In this issue:

China's SAT issues new rules on reporting of related-party transactions and contemporaneous documentation.......... 1
United States issues final country-by-country reporting regulations 11
OECD releases discussion draft on revised guidance on profit splits.......... 16
Belgium finalizes mandatory transfer pricing reporting requirements.......... 20
OECD issues additional guidance on CbC reporting 21
Ireland introduces bilateral APA program 23
OECD approves incorporation of BEPS amendments into transfer pricing guidelines.......... 25
In *Medtronic*, US Tax Court rules against IRS's use of CPM, applies CUT method.......... 25
European Union's CbC reporting directive enters into effect 28
Indian tribunal rules on adjustments in relation to interest-free loans from foreign parent to Indian subsidiary 29

China's SAT issues new rules on reporting of related-party transactions and contemporaneous documentation

China's State Administration of Taxation (SAT) on June 29 issued new regulations[1] to improve the reporting of related-party transactions and contemporaneous documentation. SAT Bulletin [2016] No. 42, published on the SAT's website

[1] See full text in Chinese.
URL: http://www.tax.sh.gov.cn/pub/xxgk/zcfg/ssxd/201607/t20160713_425681.html

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

on July 13, will replace the existing transfer pricing documentation regulations in Circular Guoshuifa [2009] No. 2, known as Circular 2.

Unlike Circular 2, which covered various aspects of special tax adjustments comprehensively, Bulletin 42 deals only with the reporting of related-party transactions and contemporaneous documentation. Our understanding is that additional regulations will be issued to complete the revision of Circular 2.[2] Bulletin 42 will apply from 2016, and the applicable sections in the old regulations (Chapters 2 and 3, and Articles 74 and 89 of Circular 2; and Circular Guoshuifa [2008] No. 114) will be repealed.

Bulletin 42 introduces a three-tiered documentation framework, as set out in the OECD's final report on BEPS Action 13, while requiring technical analysis and consideration of positions that are familiar to the China market – for example, the impact of location-specific advantages on pricing arrangements. Requirements that were included in the September 2015 discussion draft revision to Circular 2, including country-by-country reports, master file and local file, the special issue file, and value chain analysis are covered as well by Bulletin 42.

Bulletin 42 addresses issues that have been the focus of the Chinese tax authorities' interest for years, deals with practical issues they have experienced, and provides a new landscape for transfer pricing practice and management in China. Additionally, the localization and implementation of BEPS Action 13 in China is a milestone in the internationalization of China's transfer pricing practice.

Recognition of related-party relationships and related-party transactions

Bulletin 42 updates the related-party relationship definitions from the September 2015 discussion draft, refines the existing rules, and expands them to ensure that relationships between natural persons are taken into account when considering the relationship between two parties. The bulletin also clarifies certain issues, such as the determination of the debt-to-equity ratio, and provides that two parties will be considered related if they have "other substantial common interests." There are also changes to reflect public comments on the detailed rules regarding relationships involving directors on boards and senior management personnel. In addition, the regulation recognizes that related-party relationships may change, and relationships should be recognized during the periods when they exist.

The types of covered related-party transactions are updated from the existing Circular 2 definitions to more comprehensively cover the types of transactions that take place between related parties, expanding the potential coverage of special tax adjustments. The changes in the final regulation are effectively the same as those included in the September 2015 discussion draft, and cover tangible assets, financial assets (for example, equity investments), intangible assets, financing transactions (such as cash pooling, guarantee fees, and all kinds of interest accrued advances and deferred payments) and service transactions.

Reporting of related-party transactions

Key changes: Bulletin 42 includes the formal templates and filing instructions for the Annual Related Party Transactions Reporting Forms (the "new forms"). These new forms entirely replace the previous nine forms, and increase the total number of forms to 14. Overall, the information disclosure requirements are increased, and the new forms also include the country-by-country (CbC) reporting form. Please refer to the appendix for a comparative analysis of the original forms and the new forms.

The new forms will take more time to complete, given the increase in the number of forms and the fact that more detailed information is required. The design of the forms reflects the enhanced requirements of the tax authorities regarding disclosure, especially for related-party relationships and transactions, while also trying to streamline the preparation and reduce uncertainty in the filing process. The inclusion of the CbC form also shows how China has adopted the requirements of BEPS Action 13, and lays the foundation for future CbC information exchanges.

---

[2] A discussion draft revision to Circular 2 was published on September 17, 2015, for public consultation. See full text of the draft in Chinese.
URL: http://hd.chinatax.gov.cn/hudong/noticedetail.do?noticeid=577376

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

CbC reporting: The SAT has included the CbC form in the reporting forms of related-party transactions, and seems to require taxpayers to provide both Chinese and English versions simultaneously. Consistent with the treatment in the previous discussion draft, a CbC form will be required for the following taxpayers:

- China resident enterprises that are the ultimate parents of a multinational enterprise group, with consolidated revenue greater than RMB 5.5 billion in the last fiscal year; or
- China resident enterprises that are nominated by the multinational group as the filing entity.

Bulletin 42 includes a number of definitions for determining the group parent and the member entities, consistent with the definitions in the BEPS Action 13 final report. Of interest to some taxpayers, the regulation partially or entirely exempts Chinese enterprises from the CbC filing obligation if the information relates to "national security." Similar exemptions have already been adopted by a few other countries. There are also provisions that allow the Chinese tax authorities to request copies of CbC reports from foreign tax authorities, as well as provisions to require the information from local entities if the foreign tax authorities do not provide the information.

Submission deadline

The filing deadline for the new forms is generally the same date as the income tax annual filing deadline, which is May 31 of the following year.

Contemporaneous documentation: A major focus of the feedback on the September 2015 discussion draft was the three-tiered framework for transfer pricing documentation. The master file and local file requirements in Bulletin 42 are generally similar to those included in the discussion draft, with revisions to the thresholds for preparation. The requirement for the special issue file for service transactions has been removed, although the analysis for service transactions is now required to be incorporated into the local file along with information regarding equity transfers. Of particular note, the regulation retains the high disclosure requirements of the September 2015 discussion draft, meaning the value chain analysis, location specific advantages, and other matters of concern to the SAT will be required. It has been confirmed that transactions with related parties in Hong Kong, Macau, and Taiwan will also be considered cross-border related-party transactions. The deadlines for preparing the documentation have also been revised.

The following table compares the requirements under Bulletin 42 and the existing Circular 2 for the thresholds to prepare contemporaneous documentation.

Item	Circular 2 (Chapter 3)	Bulletin 42
Report structure	**China country file only**	**Three-tiered framework (master file, local file, and special issue file)**
Threshold for preparation	• The annual sum of related-party purchases and sales is greater than RMB 200 million (for toll manufacturing businesses, the amount is calculated based on the import/export customs declaration prices); or • The annual sum of other related-party transactions is greater than RMB 40 million (for related-party financing, the amount is calculated based on the interest received/paid) The value of related-party transactions under a cost sharing arrangement (CSA) or advance pricing agreement (APA) will not be counted in determining the above annual sum of related-party transactions.	Master file requirement applies to: 1. An enterprise that has transactions with overseas related parties during the year, and the ultimate holding company of the enterprise group, which consolidates the enterprise into its financial statements, has prepared a master file; or 2. An enterprise that has related-party transactions, the aggregate value of which exceeds RMB 1 billion during the year. Local file requirement applies when: 1. The annual sum of related-party purchases/sales is greater than RMB 200 million (for toll manufacturing activities, the amount is calculated

© 2016. For information, contact Deloitte Touche Tohmatsu Limited.

Item	Circular 2 (Chapter 3)	Bulletin 42
		based on the import/export customs declaration prices); 2. The annual sum of related-party purchases/sales of financial assets or intangible assets is greater than RMB 100 million; or 3. The annual sum of other related-party transactions is greater than RMB 40 million. The value of related-party transactions under a concluded APA will not be counted in determining the above annual sum of related-party transactions. Special issue file requirement applies when: 1. An enterprise enters into or implements a CSA; or 2. An enterprise with a debt-to-equity ratio exceeding the threshold[3] wishes to prove its related-party financing's compliance with the arm's length principle
Exempt from preparation	• Related-party transactions are covered under an effective APA; or • The foreign shareholding percentage is lower than 50 percent and related-party transactions occur only among domestic associated parties.	• If the enterprise's related-party transactions are only between the enterprise and its domestic related parties, the enterprise may be exempt from the requirement to prepare a master file, local file, and special issue file. • For enterprises that have entered into an APA, related-party transactions that are covered under the concluded APA may be exempt from the requirement to prepare a local file and special issue file.
Deadline for preparation	May 31 of the following year	• Master file: within 12 months of the fiscal year end of the group's ultimate holding company • Local file and special issue file: June 30 of the following year
Deadline for submission	Within 20 days upon a request from the tax authorities	Within 30 days upon a request from the tax authorities

The disclosure requirement for the master file is consistent with the BEPS Action 13 final report, while the information required for the special issue file aligns with the requirement for CSAs and thin capitalization under Circular 2. However, Bulletin 42 has significantly expanded the scope of information disclosure in the local file. Special attention should be paid to the following new requirements:

[3] The standard related-party debt-to-equity ratio is 2:1 for non-financial enterprises and 5:1 for financial enterprises (see Circular Caishui [2008] No. 121 issued by the Ministry of Finance and SAT on September 23, 2008).

© 2016. For information, contact Deloitte Touche Tohmatsu Limited.

- **Value chain analysis:** Details on transaction flows, the physical flow of goods, and cash flow within the group; allocation principles and actual allocation of group profits among the global value chain; and annual financial statements for the latest fiscal year of each of the group entities involved in the value chain;
- **Financial data:** Financial data for each type of business and product;
- **Equity transfer analysis:** An overview of equity transfers, information on the equity transferred, due diligence reports, and valuation report of any underlying asset for the transferred equity;
- **Related-party services analysis:** Separate analysis on related-party services, including the benefits for each party from the service transactions, methodology for determining the service costs, service items, service amount, allocation standards, calculation process and results, as well as the information on any similar service transactions the enterprise and its group enters into with third parties; and
- **Location-specific factors:** The impact of location-specific factors such as location savings and market premiums, on the pricing of transactions, and the portion of value creation from location-specific factors shared by the enterprise.

A comparison of the local file requirements of Bulletin 42 with the existing requirements under Article 14 of Circular 2 is set out below:

Disclosure requirement in local file	**Article 14 (Chapter 3 of Circular 2)**	**Bulletin 42**
A: Overview of the local entity	Organizational structure, management structure, industry description	
	• The group's organizational structure and shareholding structure • The group's consolidated financial statements The above information is now required in the master file.	• Business strategy: work flow, mode of operation and value contribution factors for each department and segment; • Financial data: financial data for each type of business and product, including details of turnover, costs, expenses, and profit; • A description of reorganizations or transfers of intangibles in which the local enterprise is involved or affected, and how the change affects the local enterprise
B: Related-party relationship	No significant change on the disclosure requirement, which includes information on related parties, tax rates applicable for each related party and any preferential tax treatments, and changes in related-party relationships during the fiscal year	

© 2016. For information, contact Deloitte Touche Tohmatsu Limited.

<table>
<tr><th>Disclosure requirement in local file</th><th>Article 14 (Chapter 3 of Circular 2)</th><th>Bulletin 42</th></tr>
<tr><td rowspan="2">C: Related-party transactions</td><td colspan="2">Description and details of related-party transactions, business processes for related-party transactions, description of functions and risks, the impact of intangible asset on the pricing of related-party transactions, financial information for the related-party transactions</td></tr>
<tr><td>“Analysis Form of the Functions and Risks of Enterprises” and “Analysis Form of the Financial Conditions of Enterprises’ Related Party Transactions” (the latter has been moved to the new reporting forms of annual related-party transactions)</td><td>The impact of location-specific factors on the pricing of related-party transactions
Value chain analysis
Outbound investment: information on outbound investment, overview of outbound investment projects, and project data of the outbound investment project
Related-party equity transfer
Related-party services: benefits to each party, methods to determine the service costs, service items, service amount, allocation standards, calculation process and results
APAs in foreign countries and other competent authorities’ tax rulings that are directly related to the enterprise’s related-party transactions</td></tr>
<tr><td>D: Comparability analysis</td><td colspan="2">No significant change on the disclosure requirement, which includes factors considered in the comparability analysis, information on functions, risks, and assets of comparable enterprises, the search method, source, selection criteria and rationale for the comparables, financial information of the comparable uncontrolled transactions and comparable enterprises and adjustments to the comparable data.</td></tr>
<tr><td rowspan="2">E: Selection of transfer pricing methods</td><td colspan="2">The selection of the transfer pricing method, and the rationale for the selection; any assumptions and judgements made in the process of determining the arm’s length prices or profits; application of the reasonable transfer pricing methods and results to determine the arm’s length prices or profits; and other information to justify the selection of the transfer pricing method.</td></tr>
<tr><td>Explanation on the enterprise’s contribution to the group’s overall profit or residual profit, only when a profit-based transfer pricing method is applied</td><td>The selection of the tested party and the rationale
Analysis and conclusion whether the arm’s length principle is complied with
Explanation of the enterprise’s contribution to the group’s overall profit or residual profit, irrespective of the selected method</td></tr>
</table>

It should be noted that Bulletin 42 replaces only the documentation regulations of the existing Circular 2. Deloitte is of the opinion that other transfer pricing circulars regarding contemporaneous documentation are still valid (notably Circulars Guoshuihan [2009] No. 363 and Guoshuihan [2009] No. 188). This means that loss-making foreign-owned enterprises with limited functions and risks, and enterprises during the follow-up periods should continue to file contemporaneous documentation regardless of whether they have reached the thresholds prescribed in Bulletin 42.

Legal responsibility: Taxpayers’ legal responsibility to comply with the regulation has not changed. If an enterprise fails to file the reporting forms on related-party transactions or contemporaneous documentation on time, the tax authorities may require the enterprise to make a correction, and may impose a penalty of no more than RMB 2,000. For serious violations, such as continued noncompliance, penalties between RMB 2,000 and RMB 10,000 could be

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

imposed. Of more significance than the direct penalties, noncompliance means that when conducting special tax adjustments, the tax authorities may charge an additional 5 percent interest above the RMB base loan rate published by the People's Bank of China. In addition to the aforementioned penalties, enterprises that fail to file their contemporaneous documentation on time will be exposed to a higher risk of transfer pricing audit under the related regulations.

Bulletin 42 confirms that the aforementioned additional 5 percent interest may be waived if the enterprise has appropriately reported its related-party transactions, submitting the contemporaneous documentation and other relevant materials. Such a waiver is provided to encourage compliance with the transfer pricing documentation requirements.

Deloitte observations: There is no doubt that Bulletin 42 will require multinational enterprises to invest more time and resources to meet China's contemporaneous documentation and reporting requirements. In particular for the master file requirements, the absence of a consistent threshold or filing requirement from the OECD means that China's regulations may be different from other those of other countries. There could be difficulties when a foreign parent company is not required to prepare a master file in the country where it is located, while its Chinese subsidiary is required to prepare a master file under Chinese domestic law.

Bulletin 42 requires taxpayers to provide some sensitive and complicated information in the new forms and in the contemporaneous documentation, and in some cases communication between the local filing enterprises and their overseas related parties is required. The depth and scope of the content that must be analyzed has increased significantly. Taxpayers should take early action to ensure that they are ready for this significant change, ensuring that they are communicating with their related parties to ensure that information can be gathered on time. Furthermore, given the increased disclosure requirements and collaboration and sharing between tax authorities, taxpayers will need to improve the efficiency of information collection, control compliance costs, and maintain consistency in the transfer pricing information disclosed globally.

It is worth noting that the Multilateral Convention on Mutual Assistance in Tax Collection entered into force in China effective February 1, 2016, with implementation from January 1, 2017.[4] More than 130 countries will be able to exchange tax information with China at that time. On May 12, 2016, as one of the most important results of the tenth Forum on Tax Administration (FTA), the SAT signed the CbC Multilateral Competent Authority Agreement, along with Canada, India, and other countries, agreeing to the automatic exchange of CbC reports for multinational enterprise groups. As of late June, the number of signatories to the agreement had reached 44. At the same time, Japan, the United States, and many developed countries are drafting or have announced their national regulations for CbC reports. Thus, multinational enterprises will face stricter requirements on information transparency and compliance.

The OECD recently published additional guidance on filing requirements for CbC reports. The guidance made suggestions on several outstanding issues, including the filing of CbC reports during the transition period, and the effect of fluctuations of exchange rates on the filing threshold. Attention should be paid to whether the additional guidance will cause any changes to filing regulations in different countries.

Overall, information required to be disclosed (e.g., comprehensive analysis and disclosure of group value chains and related-party transactions) through the reporting of related-party transactions and contemporaneous documentation will be more transparent and the information exchange between tax authorities of different jurisdictions will be much more extensive and efficient. This will enable the Chinese tax authorities to exert more control than before over taxpayers' information for the purpose of risk assessment and determining the targets of tax audits, and will allow the SAT to participate more actively in global anti-tax avoidance action.

[4] See SAT Bulletin [2016] No. 4.

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

Appendix: Comparative analysis of original and new forms

Content	Original Forms	New Forms	Comparative analysis and points to note
Basic information	Cover page	Cover page and form number index	The new forms' cover page and form number index are in similar formats as the Annual Enterprise Income Tax Return of the People's Republic of China (Type A, 2014 Version) (the "EIT return"), with requirements on the statements and signature of legal representative, and the signature of taxpayer, agency and tax authorities.
		Reporting Enterprise Information Form (G000000)	Under the current practice, the original forms are generally submitted with the EIT return as an appendix, and the taxpayer's relevant information is not required. For the new forms, it appears to be a separate reporting package. A taxpayer now is required to provide information on the organization's structure, senior management, and shareholders apart from the basic information.
Summary of forms	Summary of Related-Party Transactions Form (Form 2)	Summary of Annual Related Party Transactions of Enterprises of the People's Republic of China (G100000)	In the new forms, the order of the forms has been adjusted and both related-party debt and equity information and information on CSAs are required to be listed separately in the summary form, echoing the requirements of the two kinds of special issue files and reflecting the regulatory focus. In addition, whether or not the filing of contemporaneous documentation is required, the summary form also reflects the new three-tier structure for documentation in Bulletin 42.
Related-Party Relationship Disclosure	Related-Party Relationships Form (Form 1)	Related-Party Relationships Form (G101000)	The new forms require the identification of the type of related-party relationships, and information on the starting and ending dates of or changes to related-party relationships.
Tangible Assets Transactions	Purchase and Sales Form (Form 3), Fixed Assets Form (Form 6)	Tangible Assets Ownership Transaction Form (G102000), Tangible Assets Use Right Transaction Form (G104000)	The new forms no longer differentiate between goods and fixed assets. Instead, the two forms are designed based on the nature of the related-party transactions (ownership and right to use). For goods purchases and sales transactions, the new forms cancelled the requirement to provide details for "foreign parties and transactions that account for more than 10 percent of total exports," "foreign parties and transactions that account for more than 10 percent of total imports," the amount of unrelated-party purchase and sales and the pricing method of related-party transactions. The new forms require the taxpayer to disclose the transaction details of related parties with the five highest total amounts of related-party transactions.

© 2016. For information, contact Deloitte Touche Tohmatsu Limited.

Content	Original Forms	New Forms	Comparative analysis and points to note
Intangible Assets Transactions	Intangible Assets Form (Form 5)	Intangible Assets Ownership Transaction Form (G103000), Intangible Assets Use Right Transaction Form (G105000)	Similarly, the two forms are now designed based on the nature of the related-party transactions (ownership and right to use), rather than the types of different intangible assets. The new forms require the taxpayer to disclose the transaction details of related parties with the five highest total amounts of related-party transactions. Taxpayers should ensure the disclosure is consistent with any information on intangible asset contracts (e.g., licensing agreements with foreign parties) that had already been disclosed to the tax authorities when the relevant contract was filed for tax purposes.
Financial Assets Transactions (new)		Financial Asset Transactions Form (G106000)	With the increasing number of tax avoidance investigations of related-party equity transfers, the tax authorities are paying attention to profit shifting through financial asset transactions. The introduction of the Financial Asset Transactions Form will help the tax authorities gather information on this new transfer pricing area.
Financial transactions	Financing Form (Form 7)	Financing Form (G107000)	The Financing Form requires the disclosure of transaction-by-transaction detailed information. According to the examples in the filing instructions, this new Financing Form will cover the disclosure of bill discounting, financing leases, group cash pooling, etc. The filing instructions also provide more examples to illustrate the broad definition of interest for transfer pricing purposes.
Related-party service transactions	Service Transaction Form (Form 4)	Related-Party Service Transactions Form (G108000)	Similarly, the Related-Party Service Transactions Form also requests disclosure of the top five related parties with transaction details and amounts. The pricing method is no longer requested. The filing instructions for this form include detailed examples of related-party service transactions that must be disclosed. Taxpayers should ensure the disclosure is consistent with any service contract information that had already been disclosed to the tax authorities when the relevant contract was filed for tax purposes.
Equity Investment (new)		Equity Investment From (G109000)	The form is newly introduced to disclose monthly equity investments, dividend distributions to taxpayers, etc.
Cost Sharing Agreements (new)		Cost Sharing Agreements Form (G110000)	The form is newly introduced to disclose preliminary information of cost sharing agreements between taxpayers and their related parties, which could be the basis for the tax authorities to further review the relevant special issue files

© 2016. For information, contact Deloitte Touche Tohmatsu Limited.

Content	Original Forms	New Forms	Comparative analysis and points to note
Outbound payments	Outbound Payment Form (Form 10)	Outbound Payment Form (G111000)	Compared with the old form, this new form has been simplified. All service-related payments are now categorized into a single line item as "service payments." Additionally, disclosures of trademark royalty payments and technology royalty payments are combined in the new form. The new form also removes some items, including "enterprise income tax withheld" and "preferential tax treatments due to tax treaties." The filing instructions for the new forms also clarify that an accrued expense will not be considered an "outbound payment" for disclosure purposes (which is not the case as required by the filing instructions to the original forms). Considering that outbound "service payments" and "royalty payments" are under scrutiny by the tax authorities, taxpayers should review their significant outbound payments considering the benefit test[5] and relevant supporting documents to better manage potential tax risks associated with information disclosure. For relevant outbound payment matters, taxpayers should prepare supporting information in advance.
Overseas Related-Party Information (New)		Overseas Related-Party Information Form (G112000)	This new form requires information on overseas related parties that have been disclosed in previous forms, i.e. the overseas related parties included in any top-five disclosures in the other forms. In addition to basic information, this new form specifies the disclosure of effective tax rates (ETR) together with instructions on the method of ETR calculation. This form is intended to focus on the signs of profit shifting to low-tax jurisdictions through related-party transactions.

[5] See SAT Bulletin [2015] No. 16

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

Content	Original Forms	New Forms	Comparative analysis and points to note
Financial Information Analysis (New)	Originally required as an appendix to contemporaneous documentation	Financial Analysis Form of Annual Related Party Transactions (Standalone information) (G113010); Financial Analysis Form of Annual Related Party Transactions (Consolidated Information) (G113020)	The new forms advance the filing of related-party transactions ahead of contemporaneous documentation as a means of strengthening transfer pricing risk management. However, the filing instructions do not specify any guidance on segmentation methodology; therefore, taxpayers should determine the segmentation themselves. Such practice might lead to different understandings of the segmentation by tax authorities and taxpayers.
CbC Report (New)		CbC Report-Country Distribution of Income, Tax, Business Activities (Chinese and English G114010, G114011) List of Multinational Group Entities (Chinese and English G114020, G114021) Additional Information Form (Chinese and English G114030, G114031)	These forms are consistent with the templates in the OECD's BEPS Action 13 final report.

— Eunice Kuo (Shanghai)
Transfer Pricing Services National Leader
Deloitte China
eunicekuo@deloitte.com.cn

Lian Tang He (Beijing)
Deputy National Leader, Northern China
Deloitte China
lhe@deloitte.com.cn

Victor Li (Shenzhen)
Partner
Deloitte China
vicli@deloitte.com.cn

Frank Tang (Chongqing)
Partner
Deloitte China
ftang@deloitte.com.cn

United States issues final country-by-country reporting regulations

The US Treasury Department on June 29, 2016, released final regulations that require annual country-by-country (CbC) reporting by US entities that are the ultimate parent entity of a multinational enterprise (MNE) group with annual revenue of $850 million or more.

Treasury based the final regulations on the model template for CbC reporting developed by the OECD as part of its base erosion and profit shifting (BEPS) project and released in October 2015 as part of the final BEPS reports. The regulations are based on Treasury's authority under §§6001, 6011, 6012, 6031, 6038, and 7805 of the Internal Revenue Code, rather than under its authority under §6662 of the Code for the transfer pricing documentation penalty

© 2016. For information, contact Deloitte Touche Tohmatsu Limited.

protection regime. The CbC report will be due with the timely filed tax return (with extensions) for the parent entity of a US MNE group. The preamble to the final regulations indicates that if a taxpayer does not file the CbC report, then the penalty rules under §6038 will "generally apply, including reasonable cause relief for failure to file."

The final regulations apply to taxable years of parents of US MNE groups that begin on or after June 30, 2016. Calendar-year taxpayers will first apply the regulations for the 2017 tax year, although Treasury indicated in the preamble to the final regulations that it is working with treaty partners to accept voluntary filings by parents of US MNE groups for tax years beginning on or after January 1, 2016, and on or before June 29, 2016. Other countries require filing for the first fiscal year beginning on or after January 1, 2016, which raises an issue as to whether members of a US MNE group that are organized or operating in those jurisdictions will be subject to CbC filing requirements for 2016. According to the final regulations, this voluntary filing procedure will be provided in separate, forthcoming guidance.

Treasury and the IRS intend to enter into competent authority arrangements to automatically exchange CbC reports, and have committed to do so in a timely manner, taking into consideration the need for appropriate review of systems and confidentiality safeguards in the other jurisdictions, so that US MNE groups will not need to file separate CbC reports with those jurisdictions in which those US MNE groups operate.[6]

The reporting period for Form 8975 is modified and now defined as the period of the ultimate parent entity's applicable financial statement prepared in the 12-month period that ends with or within the ultimate parent entity's taxable year. If the ultimate parent entity does not prepare an annual applicable financial statement, then the reporting period covered by Form 8975 is the 12-month period that ends on the last day of the ultimate parent entity's taxable year.

Basic framework of proposed regulations retained

Treasury issued proposed regulations on December 23, 2015 (REG-109822-15). Consistent with the proposed regulations, the final regulations require that the ultimate US parent entity file, along with its timely filed annual tax return (with extensions), a new form – Form 8975, the country-by-country report – that provides the following information with respect to the constituent entities[7] of the US MNE group for the applicable reporting period:

- The complete legal name of the constituent entity;
- The tax jurisdiction, if any, in which the constituent entity is resident for tax purposes;
- The tax jurisdiction in which the constituent entity is organized or incorporated (if different from the tax jurisdiction of residence);
- The tax identification number, if any, used for the constituent entity by the tax administration of the constituent entity's tax jurisdiction of residence; and
- The main business activity or activities of the constituent entity.

Of these requirements for constituent entity information, the only change from the proposed regulations is the addition of the requirement to provide the complete legal name of the constituent entity.

Tax jurisdiction of residence information: Also consistent with the proposed regulations, the final regulations require that the ultimate US parent entity provide on Form 8975 the following information in the aggregate for each tax jurisdiction in which the parent has constituent entities (and in the aggregate for all constituent entities that have no tax jurisdiction of residence):

---

[6] The US competent authority may determine that a country lacks the requisite rules and infrastructure to ensure that the information will be kept confidential and used for its intended purpose. Taxpayers need to be cognizant of which US treaty and tax information exchange agreement (TIEA) partners have been approved by the IRS, which Treasury and the IRS intend to make public, and then consider how to deal with any jurisdictions with which the IRS has not agreed to exchange CbC reports.
[7] A constituent entity is any separate business entity of a US MNE group, but the definition does not include a foreign corporation or foreign partnership for which the ultimate parent entity is not required to furnish information under §6038(a) (determined without regard to §1.6038-2(j) and §1.6038-3(c)), or any permanent establishment of such foreign corporation or foreign partnership. The definition of "business entity" is modified, as discussed in the "Significant changes" section below.

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

- Revenues generated from transactions with other constituent entities of the US MNE group;
- Revenues not generated from transactions with other constituent entities of the US MNE group;
- Profit (or loss) before income tax;
- Income tax paid on a cash basis to all tax jurisdictions, including any taxes withheld on payments received;
- Accrued tax expense recorded on taxable profits (or losses), reflecting only the operations in the relevant annual accounting period and excluding deferred taxes or provisions for uncertain tax liabilities;
- Stated capital, except that the stated capital of a permanent establishment must be reported by the legal entity of which it is a permanent establishment unless there is a defined capital requirement in the permanent establishment tax jurisdiction for regulatory purposes;
- Accumulated earnings, except that accumulated earnings of a permanent establishment must be reported by the legal entity of which it is a permanent establishment;
- Number of employees on a full-time equivalent basis; and
- Net book value of tangible assets other than cash or cash equivalents, intangibles, or financial assets.

Of these requirements, the only modification to the proposed regulations was to clarify that "tangible assets" does not include intangibles or financial assets. Treasury received comments requesting that those terms be clarified, but rejected all such requests. Treasury also received comments requesting that the above categories be expanded to include additional information, but rejected such requests to be consistent with the categories enunciated in the OECD's final BEPS reports.

Significant changes from proposed regulations to final regulations

Some of the most significant changes in the final regulations are as follows:

- **Added flexibility with respect to sources of data:** The regulations retain broad flexibility with respect to how taxpayers may obtain information for the CbC report, and also add additional flexibility by allowing taxpayers to use information contained in records used for internal management control purposes for the reporting period. The final regulations specify that the US parent entity must maintain records to support the reported information on Form 8975, but it is not required to maintain records that reconcile the reported information to tax returns or applicable financial statements.
- **Tax jurisdiction of residence for jurisdictions with no income tax:** Under the proposed regulations, an entity regarded as a corporation that is organized or managed in a jurisdiction with no corporate income tax (such as the Cayman Islands or Bermuda) would not have a tax jurisdiction of residence and would thus fall under the aggregated stateless income category. Under the final regulations, this is changed so that such an entity will be considered tax resident in the jurisdiction in which it is organized or managed, even if that jurisdiction does not impose any income tax on those entities. Thus, for example, information regarding Cayman Islands corporations will be listed on a "Cayman Islands" row instead of the aggregated stateless income row (and so forth, for other such jurisdictions). All other rules in the proposed regulations regarding the definition of tax jurisdiction of residence are retained.[8]
- **Tax jurisdiction of residence concept clarified regarding territorial systems:** The final regulations clarify that Treasury never intended for all territorial systems to be included in the stateless income category, which some commentators had suggested was unclear, given the sentence that stated that "a business entity will not be considered a resident in a tax jurisdiction solely with respect to income from sources in such jurisdiction, or capital situated in such jurisdiction." The final regulations modify this sentence to indicate that "[a] business entity will not be considered a resident in a tax jurisdiction if the business entity is only liable to tax in such tax jurisdiction by reason of a tax imposed by reference to gross amounts of income without any

---

[8] Under both the proposed and final regulations, a business is considered a "resident" in a tax jurisdiction if, under the laws of that tax jurisdiction, the business entity is liable to tax therein based on place of management, place of organization, or other similar criteria. If a business entity is resident in more than one tax jurisdiction, then the applicable income tax convention rules, if any, will be used to determine the business entity's tax jurisdiction of residence. If a business entity is resident in more than one tax jurisdiction and no applicable income tax convention exists between those tax jurisdictions, or if the applicable income tax convention provides that the determination of residence is based on a determination by the competent authorities of such jurisdictions, then the business entity's tax jurisdiction of residence is the business entity's place of effective management in accordance with Article 4 of the OECD Model Tax Convention on Income and on Capital 2014.

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

reduction for expenses, provided such tax applies only with respect to income from sources in such tax jurisdiction or capital situated in such tax jurisdiction."

- **Partnerships:** Under the proposed regulations, a business entity that was treated as a partnership in the tax jurisdiction in which it was organized and that did not own or create a permanent establishment in that or another tax jurisdiction generally would have no tax jurisdiction of residence. That rule has stayed the same. Nevertheless, a comment to the proposed regulations requested clarification as to whether the partnership or partners, or both, should report the partnership's CbC information. In response, the final regulations have clarified that the tax jurisdiction of residence information with respect to stateless entities is provided on an aggregate basis for all stateless entities in a US MNE group, and that each stateless entity-owner's share of the revenue and profit of its stateless entity is also included in the information for the tax jurisdiction of residence of the stateless entity-owner. So, for example, a *commanditaire vennootschap* (CV) treated as a partnership in the Netherlands and as a corporation by the United States (or other jurisdiction) in which the owner resides would report its income and other financial information on both the stateless income row (for the Netherlands income) and the US row (for the US partner's share of such income).[9] The final regulations also clarify that, when a partnership creates a permanent establishment for itself or its partners, the CbC information regarding the permanent establishment is not reported as stateless, but instead is reported as part of the information on the CbC report for the permanent establishment's tax jurisdiction of residence.
- **Definition of "business entity" modified, excludes grantor trusts and decedents' estates:** The final regulations modify the definition of "business entity" by defining it as an entity recognized for federal tax purposes that is not classified as a trust under Treas. Reg. §301.7701-4, but excluding decedents' estates, individuals' bankruptcy estates, and grantor trusts within the meaning of IRC §671, when the owners of such entities are individuals. The definition of "business entity" specifically includes a permanent establishment, as defined below, and any entity with a single owner that may be disregarded as an entity separate from its owner under Treas. Reg. §301.7701-3.
- **Permanent establishments:** The final regulations provide explicit guidance on what constitutes a permanent establishment. The term permanent establishment includes: (i) a branch or business establishment of a constituent entity in a tax jurisdiction that is treated as a permanent establishment under an income tax convention to which that tax jurisdiction is a party; (ii) a branch or business establishment of a constituent entity that is liable to tax in the tax jurisdiction in which it is located pursuant to the domestic law of such tax jurisdiction; or (iii) a branch or business establishment of a constituent entity that is treated in the same manner for tax purposes as an entity separate from its owner by the owner's tax jurisdiction of residence.
- **Deemed domestic corporations:** The final regulations expressly provide that foreign insurance companies that elect to be treated as domestic corporations under IRC §953(d) are US business entities that have their tax jurisdiction of residence in the United States.
- **Surrogate filings for US territory ultimate parent entities:** A US territory ultimate parent entity may file the CbC report via a US surrogate business entity that it controls, as defined under IRC §6038(e).
- **Employees:** Employees will be counted in the jurisdiction of the employer and not in the jurisdiction in which they work. The preamble to the final regulations notes that taxpayers have flexibility in reporting the number of employees so long as the method for reporting is reasonable and consistent.
- **Clarification of the definition of revenues:** The proposed regulations and the final regulations both state that the term "revenue" includes all amounts of revenue, including revenue from sales of inventory and property, services, royalties, interest, and premiums, but excludes payments received from other constituent entities that are treated as dividends in the payor's tax jurisdiction of residence. The final regulations further clarify that the term "revenue" does not include: (1) distributions and remittances from partnerships and other fiscally transparent entities and permanent establishments that are constituent entities; and (2) imputed earnings or deemed dividends received from other constituent entities that are taken into account solely for tax purposes and that otherwise would be included as revenue by a constituent entity. These clarifications suggest that a US shareholder would not report subpart F income in the United States. The final regulations also clarify that, with respect to a constituent entity that is an organization covered under certain tax code

[9] This raises the question as to what happens if a taxpayer has another partnership or fiscally transparent entity above the partnership or reverse hybrid. It would appear under the final regulations that in this situation, the taxpayer would need to report that owner's share as stateless too, and so on, until the taxpayer arrives at a stateless entity-owner in the chain that does not itself fall into the stateless income category.

© 2016. For information, contact Deloitte Touche Tohmatsu Limited.

sections,[10] the term "revenue" includes only revenue that is reflected in unrelated business taxable income as defined in IRC §512.

Changes that were requested but not made

Some of the changes requested by taxpayers but not made in the final regulations include the following:

- **National security exception rejected:** Treasury notes that it consulted with the Department of Defense (DoD) as to whether the CbC report should include a national security exception, but that the DoD indicated that no such general exception was needed. However, Treasury indicated that it would continue to work with DoD to determine whether specific guidance on national security issues should be provided in the future.
- **Surrogate filing with IRS limited to US territories:** Some commentators requested that the United States allow surrogate filing for ultimate parent entities located in other jurisdictions. Treasury rejected this request because of limited resources. The final regulations allow surrogate filing only for entities whose ultimate parent entity is located in a US territory.
- **Additional protections for confidential information rejected:** Many commentators requested additional precautions apply to confidential information before the United States automatically exchanged it (or, alternatively, that the United States consider withdrawing the proposed regulations altogether due to this concern). Treasury rejected these requests. The preamble to the final regulations indicates that, moving forward, the US competent authority will negotiate bilateral competent authority arrangements that will provide for the exchange of the CbC reporting template with other tax administrations that have entered into an income tax convention or tax information exchange agreement (TIEA) with the United States. Treasury expects that such competent authority arrangements, in accordance with the OECD model agreements, will further limit the permissible uses of CbC reports to assessing high-level transfer pricing and other tax risks and, when appropriate, for economic and statistical analysis. Treasury states in the preamble to the final regulations that the US competent authority will not enter into a reciprocal automatic exchange of information relationship with respect to CbC reports unless it has reviewed the tax jurisdiction's policies and procedures regarding confidentiality, and has determined that such an automatic exchange relationship is appropriate. Moreover, the US competent authority does not anticipate allowing CbC reports to be used by other tax jurisdictions to take the place of a comprehensive transfer pricing analysis, as required by the arm's length standard. The US competent authority will continually review how other jurisdictions are using the CbC reports that are exchanged, and the United States will pause such exchanges if it determines that a tax jurisdiction is not in compliance with confidentiality requirements, data safeguards, and appropriate use standards.

Coordination with OECD guidance on CbC

The OECD released guidance on CbC reporting at the same time as the United States' release of its final CbC regulations. For more information on the OECD guidance, see the Deloitte alert on the same [Global TP Alert 16-023]. Several salient points of comparison should be noted between the new OECD CbC guidance and the final US CbC regulations:
URL: http://www2.deloitte.com/global/en/pages/tax/articles/global-transfer-pricing-alerts.html?id=us:2em:3na:als:awa:tax:081516

- **Partnerships:** The OECD guidance clarifies that the general framework to determine whether partnerships are members of an MNE group is provided by the accounting consolidation rules. If under the accounting consolidation rules a partnership is an includable entity, then that partnership may be a constituent entity of an MNE group subject to the CbC reporting requirement. The OECD guidance provides specific guidance on how to report fiscally transparent partnerships. If the partnership is a permanent establishment in the tax jurisdiction of its country of organization or has a permanent establishment in another tax jurisdiction, then the operations attributable to the permanent establishment will be reported in accordance with the rules for permanent establishments. If the partnership earns income that is not attributable to a permeant establishment in a tax jurisdiction, the income will be reported as stateless or nowhere income. Partners that are constituent entities within the MNE group should include their share of the partnership's stateless income

[10] Specifically: an organization exempt from taxation under §501(a) because it is an organization described in §§ 501(c), 501(d), or 401(a), a state college or university described in §511(a)(2)(B), a plan described in §403(b) or 457(b), an individual retirement plan or annuity as defined in §7701(a)(37), a qualified tuition program described in §529, a qualified ABLE program described in §529A, or a Coverdell education savings account described in §530.

© 2016. For information, contact Deloitte Touche Tohmatsu Limited.

in their jurisdiction of tax residence. As with the final US CbC regulations, this will result in double reporting of stateless income. It may be advisable for the MNE to provide an explanation in the notes section of the CbC report on the partnership structure and the stateless entities.[11]

- **Voluntary filing allowed:** The OECD guidance allows for voluntary filing for US MNE groups, calling it "parent surrogate filing."
- **Surrogate filing:** If surrogate filing (including parent surrogate filing) is available, then no local filing is required, provided the conditions laid out in the OECD report – for example that the CbC report is filed by the filing deadline – are satisfied. This will help US MNEs that file voluntarily with the IRS or via surrogate in a country that has surrogate filing, such as the UK, to not have to file locally in another jurisdiction, such as France.
- **Currency coordination rule:** The OECD guidance provides a currency coordination rule to address the impact of currency fluctuations on the agreed EUR 750 million filing threshold. The Action 13 Final Report stated that the agreed filing threshold for the CbC report is EUR 750 million or a near equivalent amount in the domestic currency as of January 2015. Many countries have adopted a local currency threshold that met the "near equivalent" rule when adopted, but no longer meets that rule because of currency fluctuations. The additional guidance provides that if the jurisdiction of the ultimate parent entity has implemented a reporting threshold in accordance with the recommended threshold, such as the United States' $850 million threshold, then an MNE group that complies with that local currency threshold should not be exposed to a local filing requirement merely because the other jurisdiction is using a threshold denominated in a different currency.

Concluding remarks

The final regulations require US MNE groups to evaluate each business entity and determine the tax residence for its income and other information attributed to the entity. In some cases, this analysis will require a review of income associated with hybrid entities and hybrid transactions. The impact on tax examinations should be considered, particularly for business entities doing business in high-tax jurisdictions that engage, directly or indirectly, in transactions with related parties in lower-tax jurisdictions. Due to this and other complex interpretation issues associated with the final CbC regulations, US MNE groups should consult their local international tax and/or transfer pricing advisor to plan for compliance with the regulations.

— David Varley (Washington, DC)
Principal
Deloitte Tax LLP
dvarley@deloitte.com

Joseph Tobin (Washington, DC)
Senior Manager
Deloitte Tax LLP
jtobin@deloitte.com

Jeremy Sina (Washington, DC)
Senior Manager
Deloitte Tax LLP
jesina@deloitte.com

Christopher Trump (Washington, DC)
Principal
Deloitte Tax LLP
ctrump@deloitte.com

OECD releases discussion draft on revised guidance on profit splits

The OECD on July 4 released a Discussion Draft on Revised Guidance on Profit Splits. The discussion draft follows the work previously undertaken by the G20/OECD in relation to ensuring that transfer pricing outcomes are aligned with value creation (Actions 8-10 of the G20/OECD BEPS Action Plan). It does not reflect, at this stage, a consensus position of the governments involved, but is designed to provide substantive proposals for public review and comment. The introduction to the discussion draft specifically indicates that insofar as the guidance differs from the guidance contained in the 2010 OECD *Transfer Pricing Guidelines For Multinational Enterprises and Tax Administrations* ("2010 OECD TPG"), it is not to be relied upon by taxpayers or tax administrations.

---

[11] It appears that the only way to read the OECD guidance and the US regulations consistently is to assume that the definition of constituent entity that talks about PEs does not require the PE to be separate from the business entity. In other words, under the OECD guidance, as under the US rule, a partnership has a PE in the jurisdiction it is organized because the separate business unit is considered a PE of its partners.

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

The discussion draft was eagerly anticipated following the issuance of a first non-consensus discussion draft on profit splits in December 2014, and the public consultation on the topic held at the OECD in March 2015. The BEPS final reports published October 5, 2015, did not incorporate any proposed consensus changes to Chapter II of the 2010 OECD TPG, providing instead that Working Party 6 ("WP6") would reconvene in 2016 and 2017 to provide such consensus guidance. The discussion draft is the first step in WP6's mandate regarding profit split for 2016-2017.

Overview of discussion draft

The discussion draft modifies and expands the 2010 OECD TPG Chapter II guidance on profit splits (rather than withdraw and replace it in its entirety, as was the case with Chapter I, Chapter VI, and Chapter VIII). It clarifies and expands on the 2010 OECD TPG Chapter II guidance to conform to the new "risk control" framework of Chapter I.

Along with discussing conditions under which transactional profit splits are most appropriate, the discussion draft also articulates the role of a value chain analysis in accurately delineating a transaction (within the meaning of Chapter I), and in determining the most appropriate transfer pricing method. The discussion draft specifically indicates that the existence of an integrated value chain does not necessarily imply the use of transactional profit splits, as many multinational enterprises (MNEs) operate through a global value chain.

The tone of the discussion draft has significantly shifted from the tone of the December 2014 non-consensus draft that suggested a broad applicability of profit splits to integrated value chains. If the December 2014 draft could reasonably be interpreted as suggesting formulary apportionment of an MNE's profit as appropriate in certain circumstances, the discussion draft dismisses such an interpretation. The draft contains a number of safeguards and cautions against application of transactional profit splits when it would not be appropriate, including as a default method when comparables are hard to find, other methods are not reliable, or group synergies exist. The discussion draft also recognizes that profit splits are difficult to apply, and are generally not appropriate when a party makes only routine contributions.

Peppered throughout the discussion draft are a number of specific questions on which WP6 is requesting interested parties to comment. For example, when discussing the appropriateness of profit splits to highly integrated value chains, the discussion draft distinguishes "sequential" integration of the value chain from "parallel" integration. In the former case, parties sequentially perform discrete functions in the integrated value chain; it often will be the case that reliable comparables exist for each stage or element in the value chain. In the latter case, multiple parties to the transaction are involved at the same stage of the value chain in contributing assets or sharing functions; it is therefore more likely that an accurate delineation of the transaction will determine that each party shares economically important risks, and a transactional profit split may thus be appropriate. Commentators are asked whether that distinction between "sequential" and "parallel" integration of business operations is a useful refinement, and are also asked to help further define "parallel" integration.

Analysis of discussion draft

Value chain analysis

The discussion draft provides four new paragraphs under Section C.3.4 articulating the role of a value chain analysis in a transfer pricing study. Although that supplemental guidance is issued as part of the guidance on profit splits in Chapter II, the first paragraph on value chain analysis cross-references paragraph 1.34 of Chapter I (broad-based analysis of taxpayer's circumstances expected in the master file) and indicates that a value chain analysis is merely a tool to assist in accurately delineating a transaction, in particular with respect to the functional analysis, and thereby determining the most appropriate method, which *may* or *may not* be the profit split – there is no causal relationship.

A value chain analysis should consider where and how value is created in the business operations, including:

- Consideration of the economically significant functions, assets, and risks;
- Which company performs the functions, contributes the assets, and assumes the risks;
- How the functions, assets, and risks are interrelated;
- How the economic circumstances may create opportunities to capture profits in excess of what the market would allow (e.g., unique intangibles or first mover advantages); and
- Whether the value creation is sustainable.

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

Because the value chain analysis discussion appears to provide additional guidance on identifying the commercial or financial relations between the associated enterprises required under paragraph 1.34, commentators are likely to question the placement of such guidance in Chapter II (guidance on profit split), rather than in Chapter I (guidance on accurate delineation) and require clarity in the next draft as to whether or not a value chain analysis is viewed by WP6 as part of a functional analysis to be performed in the accurate delineation of every transaction, or merely as a tool to be applied in transactions in which the profit split is being considered as the most appropriate method. Providing this guidance under Chapter I would reinforce what *appears* to be the intent of WP6, namely, to use value chain analyses to *inform* the selection of the most appropriate method as opposed to *cause* the transactional profit split to be the most appropriate method in every case of an MNE operating through a global value chain.

The main takeaway from the supplemental guidance on value chain analyses provided in the discussion draft is the casting of a value chain analysis as a delineation tool for a specific transaction, rather than as a justification to apply a profit split on every integrated MNE operating through a global value chain. This is a significant change in direction (likely to be welcomed by taxpayers) from the December 2014 non-consensus draft on profit splits, which suggested the latter rather than the former.

Profit split guidance

The overriding purpose of the use of a transactional profit split should be to approximate as closely as possible the split of profits that would have been realized had the parties been independent enterprises. Consistent with the guidance provided in the October 5, 2015, final report under actions 8-10, identifying the economically significant risks each party to a transaction controls, and accurately delineating such transactions (including the respective contributions of each party and the profits to be split), is the starting point to inform whether or not transactional profit splits are appropriate and reliable.

The discussion draft describes transactional profit split as a method whereby the combined profits are split between associated enterprises on an *economically valid basis* that approximates the division of profits that would have occurred in comparable circumstances at arm's length. The discussion draft distinguishes transactional profit splits of *anticipated profits* from profit splits of *actual profits*. Although most of the guidance provided in the discussion draft addresses splitting actual profits, this distinction, and the provision of separate guidance for these two types of transactional profit splits, expands on Chapter II of the 2010 OECD TPG.

Irrespective of whether anticipated or actual profits are split, the determination of which profits need to be combined (base for the split), and the way combined profits are split (key for the split) must be determined *ex-ante* on the basis of data that is capable of being measured in a reliable and verifiable manner and without the use of hindsight; a key criteria to ensure that profit splits are consistent with the arm's length standard.

These requirements make profit split keys constructed through subjective weighing of taxpayers' representations of the various value drivers in their business inappropriate, and significantly decrease the authority granted by the guidance to tax administrations to allocate taxable income between parties based on formulary-type apportionments.

When is a profit split most appropriate?: Transactional profit splits are most appropriate in cases of (i) highly integrated operations, and (ii) unique and valuable contributions by multiple parties.

The use of a transactional profit split of actual profits is most appropriate in cases of high integration of activities performed by the parties, with greater sharing of uncertain outcomes resulting from the economically significant risks controlled by the parties. In contrast, the use of a transactional profit split of anticipated profit does not require the level of integration or risk sharing required for a transactional profit split of actual profits.

The discussion draft includes a paragraph discussing the concept of "integration of activities" within an MNE, distinguishing between "sequential" and "parallel" integration (see above). Although the distinction may be valid as a theoretical matter, it is unclear how useful the guidance is as a practical matter. For example, taxpayers and tax administrations seeking to apply the guidance and determine in a specific transaction whether there is sufficient "parallel" integration of activities to justify the use of a transactional profit split may end up at both ends of the spectrum – resulting in taxpayers benchmarking activities and tax administrations applying a transactional profit split, or *vice versa*. Commentators are likely to provide WP6 with extensive comments on this paragraph and request examples to illustrate when the "sufficient integration" bar is crossed to justify the use of transactional profit splits.

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

Commentators are also likely to question why this guidance on integration of a value does not belong to the guidance on value chain analysis, arguably better suited for Chapter I than Chapter II.

Another situation in which a transactional profit split may be the most appropriate method is when multiple parties make unique and valuable contributions. "Unique and valuable" is defined as cases in which (i) the contributions are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) the use of the contributions in business operations represents a key source of actual or potential economic benefits. Such situations require each party to control the development risks of their unique and valuable contributions and share in the combined profits resulting from their contributions per Chapter I.

Profit to split, profit split key, and delineation of transaction: The discussion draft does not provide many details as to how a transactional profit split of actual or of anticipated profits should be performed. However, some general principles are laid out, most of which highlight how the accurate delineation of the transaction pursuant to the guidance of Chapter I informs the decisions that must be made when designing a meaningful transactional profit split. Specifically, the guidance notes that the measure of profits used as the basis for the profit split will depend on the nature of the integrated operations and the sharing of risks as determined by the accurate delineation of the transaction – profit splitting gross margins involves less integration and risk sharing by the parties than profit splitting operating margins.

Similarly, the guidance notes that the determination of an appropriate profit splitting factor should reflect the key value drivers in relation to the transaction. Although the discussion draft seems to suggest that multiple factors could be weighed into one profit splitting key, such weighing cannot be subjective and must be verifiable by tax administrations. This requirement is likely to make it difficult to use multiple weighed factors as a practical matter, because finding objective and verifiable data to derive the weights will be challenging in most cases.

Finally, the discussion draft provides a useful discussion of how the profits associated with a specific transaction need to be identified, and how required segmentations and allocations may affect the reliability of the analysis.

Chapter II and Chapter VI consistency

Because transactional profit splits are the most appropriate candidate methods when intangibles are involved, consistency in the guidance provided under Chapter II and Chapter VI is of great importance. Paragraph 6.145 of Chapter VI, for example, provides for the comparable uncontrolled price (CUP) and transactional profit split methods, complemented by valuation techniques, as the most likely useful pricing methods. Section D.2.6.2 of Chapter VI discusses the application of transactional profit split methods to intangibles with Chapter II being cross-referenced.

Similarly, although the distinction between *contribution* and *residual* profit splits existed in the 2010 OECD TPG, it is complemented in the discussion draft by a new paragraph addressing the use of valuation methods under Chapter VI sections D.2.6.3 and D.2.6.4 in the application of a residual analysis in a transactional profit split of *anticipated* profits to set a price for the contribution made by the transferor – with Chapter VI being cross-referenced in Chapter II.

There may appear to be a tension in the guidance provided under Chapter II and Chapter VI. Chapter VI appears to suggest that a two-sided transactional profit split is the most appropriate method in more situations than the new guidance provided under Chapter II seems to suggest. Similarly, Chapter VI does not contain the refinement introduced in Chapter II of distinguishing between sequential integration of a value chain and parallel integration. Chapter II suggests that in sequential integration of a value chain it is often possible to reliably benchmark the sequential activities. Applied to the DEMPE functions of Chapter VI (development, enhancement, maintenance, protection, and exploitation of intangibles) this would suggest that exploitation functions that sequentially follow development functions ought to be reliably benchmarked to the extent they are of a routine nature, which would leave valuation methods as the only suggested method to price the DEMPE functions if no reliable CUP exists. It is unclear whether Chapter VI as currently drafted concurs with that view.

Next steps

Comments are invited by September 5, 2016, and a public consultation will be held on October 11-12, 2016, at the OECD Conference Center in Paris, France.

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

— Philippe G. Penelle (Washington, DC)
Principal
Deloitte Tax LLP
ppenelle@deloitte.com

Joseph Tobin (Washington, DC)
Senior Manager
Deloitte Tax LLP
jtobin@deloitte.com

Alan Shapiro (Tokyo)
Senior Technical Advisor
Deloitte Japan
alan.shapiro@tohmatsu.co.jp

Belgium finalizes mandatory transfer pricing reporting requirements

On July 4, 2016, Belgium's Program Law of July 1, 2016, introducing legislation implementing Action 13 of the OECD's Base Erosion and Profit Shifting (BEPS) project was published in the Belgian Official Journal. As expected, the new transfer pricing documentation legislation does not deviate from the draft program law issued on June 2, 2016.
URL:
http://www2.deloitte.com/content/dam/Deloitte/be/Documents/tax/TaxAlerts/CorporateTaxAlerts/Transfer%20pricing%20alert%20-%20BEPS%20-%20Belgian%20program%20law%20on%20implementation%20of%20Action%2013%20-%2030%20May%202016.pdf

The new transfer pricing documentation rules will be embedded in new articles 321/1 – 321/7 of the Belgian Income Tax Code.

Belgium generally follows OECD guidance and the EU directive on the harmonized implementation of a country-by-country (CbC) reporting requirement. Consequently, the OECD's three-tiered approach to transfer pricing documentation – master file, local file, and country-by-country report – will be mandatory in Belgium going forward.

Master and local file

A Belgian entity that is part of a multinational group will have to compile (1) a master file and (2) a local file when it exceeds one of the following thresholds (on a non-consolidated basis) in the accounting year immediately preceding the last closed accounting year:

- Combined operating and financial income of EUR 50 million (excluding non-recurring income);
- A balance sheet total of EUR 1 billion; or
- Annual average number of 100 full-time equivalents.

Both the master file and local file will have to be filed in specific forms, which will be published in a forthcoming Royal Decree. The master file form must be filed within 12 months after the reporting period of the multinational group with the Belgian tax authorities; the local file form must be submitted together with the tax return.

Additional documentation must be provided in the local file, including a comparability analysis, in case at least one "business unit" of a Belgian group entity has cross-border, intragroup transactions of more than EUR 1 million in total during the last closed accounting year.

Country-by-country report

In line with OECD guidance, a CbC report must be filed in Belgium within 12 months after the final date of the multinational group's reporting period, if the group's ultimate parent entity is located in Belgium.

Even if the ultimate parent entity is not located in Belgium, a Belgian group entity may be required to file a CbC report under certain circumstances (for instance, when the ultimate parent entity's jurisdiction does not require a CbC report to be prepared). However, this would not be the case if the multinational group appoints a "surrogate parent entity" within the group to file the CbC report in its tax jurisdiction, when certain conditions are fulfilled.

The CbC report is due only when the multinational group's consolidated gross revenue exceeds EUR 750 million in the reporting period immediately preceding the last closed reporting period.

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

Entry into force and penalties

The new transfer pricing reporting rules will apply to reporting periods of multinational groups with accounting years starting on or after January 1, 2016.

Noncompliance with the transfer pricing reporting requirements will trigger special penalties ranging from EUR 1,250 to EUR 25,000 after the second violation.

— André Schaffers (Brussels)
Partner
Deloitte Belgium
aschaffers@deloitte.com

Patrick Cauwenbergh (Brussels)
Partner
Deloitte Belgium
pcauwenbergh@deloitte.com

Rob Peeters (Brussels)
Senior Manager
Deloitte Belgium
robpeeters@deloitte.com

Joachim Janssen (Brussels)
Senior
Deloitte Belgium
joajanssen@deloitte.com

OECD issues additional guidance on CbC reporting

The OECD on June 29, 2016, issued additional guidance on the implementation of the country-by-country (CbC) reporting requirement introduced in the BEPS Action 13 Final Report issued on October 5, 2015.

The guidance covers four issues:

- Transitional filing options to eliminate initial year effective dates differences (the "gap" year issue);
- The application of CbC reporting to investment funds;
- The application of CbC reporting to partnerships; and
- The impact of currency fluctuations on the EUR 750 million filing threshold.

Parent surrogate filing

The OECD guidance introduces the concept of "parent surrogate filing" on a voluntary basis to address transition issues that arise in the case of jurisdictions that have implemented CbC reporting for fiscal periods commencing after the January 1, 2016, recommended date, the so-called gap year issue. In those situations, the OECD recommends that jurisdictions permit voluntary filing by ultimate parent entities resident in their jurisdiction, parent surrogate filings, under specified conditions. When an MNE makes a voluntary parent surrogate filing, the OECD recommends that local filing obligations should not apply in any jurisdiction that otherwise would require local filing of the CbC report.

Japan, Switzerland, and the United States have indicated that they would permit voluntary parent surrogate filings for companies with fiscal years beginning on or after January 1, 2016, and before the effective date of their CbC filing requirements.

The parent surrogate filing rule is subject to the following conditions:

- The ultimate parent entity must make available a CbC report to the tax authority of its jurisdiction of tax residence by the filing deadline (12 months after the last day of the MNE group's reporting fiscal year).
- The ultimate parent entity's jurisdiction of tax residence must have a CbC reporting requirement in place by the first filing deadline of the CbC report (even if filing a CbC report for the fiscal year in question is not required under those laws).
- A Qualifying Competent Authority Agreement must be in effect between the ultimate parent entity's jurisdiction of tax residence and the local jurisdiction.
- The ultimate parent entity's jurisdiction of tax residence must not have notified the local jurisdiction's tax administration of a systemic failure.
- Two notifications must have been provided:

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

- The jurisdiction of tax residence of the ultimate parent entity must have been notified by the ultimate parent entity, no later than the last day of the reporting fiscal year of the MNE group (or other date as chosen by that jurisdiction); and
- The local jurisdiction's tax administration must have been notified by a constituent entity of the MNE group that is resident for tax purposes in the local jurisdiction that it is not the ultimate parent entity nor the surrogate parent entity, stating the identity and tax residence of the reporting entity, no later than the last day of the reporting fiscal year of the MNE group (or other date as chosen by the jurisdiction.

Investment Funds

The guidance confirms that there is no general exemption from CbC reporting for investment funds. The governing principles to determine whether an investment fund is part of an MNE group or must include investees in its compliance with the CbC requirements are the accounting consolidation rules.

Partnerships

The release provides additional guidance on the treatment of fiscally transparent partnerships. The guidance clarifies that the general framework to determine whether partnerships are members of an MNE group is provided by the accounting consolidation rules. If under the accounting consolidation rules a partnership is an includable entity, then that partnership may be a constituent entity of an MNE group subject to CbC reporting.

The guidance provides specific guidance on how to report fiscally transparent partnerships. If the partnership is a permanent establishment in the tax jurisdiction of its country of organization or has a permanent establishment in another tax jurisdiction, then the operations attributable to the permanent establishment will be reported in accordance with the rules for permanent establishments. If the partnership earns income that is not attributable to a permanent establishment in a tax jurisdiction, the income will be reported as stateless income. Partners that are constituent entities within the MNE group should also include their share of the partnership's stateless income in their jurisdiction of tax residence.

It may be advisable, according to the OECD guidance, for the MNE to provide an explanation in the notes section of the CbC report on the partnership structure and the stateless income reported in the owner's jurisdiction of residence.

Impact of currency fluctuations on the CbC reporting threshold

The guidance provides a currency coordination rule to address the impact of currency fluctuations on the agreed EUR 750 million filing threshold. The Action 13 Final Report stated that the agreed filing threshold for the CbC report is EUR 750 million or a near equivalent amount in the domestic currency as of January 2015. Some countries have adopted a local currency threshold that had met the "near equivalent" rule when adopted, but no longer meets that rule because of currency fluctuations. The additional guidance provides that if the jurisdiction of the ultimate parent entity has implemented a reporting threshold in accordance with the recommended threshold, an MNE group that complies with that local currency threshold should not be exposed to a local filing requirement merely because the other jurisdiction is using a threshold denominated in a different currency.

— David Varley (Washington, DC)
Principal
Deloitte Tax LLP
dvarley@deloitte.com

Joseph Tobin (Washington, DC)
Senior Manager
Deloitte Tax LLP
jtobin@deloitte.com

Christopher Trump (Washington, DC)
Principal
Deloitte Tax LLP
ctrump@deloitte.com

Jeremy Sina (Washington, DC)
Senior Manager
Deloitte Tax LLP
jesina@deloitte.com

Alan Shapiro (Tokyo)
Senior Advisor
Deloitte Japan
Alan.shapiro@tohmatsu.co.jp

© 2016. For information, contact Deloitte Touche Tohmatsu Limited.

Ireland introduces bilateral APA program

The Irish Revenue on June 23 published bilateral advance pricing agreement guidelines relating to the operation of Ireland's APA program, which is effective for applications received on or after July 1, 2016. The guidance outlines the framework of the APA program, as well as the requirements to apply for an APA, and the roles and responsibilities of taxpayers and Irish Revenue.

The bilateral APA program was launched in response to action 14 of the OECD's base erosion and profit shifting (BEPS) project, "Making Dispute Resolution Mechanisms More Effective."
URL: http://www.oecd.org/ctp/making-dispute-resolution-mechanisms-more-effective-action-14-2015-final-report-9789264241633-en.htm

Summary of the guidelines

The APA program applies to bilateral APA applications made to Irish Revenue on or after July 1, 2016. Thus, the guidelines do not apply with respect to:

- Bilateral APAs signed before July 1, 2016;
- Formal bilateral APA applications submitted to Irish Revenue before July 1, 2016, but in respect of which an APA has not been concluded as of July 1, 2016 (Ireland had been accepting APA applications on an ad hoc basis before the introduction of the APA program in cases when a tax treaty partner has agreed to enter into APA negotiations); and
- Unilateral APAs (agreements between the taxpayer and Irish Revenue that do not involve another competent authority).

A separate process applies to taxpayer requests for opinions and confirmations that the taxpayer's analysis of the tax consequences of a proposed transaction is acceptable to Revenue.

The APA program applies to transfer pricing issues, including the attribution of profits to a permanent establishment (PE), and is conducted within the legal framework of the double tax treaties Ireland has entered into with other jurisdictions. An application may be made by a company that is tax resident in Ireland for purposes of the relevant double tax treaty and also by a PE in Ireland of a nonresident company, in accordance with the provisions of the relevant treaty.

The bilateral APA program is intended to apply to transaction that involve complex transfer pricing issues; for example, if there is significant doubt over the appropriate application of the arm's length principle, or there is a high likelihood of double taxation arising.

When the transfer pricing issues involve more than two tax jurisdictions, one of which is Ireland, Revenue will consider entering into a series of bilateral APAs to deal with such multilateral situations.

The bilateral APA program is voluntary – taxpayers choose whether or not to enter into an agreement.

Suitable cases

An application may be made by a taxpayer for an APA in respect of the following:

- Transactions between separate business enterprises; and
- Transactions between parts of the same business enterprise operating in different countries (for example, between a head office and a PE, or between two separate PEs), subject to the provisions of the relevant double tax treaty.

Term and rollback

An APA will be granted for a fixed period of time, typically between three and five years (excluding any rollback years). Irish Revenue are willing to consider other fixed periods subject to the other tax administration's agreement.

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

In accordance with action 14 of the OECD's BEPS plan, Ireland will provide for the rollback of APAs in appropriate cases, subject to the applicable time limits of both countries that are party to the APA.

APA process

Part 4 of the guidelines sets out the distinct stages of the APA process:

- The prefiling stage, during which contact can be made with Irish Revenue on an informal basis to discuss the potential APA application. A prefiling meeting is encouraged to discuss the case. In exceptional cases, Irish Revenue are prepared to consider prefiling meetings on an anonymous basis.
- The formal APA application stage, during which certain information must be provided as part of the process. The necessary information is listed in an appendix to the guidelines and includes:
  - A cover letter;
  - An executive summary;
  - Company background;
  - An industry analysis;
  - An overview of covered transactions;
  - A functional and economic analysis;
  - Financial information;
  - Legal agreements; and
  - Details of any other tax authority audit inquiries relevant to the application.
- Evaluation of the APA application by Irish Revenue and negotiation of the APA with the other competent authority.
- Formal agreement.
- An annual reporting requirement, whereby an annual report must be filed with Irish Revenue. The annual report should include:
  - A statement whether the terms and conditions of the APA have been complied with;
  - A statement whether any critical assumptions underlying the transfer pricing methodology remain valid;
  - Financial data for the reporting period, and a comparison to the target arm's length result agreed to in the APA;
  - Details of any adjustments made to stay within the arm's length range; and
  - Any other information that may have a material impact on the APA.

The Irish Revenue have committed to conclude a bilateral APA, whenever possible, within a 24-month time frame once the formal application is received.

Comments

With the increasing scrutiny and auditing of transfer pricing activities by tax authorities worldwide, the formalization of a bilateral APA program is a welcome development for Irish taxpayers.

APAs help prevent disputes between the taxpayer and a tax administration regarding the covered transactions, and the risk of double taxation. They provide certainty the taxpayer's selected transfer pricing method, and may mitigate audit exposure on major transfer pricing issues. Within the APA framework, tax administrations and taxpayers cooperate with each other in a nonadversarial environment.

Bilateral APAs provide certainty to taxpayers that the covered transfer pricing issues will not be subject to audit adjustments by the tax authorities of the countries that enter into the APA, provided the terms and conditions of the agreement are satisfied.

Overall, the formalization of the bilateral APA procedure is a positive development for Irish businesses, which are dealing with an increasingly challenging international tax environment where transfer pricing attracts significant attention from tax authorities globally.

Taxpayers contemplating entering into a bilateral APA should note that as a result of changes to transfer pricing documentation resulting from BEPS action 13, "Transfer Pricing Documentation and Country-by-Country Reporting," such arrangements may have to be disclosed in the master file and relevant local file. Moreover, EU Council Directive

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

(EU) 2015/2376 on the mandatory automatic exchange of information will apply from January 1, 2017, and Irish Revenue will be obligated to automatically exchange certain information in relation to APAs with other EU member states, and to inform the European Commission of that information. In addition, some basic information will have to be provided in relation to APAs with non-EU jurisdictions. Taxpayers should consider these developments as part of their APA strategy.

— Gerard Feeney (Dublin)
Director
Deloitte Ireland
gfeeney@deloitte.ie

James Smyth (Dublin)
Senior Manager
Deloitte Ireland
jasmyth@deloitte.ie

OECD approves incorporation of BEPS amendments into transfer pricing guidelines

In a June 15 press release, the OECD announced that the OECD Council on May 23 had formally approved the amendments to the transfer pricing guidelines set out in the 2015 BEPS report on Actions 8-10, "Aligning Transfer Pricing Outcomes with Value Creation," and the report on Action 13 regarding transfer pricing documentation and country-by-country reporting.

In the press release, the OECD stated that "the amendments provide further clarity and legal certainty about the status of the BEPS changes to the Transfer Pricing Guidelines," which were endorsed by the Council on October 1, 2015, by the G20 Finance Ministers on October 8, 2015, and by the G20 leaders on November 15-16, 2015.

The amendments approved by the Council – the OECD's governing body – incorporate the BEPS transfer pricing measures into the transfer pricing guidelines. Given that the transfer pricing guidelines are integrated into the domestic law of some countries, including, in some cases, by direct reference to the guidelines themselves, this approval process further clarifies the status of the BEPS reports' changes to the transfer pricing guidelines.

According to the press release, the continuing efforts to make conforming amendments to the remainder of the transfer pricing guidelines, in particular to Chapter IX on the transfer pricing aspects of business restructurings are well advanced. Working Party No. 6 of the Committee on Fiscal Affairs is expected to soon invite interested parties to review the conforming changes to Chapter IX.

Andrew Hickman, head of the OECD's transfer pricing unit, said last week at a conference sponsored by the OECD, USCIB, and BIAC that the OECD intends to publish a new edition of the transfer pricing guidelines by year end, once the process is complete.

— Philippe Penelle (Washington, DC)
Principal
Deloitte Tax LLP
ppenelle@deloitte.com

Alan Shapiro (Tokyo)
Senior Advisor
Deloitte Japan
Alan.shapiro@tohmatsu.co.jp

Joseph Tobin (Washington, DC)
Senior Manager
Deloitte Tax LLP
jtobin@deloitte.com

In *Medtronic*, US Tax Court rules against IRS's use of CPM, applies CUT method

The US Tax Court on June 9 rejected the IRS's use of the aggregate comparable profits method (CPM) in *Medtronic Inc. v. Commissioner*, T.C. Memo 2016-112, to determine the appropriate royalty rate between Medtronic US and its Puerto Rican subsidiary, Medtronic Puerto Rico Operations Co. (MPROC) (the licensed manufacturer issue).

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

Also at issue were: (i) royalty payments made by Medtronic Europe, S.a.r.L. (Medtronic Europe) to Medtronic US for use in the manufacture of medical devices that were sold to another US affiliate named Medtronic USA, Inc. (Med USA) pursuant to a supply agreement among Medtronic US, MPROC, and Medtronic Europe (the Swiss supply agreement issue); and (ii) whether Medtronic US, Med Rel, Inc., or Medtronic Puerto Rico, Inc.,[12] transferred intangible property compensable under Internal Revenue Code section 367(d) to MPROC when Medtronic US restructured its Puerto Rican operations in 2002 (the section 367(d) issue).

Licensed manufacturer issue

MPROC and Medtronic US entered into four separate intercompany agreements covering: (1) Medtronic US's sales of components to MPROC; (2) MPROC's sales of finished products to Med USA for distribution in the US; (3) Medtronic US's grant of a trademark license to MPROC; and (4) Medtronic US's grant of technology and know-how licenses for devices and leads to MPROC. The taxpayer priced each of the four agreements separately, such that MPROC was treated as "a full-fledged entrepreneurial licensee responsible for its own success." In addition, Medtronic US argued that quality was the most important determinant of success in the medical device industry.

Upon review, the IRS treated MPROC not as a licensee but as a contract manufacturer, and performed a functional analysis that analyzed all four covered agreements together. Under this approach, MPROC was benchmarked against 14 companies in the medical device industry, and the remainder of the operating profits accrued to Medtronic US. The IRS also disagreed that quality was the most important determinant of success in this industry.

At trial, the IRS's expert concluded that the first two agreements were arm's length. As a result, the court did not examine them further. With respect to the other two agreements, Medtronic US had used the comparable uncontrolled transaction (CUT) method to benchmark each one. The court found that Medtronic US's proposed CUT method for the trademark license met the requirements of section 482 and therefore accepted that royalty as proposed.

In contrast, the court disagreed with the taxpayer's proposed CUT for the devices and leads licenses. At the same time, however, the court concluded that the IRS's aggregate CPM analysis was unreasonable too. In particular, the court quickly dismissed the IRS's attempt to aggregate the covered transactions, finding under the facts of the case that aggregation did not result in a reasonable allocation of system profits. In addition, the court dismissed the IRS's argument that its analysis met the commensurate with income standard under section 482 but that the taxpayer's proposed method did not.

Because of this, the court resorted to its own analysis, which involved using an adjusted CUT method that was based on Medtronic US's original position. As described in more detail below, the court's own analysis ended up with royalty rates similar to the IRS's position and to rates in a memorandum of understanding (MOU) that the taxpayer and IRS had entered into covering earlier years. The court stressed that the similarity between its conclusion and the MOU was purely coincidental.

The court agreed in large part with the criticism levelled at the IRS economist's report by Medtronic US's experts, and concluded that the IRS did not place enough emphasis on the importance of quality in the medical device industry. In particular, the court found that:

Product quality is the foundation for which implantable medical devices can be successful. A recall could make it very difficult for a company to continue to compete in the industry at the same level. A company can have a strong sales force and a creative marketing department, but these will not make a difference if the underlying product is unsafe and ineffective.

The court concluded that MPROC bore some of the risk involved in these transactions, and stated that MPROC contributed to the design process and had a role in product development. Finally, the court concluded that there was an ongoing relationship between Medtronic US and MPROC and that each party thereby benefitted from the other's know-how.

The court also disagreed with the IRS's proposed CPM comparables. More specifically, the court was concerned that the comparables manufactured different products at a smaller scale than MPROC, and that they engaged in additional

---

[12] Medtronic Puerto Rico, Inc. was the predecessor of MPROC.

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

functions such as sales and distribution. Furthermore, the IRS used the same set of comparables for what the court considered were two very different tested parties – Medtronic US's component manufacturing and MPROC's assembly of finished products.

Furthermore, the court took issue with the IRS's use of the return on assets (ROA) as the profit level indicator on the basis that "MPROC is more valuable than just buildings and equipment." The court concluded that the ROA was "misleading," because MPROC had "valuable intangible assets that were obtained through the devices and leads licenses…[which] are not recorded on petitioner's balance sheet."

As noted above, even though the court disagreed with the IRS's position, the court also took issue with Medtronic US's proposed CUT method, but mostly on the basis that such method did not make all the necessary comparability adjustments. Under Medtronic US's approach, a 7 percent royalty was adjusted to a 29 percent royalty due to certain factors such as exclusivity and know-how. The court disagreed with this for several reasons. First, the court rejected the taxpayer's assertion that market and product stage and development are proxies for profit potential. Second, the court noted that the controlled transactions included more intangibles than the adjusted internal CUT proposed by Medtronic US. Third, the court accepted the adjustments for exclusivity and know-how; however, the court concluded that the know-how adjustment was only for future technology. As noted above, the court found that there was an ongoing relationship between Medtronic US and MPROC, and that each entity shared with the other current know-how. The court concluded that such know-how was just as valuable as the exclusivity aspect of the agreement and warranted an upward adjustment.

Despite these deficiencies, the court did find that Medtronic US's approach could be used as a starting point. The court then made additional comparability adjustments to increase the royalty from 29 percent to 44 percent. As noted above, this final royalty rate is similar to the rate for leads used in the MOU that covered earlier years for this transaction. The 44 percent rate is also closer to the royalty rates proposed by the IRS using its aggregate CPM method (49.4 percent in 2005 and 58.9 percent in 2006) than Medtronic US's proposed royalty rate of 29 percent.

In contrast to the royalty for the licenses, the court found that an appropriate royalty for the leads was, as Medtronic US argued, half of the rate for the licenses. The court held, therefore, that the leads royalty should be 22 percent. This, too, was close to the 26 percent rate for the leads agreed to in the MOU.

Swiss supply agreement issue and section 367(d) issue

The court applied the same analysis to the Swiss supply agreement issue as to the devices licenses, and held that the royalty for the Swiss supply agreement issue should be 44 percent as well.

Finally, the court examined the section 367(d) issue, but rejected the IRS's assertions. The court concluded that the IRS did not identify what intangibles, as defined under section 936(h)(3)(B), had been transferred, or explain the specific value of any intangibles that should be covered by section 367(d). In addition, the court concluded that there was no section 367(d) transfer, because the intangibles used by MPROC were the subject of the devices and leads licenses.

Conclusion

It remains to be seen just how far-reaching this decision will be. Unlike the decision in *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (July 27, 2015), which was decided by a panel of Tax Court judges 15-0, the *Medtronic* decision is a Tax Court memorandum opinion issued by one judge. Such an opinion is issued when the Tax Court considers that a case does not involve a novel legal issue and when the law is settled or factually driven.

In some ways, this decision might be interpreted as just an affirmation of the court's long-standing disagreement with the IRS in cases like *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525, 582 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991), where the IRS contended that an offshore manufacturing company should be analyzed simply as a contract manufacturer. In this case, the court, continuing its demonstrated preference for CUTs, even if inexact, rejected the IRS's aggregate CPM value chain analysis. In doing so, the court focused for the most part on the strength of the taxpayer's functional analysis, which highlighted the importance of the licensee's contributions to maintaining product quality and assuming quality-related risks.

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

On the other hand, this decision may provide a level of comfort for taxpayers who are concerned about the possible changes that could be brought on by the OECD's base erosion and profit shifting (BEPS) initiative, which some governments might interpret as advocating for an aggregate value chain analysis. In this case, the court squarely rejected that approach and instead opted for one that more carefully delineated each individual transaction.

— Aydin Hayri (McLean)
Principal
Deloitte Tax LLP
ahayri@deloitte.com

Philippe Penelle (Washington, DC)
Principal
Deloitte Tax LLP
ppenelle@deloitte.com

David Varley (Washington DC)
Principal
Deloitte Tax LLP
dvarley@deloitte.com

European Union's CbC reporting directive enters into effect

The EU Council's directive on country-by-country (CbC) reporting of information by multinationals to tax authorities entered into force on June 3, 2016. The directive must be implemented into the domestic law of member states by June 4, 2017, although that law is required to have effect for accounting periods starting on or after January 1, 2016.

The CbC reporting directive follows the recommendations of the OECD in the final report issued on action 13 of the BEPS project (*Transfer Pricing Documentation and Country-by-Country Reporting*), and includes the common template agreed to by the countries involved in the project.

This directive relates to requirements for filing with, and the sharing of, CbC information to tax authorities only. Separately, the European Commission has proposed requirements for public reporting of some CbC tax information by multinationals operating in the EU.

CbC information to be submitted

Under the directive, parent companies of groups with operations resident for tax purposes in more than one EU member state are required to report CbC information to the tax authorities of the member state in which they are resident for tax purposes. The reporting requirements apply to multinational groups with consolidated group revenue exceeding EUR 750 million, matching the recommendations in the BEPS action 13 report.

The filing requirement applies to tax years beginning on or after January 1, 2016, and multinationals must file reports within 12 months of the end of each accounting period. The tax authorities of the member states are required to automatically share CbC templates they receive with other member states in which the multinational group has operations within 15 months of the end of the period to which the report relates (18 months for the first period).

When the parent of the multinational group is not resident in a jurisdiction that requires it to report CbC information to the tax authorities, the group may designate one EU-resident entity to file the information on behalf of the group, or elect another group entity that is required to file a CbC report to the tax authorities of its country of residence, as a surrogate for the parent, provided the surrogate entity is resident in a jurisdiction that has an agreement for the sharing of information (under a tax treaty, tax information agreement, or other agreed sharing mechanism).

The directive allows member states to be able to defer CbC reporting obligations for non-EU-headed groups by one year to allow non-EU countries' legislation (in particular, that of the United States) to catch up. However, several member states already have adopted CbC legislation as part of the minimum standard set by the OECD, including some form of local filing requirement.

Information to be filed

The information to be filed is the common template prepared by the OECD, including by country:

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

- Revenue, split between related-party and unrelated-party revenues;
- Profit (loss) before income tax;
- Income tax paid (on cash basis);
- Income tax accrued (current year);
- Stated capital;
- Accumulated earnings;
- Number of employees;
- Tangible assets other than cash and cash equivalents; and
- Details of all group entities by tax residence, and their country of incorporation (if different), along with the main business activity(ies) of each entity.

The directive provides that CbC reports are to be filed electronically, presumably following the xml schema developed by the OECD (although this has not yet been adopted).

Penalties

As is the case with other EU directives, the CbC reporting directive does not contain a specific penalty regime. Member states are required to set their own penalties, which should be "effective, proportionate and dissuasive."

Comments

The CbC reporting directive amends the 2011 directive on administrative cooperation and makes use of the existing "common communication network" for the exchange of information by EU member states, although the directive acknowledges that this will need to be updated.

The directive has had only minimal changes since the draft version was published at the end of January 2016; most notably, there is an extension to the period of time member states have to share the contents of CbC reports with other member states for the first reporting period – this period has been extended from 15 months to 18 months, in line with the OECD recommendation.

It is clear that the EU intends to follow the internationally agreed recommendations of the OECD BEPS project on CbC reporting to tax authorities. The directive requires member states, in transposing the directive into domestic law, to refer to the OECD action 13 report for interpretation. The EU will continue to take into account future developments at the OECD level, including presumably the OECD review of the CbC template scheduled for 2020.

As set out by the G20/OECD, member states should use the information contained within a CbC report to assess high-level transfer pricing risks and other risks related to BEPS and can use the information as a basis for making further enquiries in the course of a tax audit. Transfer pricing adjustments should not be made based only on the CbC information provided. The CbC reporting directive does not go as far as the OECD in stating that should such an adjustment be made solely on the basis of the CbC template, it should be conceded by the tax authorities promptly in mutual agreement proceedings.

— Bill Dodwell (London)
Partner
Deloitte United Kingdom
bdodwell@deloitte.co.uk

Indian tribunal rules on adjustments in relation to interest-free loans from foreign parent to Indian subsidiary

A three-member special bench of India's Income Tax Appellate Tribunal issued an important ruling on July 15 in the case of *Instrumentarium Corporation Limited, Finland*, on the basics of transfer pricing. The special bench concluded in its ruling that the transfer pricing regime in India's tax laws does not support the contention that if a foreign company is taxed on the same income on which the Indian associated enterprise (AE) is to be allowed a corresponding deduction, it will erode the tax base in India.

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

The ITAT also ruled that Section 92(3) of the Income Tax Law indicates that what is relevant is the impact on profits or losses for the year under consideration, as it is to be computed on the basis of entries made in the books of accounts in respect of the previous year in which the international transaction was entered into. There is no scope for taking into account the impact on taxes for subsequent years.

The special bench further held that:

> *"[E]ven if it is indeed intent of the legislature that transfer pricing provisions are not to be invoked in the cases where there is lowering of the overall profits of all the associated enterprises connected with the transaction, since the words of the statute do not translate this intent into the law, it cannot be open to us to hold that in the light of the legal provisions as they stand embodied in section 92(3) of the Act, transfer pricing provisions are not to be invoked when, as a result of the structuring of a transaction in a particular way, there is no erosion of Indian tax base…"*

Facts

The taxpayer is a company incorporated in Finland and engaged in the manufacture and sale of medical equipment. It had a wholly owned subsidiary, Datex Ohmeda India Pvt. Ltd. – the Indian AE – that acted as its marketing arm. The taxpayer made an interest-free loan to the Indian subsidiary in 2002. The taxpayer sought an advance ruling from the Authority for Advance Rulings (AAR) to obtain certainty on the transaction, and for that purpose raised two questions: (a) whether providing an interest-free loan would be subject to the transfer pricing provisions; and (b) whether it should charge interest from its subsidiary under the principles of the arm's length standard. The AAR did not issue a ruling, and instead held that the case involved a determination of fair market value (FMV), which was not within its scope of adjudication.

The matter was taken up by the assessing officer (AO), who issued notices for escapement of income, which the taxpayer did not comply with. The AO regarded the Indian subsidiary as the taxpayer's representative assessee and alleged that the taxpayer should have charged interest from its Indian AE at an arm's length interest rate, and made an adjustment for interest income in the hands of the taxpayer.

The taxpayer appealed before the Commissioner of Income Tax (Appeals) and contended that the interest adjustments in the hands of the taxpayer would have the overall impact of reducing the tax base in India, which was not the intent of the legislation. The taxpayer demonstrated that while the receipts in the hands of the assessee would be taxable at the rate of 10 percent on a gross basis under applicable treaty provisions, the expenditure so incurred would be fully deductible by the resident subsidiary, and thus would reduce taxable income, which would otherwise be subject to a 36.75 percent tax rate. The net effect would be that, if interest-free loans from a foreign parent company were subjected to arm's length price adjustments, the Indian tax base would stand eroded by 26.75 percent of such an adjustment.

The CIT (A) did not agree with the taxpayer. The taxpayer then filed an appeal before the Income Tax Appellate Tribunal. Concluding that the matter was important and that the issues are basic to the provisions of the transfer pricing regime, the tribunal referred the matter to a special bench.

Issue before the tribunal

Whether an arm's length price adjustment was required to be made, in respect of an interest-free loan granted by the taxpayer to its wholly owns subsidiary in India.

Observations and ruling

The special bench considered in detail the taxpayer's basic argument that if the Indian AE were charged arm's length interest on the loan, that interest income to the taxpayer would be subject to withholding tax at the rate of 10 percent, while the Indian subsidiary, which is subject to tax at the rate of 36.75 percent, would get the full deduction of this expense, with the net effect that the Indian tax base would be eroded by 26.75 percent.

The taxpayer highlighted CBDT Circular No. 14 of 2001, which makes it clear that the basic intent underlying the transfer pricing regulations is to prevent the shifting of profits by manipulating prices charged or paid in international transactions, thereby eroding the country's tax base. Thus, the transfer pricing provisions are not to be applied in

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

cases where adoption of an arm's length price would result in a decrease in overall tax incidence in India in respect of parties involved in the international transactions.

The taxpayer also sought to rely on Ruling No. 2007/1 of the Australian Tax Office (ATO) on a similar issue, wherein it was held that no arm's length price adjustment was needed in the case of a nonresident lender providing an interest-free loan to an Australian domestic company, and that this principle would apply even if the Australian domestic company were to incur a genuine tax loss because of the tax loss eligible to being carried forward.

The tax authorities argued that any profits arising out of international transactions between associated enterprises are required to be computed under the provisions of the transfer pricing rules. They argued that the provisions of Section 92 do not apply when the computation of income has the effect of reducing the income chargeable to tax or increasing the loss, as the case may be, computed on the basis of entries made in the books of account in respect of the previous year in which the international transaction was entered into. The tax authorities further contended that there is no theory of holistic view in the tax statute regarding the overall taxability in the hands of all AEs.

Against the above contentions, the taxpayer submitted that the transfer pricing provisions deal with the tax implication on the transaction as a whole, and not just the tax implications in the hands of one of the parties to the transaction. The taxpayer relied on the Supreme Court decision in *KP Verghese*[13] and submitted that the law should be interpreted in a manner to achieve and advance the legislative intent.

The tax authorities also alleged that the taxpayer had earlier charged interest on loans extended to Indian companies, but it was only when the losses suffered by the Indian AEs surfaced, and the Indian AEs did not gain any tax advantage from these interest payments, that the taxpayer stopped charging interest on loans to its Indian AEs, and that by no stretch of logic could it be said that not charging interest was a *bona fide* business decision.

The special bench analyzed the provisions of section 92(3) of the Act and agreed with the tax authorities' view that exemption from the transfer pricing provisions applies only in cases where the transfer pricing adjustment results in reducing the taxable profit or enhancing the losses of the taxpayer. The special bench held that there is no provision for a corresponding deduction of the transfer pricing adjustment in the hands of the Indian AE. The tax base erosion would have taken place only in a situation whereby the Indian AE would have actually allowed interest income to the taxpayer, which was not the fact in this case. Based on the above, the bench held that there was no tax base erosion.

The special bench also held that the provisions of section 92(3) of the Act provide for determining the impact on profit or losses only for the year under consideration, and not for taking into consideration the impact of any transfer pricing adjustment in subsequent years. The bench observed that in the relevant assessment year, because the Indian AE was incurring losses, failure to apply the transfer pricing provisions to the taxpayer would, on the contrary, result in erosion of the Indian tax base, as it would result in the loss of withholding tax of 10 percent in the hands of the taxpayer, while the Indian AE would not have anything to lose.

The special bench held that the tax administration cannot be expected to be clairvoyant as to whether or not the Indian AE will actually earn sufficient profits in the future to subsume its losses from the transaction with the taxpayer. The possibility of set-off of future profits against the losses incurred by the AE cannot be taken into account for determining the overall tax impact.

The special bench observed that it could not rely on the ATO ruling because the provisions of Indian law are different from Australia's transfer pricing provisions. The tribunal stated that, "The provisions of the Indian Income Tax Act 1961 and the Australian Income Tax Assessment Act 1936 are thus not at all in pari materia in this context….The Indian transfer pricing regulations do not give any such discretions to the tax administration for the application of arm's length price in computation of profits arising from international transactions. As there is no discretion with the tax administration, there is no occasion for any guiding principles in the use of discretion."

Conclusion

This is an important ruling on the concept of tax base erosion under the transfer pricing provisions. Although the special bench analyzed in detail the legislative intent and the Indian transfer pricing provisions, it has taken a view

[13] K P Verghese vs Income Tax officer [(1981)131 ITR597(SC)]

© 2016. For information,
contact Deloitte Touche Tohmatsu Limited.

that tends to restrict the arm's length determination only to the year of the transaction at hand, and not a long-term view of the business arrangements, and in that context added, "The approach adopted by the tax administration, therefore, can at the most be conservative, but certainly not myopic. In any case, that is what the law provides."

The ruling stated the commercial expediency of a loan to subsidiary is wholly irrelevant in ascertaining the arm's length interest on such a loan. There is indeed no bar on anyone advancing an interest-free loan to anyone, but when such transactions are covered by the international transactions between associated enterprises, Section 92 of the Act mandates that the income from such transactions is to be computed on the basis of an arm's length price.

The above issues are highly contentious. Taxpayers may have to await a ruling from a higher appellate authority on the issue of the relationship between base erosion and transfer pricing within the framework of the law and the overall intent of the legislature.

Source: Instrumentarium Corporation Limited, Finland (ITA No. 1548 and 1549/Kol/2009, AY 2003-04 and 2004-05)

— Sanjay Kumar (Delhi)
Senior Director
Deloitte India
kumarsanjay@deloitte.com

Chhavi Poddar (Delhi)
Senior Manager
Deloitte India
cpoddar@deloitte.com

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/about to learn more about our global network of member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

© 2016. For information, contact Deloitte Touche Tohmatsu Limited.