered into a technology license agreement (TLA) and a technology research and development (R&D) cost-sharing agreement (CSA). Under the TLA, Altera US licensed to Altera International the right to use and exploit, everywhere except the United States and Canada, all of Altera US's intangible property relating to PLDs and programming tools that existed before the CSA. Under the CSA, Altera US and Altera International agreed to pool their respective resources to conduct research and development using the pre-cost-sharing intangible property relating to PLDs. Altera US and Altera International also agreed under the CSA to share the costs and risks of R&D activities they performed on or after May 23, 1997, relating to PLDs.

During Altera's tax years 2004 through 2007, Altera US granted stock options and other SBC to some of its employees, including employees who performed R&D activities subject to the CSA. These employees' cash compensation was included in the cost pool under the CSA, but the SBC was not included. The IRS sent Altera notices of deficiency for those tax years, making allocations of $15,463,565 in 2004, $23,015,453 in 2005, $17,365,388 in 2006, and $15,463,565 in 2007, all pursuant to the "all costs rule" requiring SBC related to the IDA of the QCSA to be shared by the participants in the QCSA.

Legal background

In *Xilinx, Inc. v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010), the Ninth Circuit Court of Appeals upheld the Tax Court's decision that a previous version of the all costs rule (which did not specifically state that SBC must be included) was inconsistent with the arm's length standard (Treas. Reg. 1.482-1(b)(1)) and thus invalid. In *Xilinx*, both the Tax Court and the Ninth Circuit held that the arm's length standard must be followed in all IRC section 482 adjustments, and that the arm's length standard requires an analysis of the *actual behavior of unrelated parties* when they enter into transactions with one another (the "behavioralist" interpretation of the arm's length standard). In doing so, the Tax Court and the Ninth Circuit rejected the IRS's and Treasury's interpretation of the arm's length standard, which allows for the possibility of a "thought experiment" to determine arm's length pricing, rather than focusing solely on the behavior of unrelated parties.

The IRS maintains, under the "thought experiment" interpretation of the arm's length standard, that the correct price can be deduced simply by thinking about economic principles and then applying those principles to the facts of the taxpayer's transaction and thereby deriving the correct price in accordance with those principles. Under the behavioralist interpretation of the

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arm's length standard, though, the Tax Court and Ninth Circuit found that the failure of the IRS to provide any empirical evidence that unrelated parties actually shared SBC costs in similar types of arrangements indicated that requiring taxpayers in QCSAs to do so was inconsistent with the arm's length standard.

2003 regulations

In July 2002, Treasury issued a notice of proposed rulemaking with respect to proposed amendments to the 1995 cost sharing regulations pertaining to the inclusion of IDA-related SBC in the joint cost pool of QCSAs. Many commentators submitted comments to Treasury indicating that they were not aware of any agreements between uncontrolled parties in which the parties shared SBC costs in a joint venture type of an arrangement like a QCSA. Other submissions to the Treasury indicated that they had surveyed many taxpayers and conducted searches in databases containing relevant contracts and that they had not been able to find any agreements between uncontrolled parties in which the parties shared SBC costs in a joint venture type of an arrangement like a QCSA. Other commentators identified agreements similar to QCSAs in which SBC costs were not shared between the parties. Others submitted economic reports explaining that, from a theoretical perspective, unrelated parties would not agree to share SBC costs because the value of SBC is speculative, potentially large, and completely outside the control of the parties.

Despite all these comments, Treasury issued the final all costs rule in August 2003, explicitly requiring parties to QCSAs to share IDA-related SBC costs. The final rule also added Treas. Reg. 1.482-1(b)(2)(i), indicating that a QCSA produces an arm's length result only if the parties' costs are determined in accordance with the all costs rule. When it issued the final rule, the files maintained by Treasury relating to the final rule did not contain any expert opinions, empirical data, published or unpublished articles, papers, surveys, or reports supporting a determination that the amounts attributable to stock-based compensation must be included in the cost pool of QCSAs to achieve an arm's length result. Additionally, when Treasury issued the final all costs rule, it was unaware of any written contracts between unrelated parties, whether in a cost sharing arrangement or not, that required one party to pay or reimburse the other party for amounts attributable to stock-based compensation.

Tax Court's decision

Administrative Law Issue Number 1: Was the All Costs Rule a Legislative or Interpretive Regulation?: Under section 553 of the Administrative Procedure Act (APA), in promulgating regulations through informal rulemaking, an agency must publish a notice of proposed rulemaking; provide interested persons an opportunity to participate in the rulemaking; and after consideration of the relevant matter presented, incorporate in the rules adopted a concise general statement of their basis and purpose. These requirements apply only to "legislative rules," not "interpretive rules." Interpretive rules merely explain preexisting substantive law, whereas substantive rules "create rights, impose obligations, or effect a change in existing law." In other words, a legislative rule has the "force of law," whereas an interpretive rule does not.

The Ninth Circuit Court of Appeals (which would hear an appeal of this case) has held that a rule has the force of law (and is thus a legislative rule subject to the APA notice and comment

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requirements) when: (1) in the absence of the rule, there would not be an adequate legislative basis for enforcement action; (2) when the agency has explicitly invoked its general legislative authority; or (3) when the rule amends a prior legislative rule. Hemp Indus. Ass'n v. DEA, 333 F.3d 1082, 1087 (9th Cir. 2003).

Altera maintained that the all costs rule was a legislative rule subject to the APA notice and comment requirements. The IRS asserted that it was not a legislative rule, but declined to argue the issue on brief or in oral argument because it maintained that it had met the APA notice and comment requirements. The Tax Court found that it needed to determine the issue to determine whether the APA notice and comment requirements applied to the rule. The Tax Court found that the all costs rule was a legislative rule under the Ninth Circuit's *Hemp* criteria because: (1) Congress delegated legislative power to Treasury under IRC section 7805(b); (2) Treasury intended for the final rule to have the force of law because the parties stipulated that the adjustments to taxpayer's income can be sustained only on the basis of the all costs rule; and (3) Treasury also intended for the final rule to have the force of law because Treasury invoked its general legislative rulemaking authority under section 7805(a) in promulgating the all costs rule. Accordingly, the Tax Court found that the Treasury needed to comply with the APA section 553 requirements in promulgating the all costs rule.

Administrative Law Issue Number 2: What is the Correct Standard of Review for the All Costs Rule?: Altera argued that, under section 706(2)(A) of the APA, a court must "hold unlawful and set aside agency action, findings, and conclusions" that the court finds to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." Altera further maintained that a court reviewing an agency rule must ensure that the agency "engaged in reasoned decision making" *Judulang v. Holder*, 132 S. Ct. 476, 483 (2011), and that to engage in "reasoned decision making," the agency "must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made'" under *State Farm* (463 US at 43).

The IRS rejected this argument, maintaining that the court should review the validity of the all costs rule under the *Chevron* standard rather than the *State Farm* standard. The IRS maintained that *State Farm* review was not appropriate for the all costs rule because it believed the interpretation and implementation of section 482 does not require empirical analysis of the behavior of unrelated entities. The Tax Court rejected this argument, citing a prior decision that "determination under section 482 is essentially and intensely factual." *Procacci v. Commissioner*, 94 T.C. 397, 412 (1990). The Tax Court also rejected this argument by indicating that under *Xilinx*, the "arm's length standard always requires an analysis of what unrelated entities do under comparable circumstances." Thus, the Tax Court once again rejected the IRS's thought experiment interpretation of the arm's length standard in favor of the behavioralist interpretation of the arm's length standard that was adopted by the Tax Court and the Ninth Circuit in the *Xilinx* decisions, indicating that the Treasury "necessarily decided an empirical question when it concluded that [the all costs rule] was consistent with the arm's length standard." Accordingly, the Tax Court found that it was appropriate to use the *State Farm* "reasoned decision making" standard of review.

The Tax Court noted that, even if it had used the *Chevron* standard of review instead of the *State Farm* standard of review, the "analysis would be the same" because under step two of the *Chevron* test, it is necessary to determine whether an agency interpretation is "arbitrary or

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capricious in substance" *Judulang*, 132 S. Ct. at 483, which is the same kind of analysis that is done under the *State Farm* inquiry. Thus, the Tax Court determined that regardless of whether the correct standard was *Chevron* or *State Farm*, the Treasury process leading to promulgation of the all costs rule needed to satisfy the "reasoned decision making" standard in *State Farm*.

Application of the "reasoned-decision-making" standard to the all costs rule: Applying the "reasoned decision making" standard, the Tax Court agreed with Altera that the all costs rule is invalid because: (1) it lacks a basis in fact; (2) Treasury failed to rationally connect the choice it made with the facts it found; (3) Treasury failed to respond to significant comments; and (4) the all costs rule was contrary to all of the evidence before the Treasury. In making this finding, the Tax Court noted that Treasury ignored a significant amount of empirical evidence submitted by commentators indicating that unrelated parties do not share SBC costs in similar types of arrangements (and was not able to provide any agreements between unrelated parties showing that they had shared SBC costs). The Tax Court also noted that the Treasury ignored (or seemed to concede) several economic analyses submitted by commentators providing theoretical explanations for the lack of empirical evidence. The Tax Court noted several times in its decision that Treasury did not attempt to search for or locate agreements to support its positon. Instead, Treasury relied on the assumption that it had the power to simply define what should be considered arm's length. Accordingly, the Tax Court found that Treasury's "ipse dixit conclusion" (that is, Treasury's conclusion that the all costs rule must be correct "because I say so"), "coupled with its failure to respond to contrary arguments resting on solid data, epitomizes arbitrary and capricious decision making."

Tax Court rejects IRS's "harmless error" arguments: Treasury argued that, pursuant to the harmless error rule of APA section 706, any deficiencies in its reasoning in promulgating the all costs rule should not lead to invalidation of the rule because (1) the Treasury had sufficient alternative reasons for adopting the rule; and (2) the rule reflects good policy because the Financial Accounting Standards Board (FASB), International Accounting Standards Board (IASB) and the Organization for Economic Cooperation and Development (OECD) have adopted policy positions that concur with the rule.

Treasury argued that the commensurate with income (CWI) principle (the second sentence of IRC section 482, indicating that transfers of intangibles must be commensurate with the income attributable to such intangibles) provided a second independent basis for the all costs rule, regardless of whether the all costs rule was consistent with the arm's length standard. However, the Tax Court stated that the preamble to the 2003 cost sharing regulations never indicated that the Treasury was prepared to rely solely on the CWI principle; moreover, Treasury has always maintained in its treaties and other public statements that its interpretation and application of the CWI principle is consistent with the arm's length standard. Thus, the Tax Court concluded that if the CWI principle is consistent with the arm's length standard, then it would be unreasonable for the IRS to conclude that the all costs rule could be consistent with the CWI principle given that it is inconsistent with the arm's length standard.

The Tax Court also rejected Treasury's argument that it should take into account the fact that the rule represented good policy in that it was consistent with FASB, IASB, and OECD rules on treating SBC as a cost. The Tax Court maintained that it did not have to consider whether the

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all costs rule was good policy, but merely had to decide whether the rule was the result of a reasoned decision-making process.

Analysis

The Tax Court's unanimous 15-0 decision that the all costs rule is invalid may be a strong signal that the IRS may face an uphill battle to overturn the decision if it ultimately decides to appeal to the Ninth Circuit, especially given that the IRS lost on a nearly identical issue in the Ninth Circuit in *Xilinx*.

Whatever the IRS decides to do, this decision may have far-reaching consequences if it is upheld on appeal (or acquiesced to by the IRS), because it could affect other provisions in the cost sharing regulations that may not have sufficient empirical support, and possibly even provisions in other areas of the tax regulations where empirical support has not been provided.

The decision could also affect the ongoing discussions at the OECD about the base erosion and profit shifting (BEPS) program, because some of the rules proposed as part of the BEPS project have been criticized by multinational enterprises as lacking any empirical support (similar to the taxpayer's successful argument in *Altera*). Thus, the OECD BEPS proposals may come under additional scrutiny and pressure to the extent they lack any empirical grounding.

This decision raises questions regarding the inclusion of SBC costs as part of the total costs not only for purposes of Treas. Reg. § 1.482-7, but also Treas. Reg. § 1.482-9. The decision also raises a significant number of international tax and tax accounting issues related to how taxpayers should take this decision into account for tax return and financial statement reporting purposes. Taxpayers should consult with their local Deloitte Transfer Pricing and International Tax contacts to discuss the potential consequences of this decision on their QCSA and other transfer pricing policies.

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Netherlands Introduces Draft Legislation on Country-by- Country Reporting and Transfer Pricing Documentation

The Dutch government on September 15 issued draft legislation that would adopt the OECD's country-by-country reporting and transfer pricing documentation requirements set forth in guidance issued pursuant to Action 13 of the base erosion and profit shifting (BEPS) Action Plan.

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In line with the OECD recommendation, the Dutch proposed rules would require a full master file and detailed local country file for group companies belonging to a group with €50 million in worldwide revenues. Penalties for failing to comply with these requirements would increase to four years in custody for board members of any of the group companies in the Netherlands. However, in the absence of a tax disadvantage to the Dutch tax authorities, the sanction would be limited to a fine.

The degree of detail required, and the frequency of updates will become clear during parliamentary discussions of the legislation, but merely copying and pasting past transfer pricing reports will not suffice. The government's overall message is clear: a new era of transfer pricing compliance has started.

Three-tier documentation standard

The proposed legislation will be incorporated in articles 29b – 29h CITA, and is generally in line with the recommendations and conclusions of the various reports under Action 13. The most important elements of the newly proposed legislation are summarized as follows:

Country-by-Country Report

Reporting period and reporting entities: The obligation to submit a CbC report is applicable to ultimate parent companies that are Dutch tax resident entities and members of a multinational group with a consolidated group turnover of at least €750 million in the fiscal year preceding the fiscal year to which the CbC report applies. Because the first fiscal year to which the CbC report will apply is fiscal year 2016, the threshold turnover should be met in fiscal year 1 January -31 December 2015 (calendar years) or 1 April 2015-31 March 2016 (for example, in case of a broken fiscal year 1 April-31 March) in order to fall within the scope of this obligation.

The CbC report should be provided to the Dutch tax authorities within 12 months after the end of the fiscal year of the ultimate parent company. Therefore, in the above situation, the CbC report would have to be submitted before 31 December 2017 (for calendar years) and 31 March 2018 (in the example above for broken fiscal years).

The CbC report will be exchanged automatically with countries in which the multinational group operates and with which the Netherlands has entered into an information exchange agreement.

In certain situations listed below, however, the obligation to submit the CbC report within 12 months after the end of the ultimate parent company's fiscal year is shifted to a Dutch group entity rather than the ultimate parent company:

- The ultimate parent entity is not obligated to submit a CbC report under the laws of the country of tax residence;
- The ultimate parent company's country does not have a signed agreement in place regarding automatic exchange of information with the Netherlands on CbC reporting within 12 months after the last day of the fiscal year; or
- The inspector has informed the Dutch group entity that the ultimate parent company's country of tax residence has systematically failed to comply with a request for the

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exchange of information, despite the presence of an agreement for automatic exchange if information.

If the multinational group has multiple Dutch resident group entities, and one or more of the above conditions are met, the group can designate one of these group entities to fulfill the requirement of providing the CbC report.

Other provisions in the draft legislation relate to the designation of a surrogate parent entity, which would replace the ultimate parent company to file the CbC report in its country of residence. Thus, the shift in the obligation to file the CbC report to the Dutch group entity mentioned above would not occur, provided the above three situations do not apply to the surrogate parent entity as well.

CbC report: what information must be included: The CbC report can be prepared in English or Dutch, and should include for each country in which the multinational group is operating, the following items:

- Revenues
- Earnings before income tax
- Income tax paid
- Income tax according to statutory accounts
- Paid-in capital
- Retained earnings
- Number of employees
- Tangible assets (other than cash and cash equivalents)
- A description of each group entity, including the state of tax residence. If there is a discrepancy between the state of tax residence and, for instance, the state of incorporation, this discrepancy should be disclosed, as well as the nature of the main business activities of the group entity.

Purpose of the CbC report: The legislation explicitly states that a transfer pricing adjustment by the tax inspector should not be based on the CbC report. Rather, by obtaining the report, the tax inspector would be able to assess substantial transfer pricing risks and other risks to the Netherlands related to BEPS (for example, whether multinational group members comply with the applicable transfer pricing rules).

Master file and local file

Reporting period and reporting entities: Dutch tax resident group companies of a multinational group in principle have an obligation to prepare and maintain a master file and a local file. The files can be prepared in Dutch or English. Qualifying Dutch group companies are those that belong to a multinational group with consolidated group turnover of at least €50 million in the fiscal year preceding the year to which the tax return applies.

This would mean that the threshold turnover should be met in fiscal year 1 January -31 December 2015 (calendar years) or 1 April 2015-31 March 2016 (as an example for broken fiscal years) in order to fall within the scope of this obligation.

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Both files should be available within the period for which the corporate income tax return should be filed. In the above situation, both files should be available before 1 May 2018 (for fiscal years ending on 31 December 2016) and 1 August 2018 (for broken fiscal years ending on 31 March 2017), assuming that the maximum extension period for filing the return has been granted (five months filing period and 11 months extension filing period).

Both files form part of the taxpayer's tax administration; therefore, they should be turned over to the tax authorities when requested.

Master file and local file: purpose: Access to these files enables the tax authorities to judge whether there are substantial transfer pricing risks present.

The local file should further include information relevant to the transfer pricing analysis regarding intercompany transactions with Dutch entities and that substantiate the arm's length nature of the transactions as required under article 8b CITA. It also should contain information supporting the arm's length allocation of profits to a permanent establishment.

Masterfile: what information must be included: The master file should provide an overview of the multinational group's business, including the nature of the business activities, its general transfer pricing policy, and its global allocation of income and economic activities. Specifically, the master file should include the following elements:

- Organizational structure
- A description of the nature of the business activities
- A description of the intangibles
- Financial activities within the group
- The group's financial and tax position
- Lists of important agreements, intangibles, and transactions

Local file: what information must be included: The local file should include the following information:

- Relevant financial information regarding specific transactions
- A comparability analysis
- The selection and application of the most appropriate transfer pricing method

If the local file information is generally available in the group file, a simple reference to the group file will be sufficient.

The format to be followed for both files can be found in Annex I and Annex II of Chapter V of the 16 September 2014 OECD report *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*.

Administrative sanctions and penalties

The proposed legislation treats non-compliance with the CbC reporting requirement as a criminal offense, which could result in a fine of €8,100 or imprisonment for up to six months for

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the person involved. If the non-compliance occurs intentionally, the sanction could include imprisonment for up to four years, according to article 23, paragraph 4 of the Criminal Code.

However, in the absence of a tax disadvantage to the Dutch tax authorities, the penalty would include only a fine.

The commentary to this rule notes that criminal prosecution will generally be reserved for the most serious cases.

The proposed penalties for non-compliance with the CbC reporting requirement do not apply to the master file and the local file. These files are considered to be part of the taxpayer's tax administration, and are therefore subject to the existing penalties for non-compliance. Those sanctions include the reversal of the burden of proof and a fine.

Conclusion

Through the proposed legislation, the Dutch government has taken an important step to ensure that the Netherlands fully adopts to Action 13 of the BEPS Action Plan. Although the proposed requirements refer to future fiscal years, there is a clear instruction for Dutch and foreign parent companies, as well as Dutch subsidiaries of MNEs to prepare their administration timely for the upcoming three-tier documentation transfer pricing requirements. We believe that the obligation for having a master file and local file in your local Dutch subsidiary's administration requires more extensive and specific transfer pricing documentation than currently required under article 8b CITA. In the coming months, affected taxpayers should conduct a screening to determine whether your administration is already "Action 13 proof".

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IRS Issues Temporary Regulations on Coordination Between Sections 482 and 367

The Treasury Department on September 14 released temporary regulations (TD 9738) that clarify the coordination of the application of the arm's length standard and the best method rule under Internal Revenue Code Section 482 with other provisions of the code.

Although the regulations are written in general terms as applicable to coordination between Section 482 and any other provision in the code, they focus specifically on coordination between Sections 367 and 482, and were issued simultaneously with proposed regulations under Section 367(a) and (d) that would eliminate taxpayers' ability to transfer foreign goodwill or going concern value outbound on a tax-free basis. Treasury and IRS officials have made various public statements during the past year indicating that regulations that would "eliminate the daylight" between Section 367 and Section 482 were imminent. The temporary regulations are effective for taxable years ending on or after September 14, 2015.

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The temporary regulations

The new temporary regulations state that all value (including synergies) provided between the parties in a controlled transaction requires an arm's length amount of compensation determined under the best method rule and without regard to the form or character of the transaction.[1] The regulations also broaden the scope of existing regulations to allow the IRS to aggregate the valuation of separate transactions (whether before, during, or after the year under review) under Section 482 even if those transactions are governed by other sections of the code (and the regulations under those code sections) if the transactions are so interrelated that an aggregate analysis provides the most reliable measure of an arm's length result.[2] Such aggregation would entail a coordinated best method analysis that includes a consistent consideration of the facts and circumstances of the functions performed, resources employed, and risks assumed for the relevant transactions, and a consistent measure of the arm's length results, for purposes of all relevant statutory and regulatory provisions.[3]

If compensation determined pursuant to a coordinated best method analysis is required to be allocated (for example, for purposes of determining whether some of the value is attributable to services and other parts of the value is attributable to intangibles, because the rules for sourcing are different for services and intangibles), then such allocation must be made using the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result for each allocated amount.[4] The examples illustrating these rules indicate that the IRS intends to apply these regulations to eliminate the statutory grant of non-compensability for foreign goodwill and going concern value in Section 367 when it believes that such a 367 transaction can be aggregated with another related transaction entered into under 482 (such as a cost sharing arrangement (CSA)).

The new temporary regulations are similar to provisions included in the recently released advance pricing agreement and mutual agreement procedure revenue procedures, in which the IRS states that the scope of an APA or MAP may be expanded to cover interrelated matters (interrelated issues in the same years, covered issues or interrelated issues in other years, and covered issues or interrelated issues in the same or other years as applied to other countries).[5]

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[1] *See* Treas. Reg. §1.482-1T(f)(2)(i)(A).
[2] *See* Treas. Reg. §1.482-1T(f)(2)(i)(B).
[3] *See* Treas. Reg. §1.482-1T(f)(2)(i)(C). Situations in which a coordinated best method analysis and evaluation may be necessary include (1) two or more interrelated transactions when either all such transactions are governed by one regulation under Section 482 or all such transactions are governed by one subsection of Section 367; (2) two or more interrelated transactions governed by two or more regulations under Section 482; (3) a transfer of property subject to Section 367(a) and an interrelated transfer of property subject to Section 367(d); (4) two or more interrelated transactions when Section 367 applies to one transaction and the general recognition rules of the code apply to another interrelated transaction; and (5) other circumstances in which controlled transactions require analysis under multiple code and regulatory provisions.
[4] *See* Treas. Reg. §1.482-1T(f)(2)(i)(D).
[5] Rev. Proc. 2015-40, §2.04 and Rev. Proc. 2015-41, §2.02(4).

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Reasons for change

The preamble to the regulations indicates that the Treasury promulgated the regulations because it is concerned about situations in which controlled groups evaluate economically integrated transactions involving economically integrated contributions, synergies, and interrelated value on a separate basis in a manner that results in a misapplication of the best method rule and fails to reflect what it believes is an arm's length result. The preamble states that the regulations specifically target transactions in which taxpayers assert that, for purposes of Section 482, separately evaluating interrelated transactions is appropriate simply because different statutes or regulations apply to the transactions (for example, when Section 367 and the regulations thereunder apply to one transaction and the general recognition rules of the code apply to another related transaction).

Treasury maintains that taxpayers combine a disaggregated approach to Section 482 and other statutes with an inappropriately narrow interpretation of Treas. Reg. 1.482-4(b)(6) (which provides guidance on when an item is considered similar to other items identified as constituting intangibles for purposes of Section 482) to yield a result where no compensation is required for certain value provided in controlled transactions. Treasury indicates its belief that this result is not arm's length, and the regulations are designed to eliminate the conclusion that no compensation is required for the provision of such value in controlled transactions.

Examples

The regulations add several new examples that clarify how they will be applied. In Example 6,[6] Treasury targets an intellectual property (IP) migration strategy whereby a US parent (USP) first transfers IP to a foreign subsidiary (FS) in a transaction governed by Sections 351 and 367 in Step 1. Later, USP and FS enter into a CSA under Treas. Reg. §1.482-7 in Step 2 to further develop the IP transferred in Step 1, but the taxpayer maintains that FS does not need to make a platform contribution transaction (PCT) payment for the items of value that it obtained in nonrecognition transactions in Step 1. Example 6 indicates that if the IRS determines that the formal arrangement fails to reflect the full scope of the value provided between the parties in accordance with the economic substance of their arrangement, the IRS may impute one or more agreements between USP and FS that fully reflect their respective reasonably anticipated commitments in terms of functions performed, resources employed, and risks assumed over time. The example provides that the taxpayer may present additional facts that could indicate whether this or another alternative agreement best reflects the economic substance of the underlying transactions and course of conduct, provided the taxpayer's position fully reflects the value of the entire arrangement consistent with the realistic alternatives principle.

Example 7 has a similar fact pattern as that in Example 6.[7] The facts in Example 7 are not as clear as Example 6, but it appears that the parties have entered into a Section 367(d)/CSA "two-step" bifurcated transaction (because there is a 351/367 transaction followed by a valuation done under Treas. Reg. §1.482-7(g)(2)(ix), implying that the parties are in a CSA). In Example 7, the taxpayer takes the position that the items of value transferred in the 351/367

[6] *See* Treas. Reg. § 1.482-1T(f)(2)(i)(E)(Example 6).
[7] *See* Treas. Reg. § 1.482-1T(f)(2)(i)(E)(Example 7).

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transaction do not need to be valued under the Section 482 valuation. Example 7 rejects this position, indicating that whether an item was transferred for no value under Section 367 is irrelevant for purposes of determining the total value of the interrelated transactions under Section 482. This conclusion suggests that the IRS intends to apply these regulations to eliminate the statutory grant of non-compensability for foreign goodwill and going concern value in Section 367. The example further states that the IRS could alternatively determine under all the facts and circumstances that the transaction in fact constitutes an exchange of property subject to, and therefore to be taken into account under, Section 367.

There are no examples discussing another IP migration strategy employed by taxpayers – one similar to Example 6, but using the 721 nonrecognition provisions for IP migration to a foreign partnership (i.e., an IP partnership). However, the regulations are worded broadly enough to apply to those transactions, so taxpayers should be cautious of the risks the new regulations may pose when entering into such IP partnerships. Taxpayers should also carefully consider the potential impact of these regulations combined with Notice 2015-54 (applying Section 482 to transfers to foreign partnerships) when entering into IP partnerships.

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IRS Releases Advance Pricing Agreement Revenue Procedure

The Internal Revenue Service on August 12 released Revenue Procedure (Rev. Proc.) 2015-41(the final APA procedures), which provides guidance on the process of requesting and obtaining an advance pricing agreement (APA). Rev. Proc. 2015-41 updates and supersedes Rev. Proc. 2006-9, as modified by Rev. Proc. 2008-31 (the prior APA procedures). The final APA procedures were issued concurrently with Rev. Proc. 2015-40, the final competent authority procedures, which provides guidance on the process of requesting assistance from the US competent authority under the provisions of US tax treaties. Many of the changes in the final APA procedures are consistent with similar changes in the final competent authority procedures.

A proposed version of Rev. Proc. 2015-41 was released for public comment in November 2013 in Notice 2013-79. The IRS received numerous comments on the notice and subsequent comments in finalizing Rev. Proc. 2015-41. The final APA procedures reflect consideration of those comments. The final APA procedures also reflect structural changes that occurred after 2012. Before 2012, the former APA Program was part of the Office of the Associate Chief Counsel International. In 2012, the APA Program merged with that portion of the Office of the US Competent Authority that resolves transfer pricing cases under the mutual agreement procedures of the United States' bilateral income tax conventions. APAs are now processed under the Advance Pricing and Mutual Agreement (APMA) office, which is part of the Office of the Deputy Commissioner International, Large Business and International Division (LB&I).

In addition to reflecting these structural changes, the final APA procedures update – and in many instances depart from – current APA practices. New APA requests and renewal APA

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requests with substantial changes in facts, transactions, or methods will require substantial additional effort, compared to prior APA procedures. In other instances – renewal APAs with no material changes from the prior APA, or APA requests that involve similar facts and issues currently under competent authority consideration – the final APA procedures provide for an "abbreviated APA request" that would reduce that burden substantially if APMA provides explicit authorization to use the abbreviated format. The procedures do not indicate how widely abbreviated APAs will be authorized or, if authorized, the extent to which items otherwise required in a complete APA request will be waived.

Taxpayers may file their APA requests under the prior APA procedures if the APA request is filed after August 31, 2015, and the substantially complete APA request is filed no later than December 29, 2015. Taxpayers seeking to cover calendar year 2014 as the first APA year will lose a few weeks of preparation time, because the substantially complete APA submission would normally be due in mid-January 2016.

Summary

A summary of the salient changes under the final APA procedures is provided below.

APA scope

Coverable issues: An APA can cover issues arising under IRC section 482,[8] other issues where transfer pricing principles are relevant, such as IRC section 367(d), competent authority issues under the business profits and associated enterprise articles of US tax treaties, the determination of effectively connected income of a US trade or business, and ancillary issues. The definition of ancillary issues includes the repatriation of funds arising from an APA adjustment, and explicitly provides for addressing interest on refunds and deficiencies (i.e., statutory interest) and penalties. The prior APA procedures did not address statutory interest and penalties, and treatment of those items was inconsistent in practice. Thus, the inclusion of statutory interest and penalties as a coverable issue is a welcome addition and likely to be helpful for bilateral and multilateral APAs.

If a covered issue is the transfer of intangible property (which does not constitute a platform contribution transaction) the APA may provide that such transfer will not be subject to periodic adjustments, during or after the APA term, under Treas. Reg. §1.482-4(f)(2) or (6). If a covered issue is a platform contribution transaction, the APA may provide that such transaction will not be treated as a "trigger PCT" within the meaning of Treas. Reg. §1.482-7(i)(6)(i) for purposes of making periodic adjustments, during or after the APA term, under Treas. Reg. §1.482-7(i)(6).

Scope expansion: The final APA procedures state that in some cases the IRS may need to consider additional, interrelated issues (including additional APA covered transactions), additional taxable years, or additional treaty countries to reach a resolution that is in the interest of principled, effective, and efficient tax administration. The IRS will endeavor to communicate to the taxpayer any concern about interrelated matters, and any possible need to

[8] Internal Revenue Code references are to the Internal Revenue Code of 1986 and the regulations thereunder, as amended.

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expand the scope of the APA, as early as possible in the APA process. The IRS, after considering the taxpayer's and the foreign competent authorities' views, may condition its acceptance, continued consideration, or resolution of an APA request upon the agreement of the taxpayer (and, if applicable, of the foreign competent authorities) to expand the scope of the APA. The final procedures provide some helpful examples of situations in which the IRS may be inclined to expand an APA's scope.

Rollbacks

Expanding the definition of an "APA term" to include "rollback years" is a taxpayer-favorable development. Now an APA term includes both "prospective years" and "rollback years." The prior APA procedures allow for rollbacks, but the implementation of the rollback was handled separately through a closing agreement that frequently involved different IRS personnel than those drafting the APA. Additionally, a special provision amends Rev. Proc. 2006-9 to provide similar treatment of rollback years under prior APA procedures; accordingly, taxpayers with currently pending APA requests can include rollback years in the executed APA. By including rollback years in the APA term, the final APA procedures create an additional annual reporting burden in that APA annual reports must be filed for both prospective and rollback years, whereas the prior APA procedures require the filing of such reports only for prospective years.

As noted above, APMA can request expanding the scope of the APA request to include rollback years. More so than under the prior APA procedures, a taxpayer contemplating an APA must consider the implications of an APA on open tax years, and consider whether there are distinguishing features between the APA years and the open tax years on which the IRS might impose a rollback.

The final APA procedures are coordinated with the final competent authority procedures. Because rollback years are frequently the subject of ongoing or anticipated competent authority matters, APMA seeks to achieve substantive and procedural consistency under APA procedures and competent authority procedures. Depending on the facts, APMA may encourage a taxpayer seeking an APA to expand the APA to include a rollback. Conversely, APMA may encourage (but not require) a taxpayer requesting competent authority assistance to request accelerated competent authority procedure (ACAP) to extend the competent authority resolution and in some cases may encourage (but not require) the taxpayer to request an APA.

Prefiling procedures

The final APA procedures include extensive prefiling requirements that under certain circumstances are required before an APA request will be accepted. As in the past, APMA will allow informal consultations on an anonymous basis (although a second prefiling conference on a named basis may be required).

Prefiling memorandum: A prefiling memorandum must be filed if: (i) the taxpayer wishes to file a unilateral APA request that could be covered under a bilateral or multilateral APA; (ii) the taxpayer seeks to file an abbreviated APA request; or (iii) the covered issues involve the license or other transfer of intangibles in connection with an intangible development arrangement (for example, a cost sharing arrangement or similar), a global trading

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arrangement, a restructuring, or unincorporated branches, passthrough entities, hybrid entities, or entities disregarded for US tax purposes. A taxpayer not required to file a prefiling memorandum may still file such a memorandum.

The prefiling memorandum must have length and content appropriate to the size and complexity of the covered issues proposed by the taxpayer. Additionally, the prefiling memorandum must state whether the taxpayer seeks a prefiling conference, the issues expected to be covered, three possible dates for the conference, and covered issue diagrams. If the prefiling memorandum seeks an abbreviated APA request, it must include the proposed content of an abbreviated APA request, arguments to support filing an abbreviated APA request, and in the case of a renewal APA, a presentation of the results under the current APA and a summary of proposed changes from the current APA.

Prefiling conference: If a prefiling conference is granted, the taxpayer should be prepared to discuss the relevant facts and circumstances, the covered issues, proposed method(s), and terms and conditions it proposes to cover in the APA. If APMA declines the taxpayer's prefiling conference request or decides that no prefiling conference is required, APMA will direct the taxpayer as to how to proceed with its APA request.

Preference for bilateral and multilateral APAs

Both the final and prior APA procedures express a preference for bilateral and multilateral APAs over unilateral APAs. A taxpayer requesting a unilateral APA must explain in a prefiling memorandum why a unilateral APA is appropriate. Acceptable reasons are that there is no applicable treaty for a bilateral APA, or that a bilateral APA is not practical to cover the issue (for example, if the transaction is small in magnitude in each country but large in magnitude on an aggregate basis).

In a departure from the prior APA procedures,9 the final APA procedures indicate that APMA may decide to decline a competent authority request in the event of a foreign-initiated adjustment involving issues covered by a unilateral APA. Accordingly, taxpayers need to be cautious about entering into unilateral APAs with the IRS. For example, historically some taxpayers have sought separate bilateral and unilateral coverages as part of one APA request. In seeking an APA under the final APA procedures, taxpayers may consider obtaining explicit assurance in the unilateral APA that in the event of a foreign-initiated adjustment covered by the unilateral APA, the IRS agrees not to reject its competent authority request.

Restricted consents to extend the limitations period for assessment

The final APA procedures provide additional guidance on the circumstances under which the IRS will allow a restricted consent. Specifically, a taxpayer may request a restricted consent if there are no issues other than the covered APA issues under examination by the IRS. Further, requests for a restricted consent must be made no later than 15 months before the end of the

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[9] See Rev. Proc. 96-53, §7.08 (Under regular competent authority procedures on settled issues at that time, the IRS would not seek to change the outcome of a settled issue and would seek to obtain only correlative relief; however, such limitations did not apply to unilateral APAs.). Rev. Proc. 2004-40, §6.07; Rev. Proc. 2006-9, §7.07.

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remaining period of limitations, and the taxpayer must provide an explanation as to why a restricted consent is appropriate.

User fees

Under the final APA procedures, user fees increase from $50,000 to $60,000 for new APA requests. For APA requests qualifying as “small case APAs,” the new user fee is $30,000. The definition of a small case APA is much narrower than the definition of a “small business taxpayer request” under the prior APA procedures. An APA request is eligible for the small case APA user fee only if all of the following apply:

- The controlled group has sales revenues of less than $500 million in each of its most recent three back years;
- The aggregate value of the proposed covered issue(s) is not expected to exceed $50 million in any given year of the proposed APA years;
- The aggregate value of any transfer of rights in, or rights to use, intangibles is not expected to exceed $10 million in any given year of the proposed APA years; and
- No proposed covered issue involves intangible property arising from, or otherwise related to, an intangible development arrangement.

The prior APA procedures provided for (i) a small taxpayer APA request for multinational enterprises with worldwide revenues less than $200 million and (ii) a small transaction APA request for transactions that did not exceed $50 million in total and $10 million with respect intangible property transactions. In practice, very few requests under the prior APA procedures qualified as small business taxpayer requests, but instead qualified as small transaction APA requests.

Notwithstanding the increase in the revenue threshold from $200 million to $500 million for small business taxpayers, substantially fewer APA requests are expected to qualify as small case APAs under the final APA procedures compared to the prior APA procedures. The practical impact is that APA requests that previously would have qualified for small business taxpayer APAs will now be subject to substantially higher user fees: (i) for new APA requests, $60,000 under the final APA procedures compared to $22,500 under the prior APA procedures; and (ii) for renewal APA requests, $35,000 under the final APA procedures compared to $22,500 under the prior APA procedures.

Time for filing an APA request

To cover a prospective year, a complete APA request must be filed no later than the “applicable return date” (the later of (i) the actual return filing date or (ii) the return due date without regard to extensions). Additionally, for a bilateral or multilateral APA request, the APA request must be filed with the corresponding competent authority within 60 days. Otherwise, the first proposed APA year will be treated as a rollback year. The purpose of this new requirement is to better coordinate the timing of discussions between the competent authorities.

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As in the past, the final APA procedures permit "dollar-file" requests whereby a taxpayer pays the user fee by the applicable return date and files a complete APA request within 120 days of such date.

Complete APA requests

The final APA procedures clarify when the APA request is considered complete and explicitly allow for minor deficiencies to be cured. Curing such deficiencies will relate back to the time of the original filing of the APA request. A similar approach is taken for incorrect user fees.

Similar to the proposed procedures, the final procedures provide a detailed list, included in the Appendix to Rev. Proc. 2015-41, of the items to be included in a complete APA request. The prescribed format and required items represent a substantial change from current practice and will increase the burden on taxpayers.

Unlike the prior APA procedures, the final APA procedures place a strong emphasis on presenting the entire value chain in relation to the covered transactions. Accordingly, a complete APA request includes "covered issue diagrams," which are relevant tax, legal, and management structures and the value chain relating to the covered issues. Taxpayers are asked to use the format used in the diagrams accompanying the case studies "Alpha" through "Foxtrot" of the Joint Committee on Taxation's report "Present Law and Background Related to Possible Income Shifting and Transfer Pricing."[10]

Conforming adjustments

When there is an adjustment arising from an APA (an "APA primary adjustment"), a further adjustment is needed to conform the account of the affected members of the affiliated group. If the taxpayer desires, the conforming adjustment may be made by a repatriation of funds between the affected group members. Unlike the prior APA procedures, the final APA procedures require taxpayers seeking a bilateral or multilateral APA to request competent authority repatriation before a tentative competent authority resolution is reached, although the procedures are not clear as to whether this requirement applies to uncompleted years or completed years for which the APA primary adjustment has not yet been computed. Taxpayers may wish to address repatriation issues before completion of competent authority negotiations.

For unilateral APAs, taxpayers must follow Rev. Proc. 99-32; for bilateral and multilateral APAs, taxpayers must follow the repatriation rules in the final competent authority procedures.

Same information to all competent authorities

The final APA procedures require taxpayers to provide both (or all) competent authorities with any written responses, analyses, or other documents they provide to one competent authority, whether such materials are provided in response to a request from a competent authority or are submitted voluntarily by taxpayers in support of their APA requests.

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[10] Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing (JCX-37-10), July 20, 2010.

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IRS Releases New Competent Authority Revenue Procedure

The Internal Revenue Service (IRS) on August 12 released Revenue Procedure (Rev. Proc.) 2015-40, which provides guidance on the process of requesting and obtaining competent authority assistance under the mutual agreement procedure (MAP) article of US tax treaties.

Rev. Proc. 2015-40 updates and supersedes Rev. Proc. 2006-54. The revenue procedure is applicable to the following types of requests: (1) cases arising under the associate enterprises and business profits articles of US tax treaties; and (2) cases arising under all other articles of US tax treaties. Rev. Proc. 2015-40 is effective for competent authority requests filed on or after October 30, 2015.

The Rev. Proc. was issued concurrently with Rev. Proc. 2015-41, which provides guidance on advance pricing agreements (APAs). Many of the changes in the Rev. Proc. are consistent with similar changes in the new APA procedures.

A proposed version of Rev. Proc. 2015-40 was released for public comment in Notice 2013-78 (the notice). The IRS received numerous comments on the notice, and in finalizing Rev. Proc. 2015-40 made some welcome amendments to reflect a number of concerns raised by taxpayers and practitioners. Overall, Rev. Proc. 2015-40 provides a greater level of transparency in terms of the process of requesting and obtaining competent authority relief, and will be useful reading for taxpayers unfamiliar with the competent authority process. However, Rev. Proc. 2015-40 imposes significantly more information and procedural requirements on taxpayers than the prior guidance.

Summary

A summary of the salient changes under the final revenue procedure is provided below.

Assistance for taxpayer-initiated transfer pricing adjustments: Consistent with the proposal contained in the notice, Rev. Proc. 2015-40 allows requests for assistance arising from taxpayer-initiated transfer pricing adjustments. In the past, the IRS generally has not accepted such cases, on the basis that double taxation was not the result of government action as predicated in the MAP article of the relevant tax treaties. This would allow US taxpayers to proactively address foreign transfer pricing risks in a manner that would otherwise be prohibited by Treas. Reg. §1.482-1(a)(3). The taxpayer must submit a prefiling memorandum (see below) prior to filing its request for assistance. The IRS reserves the right

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to deny requests for assistance for taxpayer-initiated positions if the taxpayer failed to request the assistance of the foreign competent authority and the US competent authority in a timely manner in relation to the taxable year for which relief is sought, or the taxpayer otherwise has pursued competent authority assistance in a way that has undermined or prejudiced the competent authority process or has impeded the US or foreign competent authority from engaging in full and fair consultations on the competent authority issue(s). This is a welcome addition, given the IRS's historical policy position regarding taxpayer-initiated adjustments.

Mandatory prefiling memoranda/conferences: In welcome news, Rev. Proc. 2015-40 requires mandatory prefiling procedures only for proposed competent authority requests that involve a taxpayer-initiated adjustment. The notice required mandatory prefiling procedures for a wide variety of circumstances, which would have significantly increased the administrative burden on taxpayers, particularly in light of the time frames contained in most US tax treaties under which a taxpayer must file a request for competent authority assistance. A taxpayer must submit a prefiling memorandum prior to filing a competent authority request for a taxpayer-initiated adjustment with the specific information set out in Rev. Proc. 2015-40, and once received, the US competent authority will decide whether to hold a prefiling conference with the taxpayer. Rev. Proc. 2015-40 also lists the following issues for which an optional prefiling conference is recommended by the US competent authority:

- A foreign-initiated adjustment that exceeds $50 million for all competent authority years combined;
- A competent authority issue that is likely to involve interrelated issues;
- An intangible development arrangement;
- A business restructuring;
- A global trading arrangement;
- An unincorporated branch, passthrough entity, hybrid entity, or entity disregarded for US tax purposes;
- A discretionary limitation on benefits (LOB) request; or
- A competent authority issue that has arisen outside the context of an examination, for example, through the withholding of tax by a withholding agent or a ruling or promulgation issued by a foreign tax authority.

Scope of requests for assistance: To ensure that taxpayers have broad access to the US competent authority to resolve disputes under US tax treaties, Rev. Proc. 2015-40 provides that taxpayers are not required to expand the scope of a competent authority request to include interrelated issues as a condition of receiving competent authority assistance, as proposed in the notice. However, the US competent authority may determine during the competent authority process that it cannot reach a competent authority resolution consistent with principled, effective, and efficient tax administration unless it evaluates the relief sought by the taxpayer in light of whether such relief, together with the taxpayer's position on interrelated issues, would yield consistent and appropriate results.

Rev. Proc. 2015-40 provides examples of interrelated issues and notes that the US competent authority may request, in writing, that the taxpayer amend its competent authority request to include interrelated competent authority issues identified by the US competent authority. Rev. Proc. 2015-40 states that taxpayers should be prepared to provide information on interrelated issues throughout the competent authority process. If a taxpayer declines to amend its

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request, the US competent authority will still endeavor to reach a resolution, but it will take into account the taxpayer's position on interrelated issues in determining the extent to which it will provide relief for the matters in the competent authority request. Rev. Proc. 2015-40 also provides that the US competent authority may encourage (but will not formally request or require) taxpayers to extend competent authority resolutions forward into APAs or accelerated competent authority procedure (ACAP) years.

Informal advice and consultation: The US competent authority is available for informal consultations with taxpayers (including consultations in which the taxpayer chooses to be anonymous) regarding any competent authority issue. Any such informal advice is advisory only and is not binding on the IRS. Rev. Proc. 2015-40 also provides that the US competent authority is available for informal consultations on issues that arise in connection with competent authority issues (e.g., advice regarding whether a taxpayer has exhausted all effective and practical remedies to reduce its liability under foreign law for tax within the meaning of Treas. Reg. 1.901-2(e)(5) and Revenue Ruling 92-75). In practice, informal consultations have always been available; however, the new revenue procedure makes such consultations explicitly available.

Protective claims and treaty notifications: Under Rev. Proc. 2015-40, an annual notification of a protective claim and treaty notification must be filed following the close of each taxable year ending after the taxable year in which the taxpayer filed the protective claim, but no later than the date on which the taxpayer timely files a tax return for such taxable year. Under the old revenue procedure, the annual notification was required to be filed every 12 months until the formal request for competent authority assistance was filed. The authors have clarified with the IRS APMA Team that the new annual notification rules under Rev. Proc. 2015-40 will apply only for original and annual update protective claims and treaty notifications filed on or after October 30, 2015. Rev. Proc. 2015-40 indicates that a template treaty notification will be made available.

Content and form of competent authority request: The appendix to Rev. Proc. 2015-40 sets forth the required contents of a competent authority request and specifies the order in which such contents should be presented. A competent authority request must comply with all such requirements before it will be considered complete. The new revenue procedure considerably expands the scope of information that must be submitted and outlines specific requirements for cases filed with the Advance Pricing and Mutual Agreement (APMA) program, cases filed with the Treaty Assistance and Interpretation Team (TAIT), discretionary LOB requests, and pension plan requests.

Small case competent authority requests: Consistent with the proposal contained in the notice, Rev. Proc. 2015-40 increases the threshold amounts at issue for a small case competent authority request from $1,000,000 to $5,000,000 for corporations and partnerships and from $200,000 to $1,000,000 for others (including individuals). Certain cases are excluded from qualifying for a small case competent authority request, including if it (a) arises from a taxpayer-initiated position; (b) is a discretionary LOB request; or (c) is a pension plan request filed by a person other than an individual plan participant. While the increased thresholds are welcome, it is unclear exactly what benefit the small case procedures will offer, because a taxpayer that meets the threshold amounts must seek an exemption from the usual competent authority request content requirements by contacting the TAIT or APMA, as appropriate. In

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addition, even if the US competent authority initially agrees to abbreviate the usual competent authority requirements, the US competent authority may subsequently require the taxpayer to supplement its competent authority request with any or all of the information required.

Coordination with US administrative and judicial proceedings: Unlike the proposal contained in the notice, Rev. Proc. 2015-40 does not condition acceptance on the taxpayer's notification of the US competent authority, or on obtaining its concurrence, with respect to signing a standard Form 870 with IRS examination. Similarly, a taxpayer will not be required to obtain the US competent authority's agreement prior to entering into a Form 870-AD, closing agreement, or similar agreement with IRS examination, but in those cases the assistance provided by the US competent authority will be limited to seeking correlative relief from the foreign competent authority, thus potentially not eliminating double taxation. Rev. Proc. 2015-40 notes that this is a change from the notice consistent with the objective of providing taxpayers with broad access to the US competent authority to resolve disputes under US tax treaties.

A taxpayer may request the simultaneous appeals procedure (SAP) as part of its competent authority request or in a separate written submission filed no later than 60 days after the taxpayer receives notification that the US competent authority has accepted its competent authority request. The US competent authority in its sole discretion will decide whether to accept the taxpayer's request for SAP review after consulting with IRS appeals and after considering whether SAP review would unduly burden tax administration, including the competent authority process. For a competent authority issue that is initially under the jurisdiction of the IRS Appeals, the US competent authority will decline to provide assistance unless the taxpayer effectively severs the issue from its protest and then timely files a US competent authority request with respect to the issue and meets the requirements set out in Rev. Proc. 2015-40. The new revenue procedure also provides for transitional rules for cases in which the competent authority issue is before IRS appeals or the IRS has issued a 30-day letter notifying a taxpayer of the right to request IRS Appeals prior to the effective date.

Acknowledgement of receipt: The US competent authority will acknowledge to the taxpayer in writing that it has received a competent authority request. The acknowledgement will indicate whether the competent authority request is complete and whether the US competent authority accepts the request. The acknowledgement will also provide the name and contact information of the APMA team leader, the TAIT analyst, or the members of the combined APMA-TAIT team to which the request has been assigned and any supplemental instructions.

Denial of assistance: The US competent authority may decline to accept a competent authority request or may cease providing assistance at any point after the process has commenced. Rev. Proc. 2015-40 sets out circumstances in which this may occur, including:

- The taxpayer fails to comply with procedural requirements set out in the revenue procedure, after having been provided reasonable opportunity to correct or remedy any deficiencies.
- The taxpayer is not eligible for the treaty benefit.
- The taxpayer's conduct has undermined or been prejudicial to the competent authority process. Examples of such conduct include:

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- The taxpayer agreed to or acquiesced in a foreign-initiated adjustment or entered into a unilateral APA with a foreign tax authority, involving significant legal or factual issues in a manner that impeded the US competent authority from engaging in full and fair consultations with the foreign competent authority on the competent authority issues.
- The taxpayer entered into a unilateral APA with the IRS when the competent authority issue could reasonably and practically have been covered if the taxpayer had instead pursued a bilateral APA.
- The taxpayer rejected a request to extend the period of limitations for assessment of tax for taxable periods (including ACAP years) covered by the competent authority request.
- The taxpayer has failed to comply with the provisions of sections 6.03, 6.04, and 6.05 governing coordination between the competent authority process and administrative and judicial proceedings, or has pursued its rights within such proceedings and within the competent authority process in a way that has undermined or is prejudicial to the competent authority process.
- The taxpayer has presented new material information or evidence during the competent authority process that reasonably could have been presented to IRS Examination during the examination of the taxable years covered by the competent authority request.
- In competent authority requests or competent authority cases involving taxpayer-initiated positions, the taxpayer failed to request the assistance of the foreign competent authority and the US competent authority in a timely manner in relation to the taxable year for which relief is sought, or the taxpayer otherwise has pursued competent authority assistance in a way that has undermined or prejudiced the competent authority process or has impeded the US or foreign competent authority from engaging in full and fair consultations on the competent authority issue(s).

Rev. Proc. 2015-40 makes it clear that the US competent authority's decision as to whether a competent authority request is complete, or to deny, suspend, or terminate assistance, is final and not subject to administrative review.

Competent authority repatriation: Rev. Proc. 2015-40 sets out the requirements for when the US competent authority will consider competent authority repatriation. Competent authority repatriation allows for specific treatment of repatriation payments when a competent authority resolution makes a primary adjustment to income, deductions, credits, allowances, basis, or any other item or element affecting taxable income between two members of a controlled group, as a means to conform their accounts to reflect the primary adjustment. When a competent authority resolution includes competent authority repatriation for a particular taxable year, that treatment replaces the treatment that otherwise would be available for that taxable year under Rev. Proc. 99-32. The terms of the competent authority repatriation may reflect a prevailing practice with a treaty partner, as well as circumstances specific to a particular case, and may include, among other things, a waiver of intercompany interest on repatriation payments made within a certain time period. The Rev. Proc. notes that repatriation will not be granted if (i) the US competent authority terminates assistance with respect to the competent authority request; (ii) the competent authority request involves issues that previously were

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decided in litigation or covered by a closing agreement or other similar agreement; or (iii) the taxpayer rejects the competent authority resolution.

Arbitration procedures: Rev. Proc. 2015-40 includes general procedural issues associated with mandatory arbitration provisions contained in the MAP articles of some US tax treaties. Those provisions require the competent authorities to refer certain MAP cases to mandatory arbitration in the event they are unable to negotiate a mutual agreement within a prescribed time period after the "commencement date." The US Competent Authority generally takes the position that the commencement date occurs when it has received a complete competent authority request as described in Rev. Proc. 2015-40. The US competent authority will notify the US taxpayer when the commencement date is established.

User fees: Consistent with the prior revenue procedure, in general, no user fee is required for a competent authority request. A $32,500 user fee is required for all requests for discretionary LOB relief filed on or after October 30, 2015, and prior to September 30, 2016. A $37,000 user fee is required for all requests for discretionary LOB relief filed on or after September 30, 2016. This is a significant increase in the user fee of $15,000 under the prior revenue procedure and the $27,500 proposed in the notice.

Requirement to provide same information to both tax authorities: Under Rev. Proc. 2015-40, a competent authority request filed with the IRS must include a description or discussion of any related requests for assistance submitted to the foreign competent authority, together with a thorough, informative explanation of any material differences between the competent authority request filed under Rev. Proc. 2015-40 and the request filed with the foreign competent authority. The US competent authority may request that the taxpayer provide a full or partial copy of the corresponding request submitted to the foreign competent authority. In addition, the taxpayer must provide both the US and the foreign competent authority any information, documents, or analyses at approximately the same time, requested by or submitted to either competent authority. In practice, the requirement that taxpayers must provide both the US and the foreign competent authority the same information has always been observed; however, the new revenue procedure explicitly incorporates it into official guidance.

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