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US Tax Court sides with Amazon in intangibles transfer case

The US Tax Court in its March 23 opinion *Amazon.com, Inc. v. Commissioner*, T.C., No. 31197-12, 148 T.C. No. 8, 3/23/17, found the IRS’s approach to valuing a cost sharing buy-in payment to be arbitrary, capricious, and unreasonable.

The Tax Court specifically addressed the following three issues under the 1995 cost sharing regulations: (i) the price of a buy-in payment; (ii) the price of other intangible transfers; and (iii) the subsequent allocation of certain intangible development costs (IDCs). All three issues arose in relation to a cost sharing arrangement (CSA) that was entered into as part of a 2004 restructuring by Amazon.com Inc. (Amazon US) and its Luxembourg subsidiary. Also at issue was whether a claw-back provision contained in the CSA for stock-based compensation (SBC) was operative in light of the Tax Court's decision in *Altera Corp. v. Commissioner*, 145 T.C. 91. The years before the court were 2005 and 2006.

It should be noted that, on January 5, 2009, the IRS and Treasury redesignated the regulations at issue in the *Amazon* case as Treas. Reg. §1.482-7A, and at the same time promulgated new temporary cost sharing regulations that were designated as Treas. Reg. §1.482-7T (T.D. 9441, 74 Fed. Reg. 352). The IRS and Treasury later issued final regulations on December 22, 2011 (T.D. 9568, 76 Fed. Reg. 80090), which adopted the effective date of the temporary regulations. Therefore, the opinion of the Tax Court in *Amazon* is limited to transactions before January 5, 2009, and is not directly applicable to cost sharing transactions that are governed by the post-2009 temporary and final regulations.

Buy-in payment and intangible transfers

In this case, the IRS proposed to value the buy-in and other intangible transfers in the aggregate using a discounted cash flow analysis (DCF) with a perpetual life. The Tax Court held that the IRS's approach to valuing the intangible transfers was arbitrary, capricious, and unreasonable. Affirming its decision in *Veritas Software Corp. v. Commissioner*, 133 T.C. 297, the Tax Court rejected IRS attempts to distinguish or overrule Veritas and held:

- The intangibles at issue did not have a perpetual useful life;
- The buy-in payment was not "akin to a sale";
- The workforce in place, goodwill, and going concern value should be excluded when determining the buy-in payment;
- The intangibles at issue should not be valued in the aggregate; and
- The transferred website technology decayed in value over its useful life.

The Tax Court rejected the IRS's attempt to value the transferred intangibles in the aggregate. Under the aggregation principle, analyzing the combined effect of multiple transactions in the aggregate may be appropriate if combining the transactions provides the most reliable measure of an arm's length result. The Tax Court rejected the use of aggregation in this case, because such an analysis would have effectively combined: (i) preexisting intangibles, which were the subject of the buy-in; and (ii) subsequently developed intangibles, which were co-owned by the cost share participants. In addition, the Tax Court found that aggregation would combine compensable intangibles (website technology, trademarks, and customer intangibles) and non-compensable residual business assets, such as workforce in place, goodwill, and going concern value.[1]

The Tax Court rejected the IRS's contention that the "realistic alternatives" principle articulated in Treas. Reg. §1.482-1(f)(2)(ii)(A) supported the IRS's application of the DCF. Under the realistic alternatives principle, the commissioner of the Internal Revenue Service is authorized to consider realistic alternatives to determine if the controlled transaction is arm's length. The IRS contended that the realistic alternative for Amazon US was to keep ownership of the IP and develop it further. This view lends support to the "akin-to-a-sale" position that the IRS argued. Based on the IRS regulations, the Tax Court concluded that the realistic alternatives considered must be consistent with the form of the transaction chosen by the taxpayer. In this case, assuming that Amazon US did not enter into the cost share arrangement was not a realistic alternative to the CSA.

The Tax Court also rejected the IRS's use of a perpetual life, maintaining that this was incompatible with the CSA requirement to compensate the transferor for preexisting intangibles. The Tax Court held that the use of a perpetual life would include subsequently developed intangibles as well as preexisting intangibles. This, according to the Tax Court, was inconsistent with the applicable 1995 cost sharing regulations.

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[1] As the Tax Court noted, the definition of intangible property in the cost sharing regulations in effect for 2005 and 2006 is nearly identical to the definition of intangible property contained in IRC §936(h)(3)(B), which is cross-referenced in IRC §367(d).

The Tax Court determined that the comparable uncontrolled transaction (CUT) method was the most reliable method to value the intangible transfers. Both Amazon US and the IRS presented CUTs to support their theories of the case. After adjusting the CUTs:

- The court determined that the required buy-in payments for the website technology was a royalty of 3.05 percent of sales decayed over seven years and with a 3.5-year "tail" of 0.40 percent. The court based its decay function on detailed expert testimony concerning the life of Amazon US's website technology.
- The court valued the trademarks at 0.75 percent of sales over 20 years with no decay rate. The court took the following into consideration in determining the value of the trademarks:
    - The high recognition of the trademarks in Europe at the time of transfer;
    - The fact that the value of the trademarks over time would be dependent on the success of the Luxembourg investment in cost shared intangibles; and
    - The Luxembourg contribution to the value of the trademarks prior to the transfer.
- Finally, the European customer information was valued at a relatively nominal amount given the churn of customers.

Intangible development costs

The IRS asserted that 100 percent of the costs attributable to certain cost centers were allocable to the CSA cost pool. At trial, Amazon US established that the employees in those cost centers engaged in substantial non-IDC activities. The Tax Court agreed that less than 100 percent of those cost centers were properly allocable to the CSA cost pool.

Stock-based compensation costs

The CSA executed by Amazon US and its Luxembourg subsidiary included SBC costs in the cost pool in accordance with the IRC §482 regulations governing the years at issue. Amazon US, like other taxpayers, included a provision in the CSA whereby those costs would be "clawed back" in the event the regulations were held to be invalid. However, that provision would take effect only if certain contingencies occurred, such as the regulation in question being invalidated by a "final decision in a court of law." In *Altera Corp. v. Commissioner*, 145 T.C. 91, the Tax Court invalidated the SBC rule at issue, which was contained in Treas. Reg. §1.482-7(d)(2) (as amended in 2004).[2] The Tax Court's decision was appealed to the US Court of Appeals for the Ninth Circuit on February 19, 2016. Because that case remains pending on appeal, the court held the CSA's claw-back provision was not operative by its own terms during the years at issue.

Conclusion

The Tax Court in *Veritas* and *Amazon* limited its decision to issues arising under the 1995 cost sharing regulations. The subsequent cost sharing regulations replaced the concept of a "buy-in" payment with the concept of a platform contribution transaction (i.e., any right, resources, or capabilities). The latter concept has a much more expansive definition of what is compensable compared to just the preexisting IRC §936(h)(3)(B) intangibles at issue under the 1995 regulations.

At the same time, the income method of Treas. Reg. §1.482-7(g)(4) (as amended in 2011) specifically relies on two critical concepts that were contained in the 1995 cost sharing regulations but that, as applied, were rejected by the Tax Court in *Amazon*, namely: (i) aggregated valuation; and (ii) the realistic alternatives principle.

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[2] As noted above, Treas. Reg. §1.482-7 was redesignated Treas. Reg. §1.482-7A with the promulgation of T.D. 9441, 2009-7 I.R.B. 460. The years at issue in *Amazon*, though, were 2005 and 2006. For that reason, the prior designation has been used here.

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China's SAT issues new rules to improve administration of Special Tax Investigation and Adjustment and Mutual Agreement Procedures

On 17 March 2017, China's State Administration of Taxation (SAT) issued new regulations – Bulletin 6 – to improve the administration of Special Tax Investigations and Adjustments and Mutual Agreement Procedures. These regulations largely complete the revision of the transfer pricing-specific clauses of Circular 2, and add to the transfer pricing framework set out in the previously issued Bulletin 42[3] and Bulletin 64[4].

The Bulletin enters into effect on 1 May 2017, and the corresponding sections of previous regulations are repealed.[5]

Following the release of the three new regulations (Bulletins 42 and 64 in 2016 and Bulletin 6 in 2017) on Special Tax Adjustments, the regulatory framework for Transfer Pricing in China is now spread across a number of regulations. The following table shows the effect of these changes, and aligns the old regulations with the SAT's 2015 discussion draft on revising Circular 2, and the newly issued bulletins.

Circular 2	2015 Discussion Draft	Applicable Regulations
Chapter 2 – Reporting and Filing of Related-Party Transactions	Chapter 2 – Reporting and Filing of Related-Party Transactions	Bulletin 42
Chapter 3 – Administration of Contemporaneous Documents	Chapter 3 – Administration of Contemporaneous Documents	
Chapter 4 – Transfer Pricing Methods	Chapter 4 – Transfer Pricing Methods	Bulletin 6
Chapter 5 – Transfer Pricing Audit and Adjustment	Chapter 5 – Special Tax Audit and Adjustment	
	Chapter 6 – Intangible Assets	
	Chapter 7 – Related Party Services	
Chapter 6 – Administrative Guidance Concerning Advance Pricing Arrangements	Chapter 8 – Advance Pricing Arrangements	Bulletin 64
Chapter 7 – Administrative Guidance Concerning Cost Sharing Agreements	Chapter 9 – Cost Sharing Agreements	Circular 2 (Article 69 and 74 annulled); Bulletin 42
Chapter 8 – Administrative Guidance Concerning Controlled Foreign Corporations	Chapter 10 – Controlled Foreign Corporations	Circular 2
Chapter 9 – Administrative Guidance Concerning Thin Capitalization	Chapter 11 – Thin Capitalization	Circular 2 (Article 89 annulled); Bulletin 42
Chapter 10 – Administrative Guidance Concerning General Anti-Avoidance	Chapter 12 – General Anti-Avoidance	Circular 2
	Chapter 13 – Profit Level Monitoring	Bulletin 6
Chapter 11 – Corresponding Adjustments and International Negotiation	Chapter 14 – Corresponding Adjustments and Mutual Agreement	
Chapter 12 – Legal Responsibility	Chapter 15 – Legal Responsibility	

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[3] See Deloitte Tax Analysis on Bulletin 42: https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2016/deloitte-cn-tax-tap2412016-en-160713.pdf
[4] See Deloitte Tax Analysis on Bulletin 64: https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2016/deloitte-cn-tax-tap2482016-en-161018.pdf
[5] In addition to corresponding sections in Circular 2, a few other regulations are repealed: Guoshuihan [2009] No. 188, Guoshuihan [2009] No. 363 (Circular 363), SAT Bulletin [2014] No. 54 and SAT Bulletin [2015] No. 16 (Bulletin 16).

Circular 2	2015 Discussion Draft	Applicable Regulations
Note: This table is a summary of the regulations related to special tax adjustment issued in 2016 and 2017 with reference to Circular 2 and the discussion draft only, which does not cover all current regulations related to special tax adjustment such as the Administrative Measures for the General Anti-Avoidance Rule (for Trial Implementation) (SAT Order No. 32) and SAT Bulletin on Regulating Cost Sharing Agreements (SAT Bulletin [2015] No. 45). We have also omitted references to introductory, administrative, and supplemental chapters of Circular 2 and the discussion draft.		

Bulletin 6 has clarified certain key transfer pricing issues, as well as the methodology and procedures for special tax audits and adjustments. In making the changes, the SAT has generally incorporated positions taken in the discussion draft regarding intangible assets, related-party services and the monitoring of profit levels, as well as the guidance on mutual agreement procedures. Bulletin 6 puts more emphasis on a risk-oriented tax administration system that looks to improve cooperation between enterprises and tax authorities, and overall compliance with the regulations. In clarifying the technical positions, the regulation incorporates changes arising from the OECD's Base Erosion and Profit Shifting (BEPS) Actions 8-10 and Action 14.

Another encouraging sign is that the SAT has given due consideration to comments provided by enterprises and the public, and has revised and clarified some points that were of concern to taxpayers, or were not entirely clear, for example:

- Reinforcement of the arm's length principle as the primary requirement for transfer pricing in China;
- Removal of the controversial "secondary adjustment" provision, as well as similar provisions allowing tax authorities to deny or recharacterize related-party transactions; and
- Permitting working capital adjustments when analyzing toll processing businesses, with the requirements of revisiting comparable companies when the adjustment to profit levels exceeds the acceptable range, that is, when working capital adjustments result in a profit level adjustment by more than 10 percent.

Key points of the bulletin are discussed in more detail below.

Monitoring of profit level

In the past, companies may have been subject to tax authority scrutiny on an ongoing basis only after they had been audited, with a five-year follow-up supervision period. However, in the future all companies may have their profit levels and transactions monitored through the improved related-party transaction disclosure requirement. It will be more important for companies to manage their transfer pricing risks proactively than ever before.

With this in mind, the introductory article of Bulletin 6 establishes an expectation that the tax authorities will focus on risk management, strengthening the monitoring of profit levels, and enhancing compliance with tax laws through special tax adjustments, supervision, and investigation. Tax authorities' monitoring of profit levels may lead to a taxpayer receiving a "Notice of Taxation Matters" from the authorities, indicating that a transfer pricing risk has been identified. Taxpayers will be encouraged to make self-adjustments if they agree with the issues raised by the authorities – although the tax authorities can still conduct a special tax audit in the future.

Overall, the changes are expected to lead to a more comprehensive, real-time, and dynamic monitoring environment. The SAT is already looking to leverage "Big Data" analyses of the information that is collected, and we expect that this will allow the SAT to more reliably monitor and focus on transfer pricing risk areas.

Special tax audits and adjustments

Bulletin 6 is written from the perspective of how the tax authorities should make special tax adjustments to a taxpayer's related-party transactions. Articles 4 to 43 step through the audit process, and the technical process that the tax authorities should follow – covering audit processes, comparability analyses, transfer pricing methods, and the treatment of services, royalties, losses, etc. Taxpayers will use this prescribed process as a roadmap for their own transfer pricing analysis.

Types of enterprises be focused on special tax audits: Article 4 of the Bulletin lists nine risk characteristics the tax authorities should focus on when conducting special tax audits. Compared with Circular 2, new characteristics are added, for example, when an enterprise is in excess of the standard related-party debt-to-equity ratio, or has tax planning or business arrangements without a bona fide commercial purpose. The Bulletin also includes a risk criteria for enterprises controlled by a Chinese resident in tax jurisdictions with an effective tax rate below 12.5 percent, and distributing no or minimal profit without reasonable business needs – effectively targeting Chinese controlled foreign companies. This new criteria reflects an understanding that Chinese "One Belt One Road" and "Go Global" enterprises have global operations and that further scrutiny of their subsidiaries may be necessary.

Transfer pricing methods: In addition to the traditional five transfer pricing methods introduced in Circular 2, Bulletin 6 permits other asset valuation methods that comply with the arm's length principle, including the cost, market, and income approaches – generally used for valuing tangible or intangible assets. The value contribution allocation method, which was introduced in Article 35(1) of the discussion draft is not prescribed as a transfer pricing method in Bulletin 6, although the general profit split method specifically includes consideration of value contribution.

Bulletin 6 also allows the tax authorities to apply other methods that could align the profit with economic activity and the creation of value. Therefore, although the "value contribution allocation method" is not specifically included, this clause, current tax authorities' practice, and the contents of Bulletins 42 and 64 suggest that the authorities may be able to allocate profits based on their perception of where the value is created.

Loss-making enterprises with simple functions: Following the release of Bulletin 42, one missing element was the documentation requirement for simple-function entities that had losses. The existing Circular 363 requirement was still applicable, but the required content of the documentation was unknown. Bulletin 6 now confirms the requirement for loss-making simple-function entities (pure manufacturing, distribution, or contract R&D activities) to maintain a reasonable level of profit in principle. If they are in a loss position, the enterprises should prepare the China local file – although there is no requirement to submit the file. The master file would be required only if the thresholds in Bulletin 42 for a master file were met.

Bulletin 6 also states that tax authorities should focus on reviewing the local file of these simple-function entities and strengthen their ongoing monitoring activities. This reveals that the Chinese tax authorities will rely on the monitoring system to identify transfer pricing risks of such loss-making entities. It also puts more pressure on subsidiaries with losses and limited activities within China – management will need to consider the rationale for any losses, and ensure robust documentation is prepared.

Concealed transactions: The Bulletin also makes specific reference to restoring any "concealed related-party transactions" reducing the collection of tax nationally – impacting domestic companies not charging their overseas related parties. If the tax authorities discover through their information-gathering activities that a Chinese company is providing a service, or allowing the use of intangible property, but not charging the related parties, a special tax adjustment may be made to restore the transaction. Along with other changes in the Bulletin, this is reflective of the fact that the Chinese tax authorities are paying more attention to the transfer pricing issues associated with "Go Global" enterprises.

Intangibles: Unlike the discussion draft, Bulletin 6 does not have a separate chapter considering intangibles. Rather, it discusses specific analyses and considerations that the tax authorities should have before making Special Tax Adjustments – as well as incorporating Bulletin 16 requirements. The definition of intangibles from the OECD comments that was included in the discussion draft has been removed, along with specific definitions and references to separate "legal" and "economic" owners of the IP.

However, the regulations have incorporated the requirement that entities that own IP without contributing to the value of the intangible will not be entitled to any returns from the intangible. Likewise, parties that contribute only funding or capital will be entitled only to a reasonable return on their capital. The regulations are consistent with the contents of the BEPS action plan.

When reviewing a royalty or other IP arrangement, the tax authorities are directed to analyze the value creation factors for the IP, and the contributions of all parties to the development, enhancement, maintenance, protection, exploitation, and promotion ("DEMPE+P") of the intangible. If the recipient of a royalty has not contributed to the value creation or DEMPE+P, and not complied with the arm's length principle, then the tax authorities may make an adjustment.

The Bulletin's specific reference to "not in accordance with the arm's length principle" seems to provide an exemption for "mere legal owners" if the royalty arrangement would still be an arm's length transaction (despite the lack of value creating functions and risks), for example, if the IP was acquired from a third party and needs to be licensed to the China subsidiary. Further observation will be needed to determine whether such related-party transactions would be acceptable.

The focus on "Go Global" companies also has been considered, specifically in relation to intangibles. The tax authorities' practice in the past has focused on reviewing royalty payments by enterprises, and the discussion draft had language focusing on the payment side of the transaction. However, the Bulletin has broadened the requirement for tax authorities, asking them to also consider royalty recipients, and whether they have received a sufficient return. Combined with the references to "concealed related-party transactions," this underlies the increasing focus on China "Go Global" enterprises.

Intragroup services: The section on intragroup services is no longer a standalone chapter, and similar to the royalties articles, takes existing regulations from Bulletin 16. The Bulletin unifies the "beneficial service" and arm's length principles, and confirms the requirement for services to bring economic benefits to the recipient, and for the service fee to be calculated in the same way as services taking place in the marketplace, or that third parties would be willing to engage in such services or otherwise perform them themselves in the same or similar circumstances. The Bulletin also sets out the "six tests" from Bulletin 16 in more detail, and clarifies that transactions failing the tests are not beneficial services.

One change from the discussion draft is the removal of the language "plus an arm's length mark-up" from the regulations on calculating a service fee – the basis for the calculation is now only the "reasonable cost" or the "apportioned cost." Therefore, any service fee calculation will need to take into consideration the cost of the service, as well as the benefit or value created by the service provider when determining the arm's length service fee. For example, if an overseas related party had outsourced almost all of the service that is provided to a China subsidiary, and therefore not created a benefit itself, the overseas related party should not be entitled to charge the China subsidiary a mark-up on that external cost.

Reinforcing this point, and also applicable to intangibles, the Bulletin specifically provides that payments made to overseas entities that do not have functions, risks, or substantial operating activities, may be subject to special tax adjustments, if the payments do not otherwise comply with the arm's length principle.

Procedures for special tax audits and adjustments: The Bulletin provides a clear outline of the formal procedures where the tax authorities conduct an audit, discussing procedures whether there are or are not going to be any special tax adjustments. This also establishes the process for when an enterprise disagrees with the tax authorities' proposed adjustment, etc.

Under the process, enterprises that disagree with proposed special tax adjustments may choose to pay the disputed tax, interest, and surcharges, and then file an application for "administrative reconsideration," and subsequent "administrative litigation."

The Bulletin also ensures that the common practice of "self-adjustments" of tax are now formalized through the "Special Tax Adjustment Self-declaration", where payments may be made before receiving a Special Tax Adjustment Notice.

Irrespective of whether the enterprise makes a self-adjustment or not interest will continue to be calculated based on the Basic Lending rate published by the People's Bank of China. The additional 5 percent penalty interest will apply in situations where the taxpayer does not provide contemporaneous documentation and other documents requested by the tax authorities. This means that if an enterprise thinks it is below the threshold and is not required to prepare documentation, but the tax authority considers the transactions are underpriced, or there are "concealed transactions", the 5 percent penalty interest may be triggered if the restored transactions exceed the threshold and the taxpayer has not prepared the documentation.

One omission from the Bulletin is the absence of the "secondary adjustment" language that was included in the discussion draft. This controversial provision seems to have been dropped in response to comments and advice received from taxpayers and advisors.

Corresponding adjustments and mutual agreement procedure

Recent regulatory changes show that China has positively implemented changes coming out of the BEPS project, through both Bulletin 42 and Bulletin 6. The revisions to China's dispute resolution mechanisms for Special Tax Adjustments, amending the existing rules in Circular 2, continues this. The changes have given more certainty to taxpayers that plan to apply for the mutual agreement procedure (MAP), with further guidance on requirements for initiating the process and providing information, as well as outlining the situations when the authorities will reject an application, or suspend or terminate the MAP process. The Bulletin also confirms that the new regulation will apply to all MAP applications that have been accepted, but not concluded at the effective date of the Bulletin.

It is noteworthy that Bulletin 6 has also specified circumstances when a "suspension of mutual agreement procedure" is applicable. This gives both taxpayers and tax authorities the right to suspend the process. This could be a response by the authorities to feedback received regarding time limits for dispute resolution mechanisms. This would show that the Chinese tax authorities are actively looking for solutions to some of the practical issues they encounter in practice, and that they will continuously implement these solutions in newly issued regulations. However, some rules are tighter under Bulletin 6. For example, when discussing circumstances where the SAT may reject a MAP application (from either an enterprise or the competent tax authorities of the tax treaty contracting party), the SAT may reject the MAP application when the enterprise fails to pay taxes from a Special Tax Adjustment.

Deloitte observation

Bulletin 6 is an important release for the administration of transfer pricing and special tax adjustments. The Bulletin has implemented changes from the Discussion Draft, and improved the regulations related to special tax audits and adjustment. Overall, the reform to the regulations through this and earlier bulletins, shows how the SAT has responded to BEPS and how it will look to monitor transfer pricing in the future. Overall, there is a strong signal that the SAT will pay more attention to the management of prospective risks in tax administration, a transition from the current "ex-post" focus in audits, to looking problems on an "ex-ante" basis. This should allow the authorities to administer the regulations through the contemporaneous documentation requirements, the annual related party transactions reporting forms, continuous monitoring of profit levels, and by encouraging self-adjustments.

We have now seen from Bulletin 42, Bulletin 64, and Bulletin 6, that the Chinese tax authorities are paying attention to technical positions regarding intangible assets, related party services and value chain analysis. Taxpayers should respond to this, by reviewing their transfer prices for related party transactions, and making changes to any unsupportable transaction pricing proactively. At the same time, taxpayers should consider the profits in the supply chain on an overall basis, and ensure that they can support the allocation as consistent with the arm's length principle through both qualitative and quantitative analysis. This will help establish a base line level of compliance, in preparation for any special tax audits or adjustment.

Finally, the changes clearly show that the Chinese tax authorities are paying more attention to related-party transactions and transfer pricing policies of Chinese-headquartered companies that are expanding around the world. There is a clear focus on identifying transactions where the Chinese company has not been adequately remunerated for its contribution to value creation, intangible development or service provision. Chinese headquartered companies will need to consider how they meet these new challenges, and put more focus on dealing with their global transfer pricing.

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UK amends country-by-country reporting rules

The UK's Statutory Instrument 2017 (No. 497), published on 30 March, amends SI 2016 No. 237, which gives effect in the UK to the G20/OECD's minimum standard for country-by-country (CbC) information to be provided to tax authorities. These amendments follow additional guidance on the Implementation of Country-by-Country Reporting released by the G20/OECD in June 2016 and updated in December 2016. In addition, the regulations ensure compliance with the amended EU Council Directive on Administrative Cooperation 2011/15/EU (DAC4).

Summary of the changes

The amendments enter into force on 20 April 2017, and affect all multinational enterprise (MNE) groups that meet the CbC threshold requirement and include at least one UK tax resident entity and/or an entity resident elsewhere with a permanent establishment in the UK. The key changes are as follows:

- The application of the rules has been amended to include MNE groups whose ultimate parent entities are partnerships governed under UK law, including LLPs. The regulations will require the reporting partner of such partnerships to ensure compliance;
- There are new annual notification requirements for UK entities, with the first notifications due on 1 September 2017 (and then by the end of the CbC reporting period thereafter); and
- There is an additional information request requirement for UK entities whose ultimate parent does not file a CbC report that is adequate for UK reporting.

HMRC now estimate that about 300 UK-parented groups will need to file, together with up to 200 UK subsidiaries or branches of overseas groups (about half for just one year until the overseas parent files in its own jurisdiction).

Comments

The main change that will affect most groups is the requirement for notifications by UK entities in advance of the filing of CbC returns.

The amended regulations require notification by the end of the period of the CbC report. There is a deferral for notifications until 1 September 2017 for those that would have been required before then (for example, for CbC reports for years ended 31 December 2016, 31 March 2017, and 30 June 2017).

The change to notifications is in line with G20/OECD guidance and the EU Directive, and it appears the UK government has felt it necessary to introduce this administrative requirement. This will not be welcomed by multinationals, as it creates a new deadline and compliance obligation outside of the annual UK self-assessment return process. In many cases, this notification will be the same year on year. It's not clear what benefit will be achieved from the early notification at the UK or international level, as presumably tax authorities will await the filing (or subsequent sharing) of CbC reports before taking any action.

The UK rules propose that notification can be made by one UK group entity required to notify on behalf of others to avoid duplication, but there remains an obligation to provide a notification or details of another entity providing notification to HMRC.

HMRC have issued additional guidance on their website indicating an email mailbox for sending notifications and suggesting that a spreadsheet would be the preferred format for a group to set out the details specified in the regulations.

The government announced that the rules would be amended to include partnerships in August 2017, in line with the international consensus at the G20/OECD, and partnerships that meet the EUR 750 million threshold requirement have been preparing in advance of the amended regulations.

The changes to the UK regulations do not affect the content of the CbC reports to be filed, which remains as set out by the G20/OECD in the final report on BEPS Action 13 Transfer Pricing Documentation and Country-by-Country Reporting published on 5 October 2015.

Partnerships that are ultimate parent entities

The amendments clarify the CbC filing and notification obligations in situations where a UK partnership (a partnership governed under UK partnership law, or a UK LLP) meets the definition for CbC purposes of ultimate parent entity. The partner of the partnership that is required to file the income tax return will also be responsible for filing the MNE group's CbC report by the relevant filing deadline, and for complying with the UK notification requirement discussed below.

Notification requirements – UK ultimate parent entity

If an MNE group subject to the CbC rules has a UK tax resident entity (or an overseas tax resident entity that has a UK permanent establishment or UK partnerships (including limited partnerships and LLPs)) as its ultimate parent entity, that entity must notify HMRC that it is responsible for filing a CbC report in respect of a particular period, and provide the names and taxpayer references of all of the group's constituent entities that are UK tax resident companies, have a permanent establishment in the UK, are UK-governed partnerships, or are UK LLPs.

Notification requirements – non-UK ultimate parent entity

If an MNE group subject to the CbC rules has an overseas entity as its ultimate parent entity, a UK entity must notify HMRC of the name and taxpayer reference number of the entity that will file the report and the jurisdiction in which it will be filed, and the names and taxpayer references of all of the MNE group's constituent entities that are UK tax resident, have a permanent establishment in the UK, or are UK partnerships (including limited partnerships and LLPs). When multiple UK entities are required to make notifications in respect of the same MNE group, it is possible to avoid duplication of details.

Timing and format of notifications

All notifications must be made by the later of the last day of the CbC reporting period or 1 September 2017. The notification must be made annually, even if there is no change to the constituent entities in the UK.

HMRC has issued brief new guidance on their website stating that they would prefer notifications in spreadsheet format to be sent to a dedicated mailbox at notification.cbcfiling@hmrc.gsi.gov.uk . It is recommended that a copy of the notification be provided to an MNE group's HMRC Customer Relationship Manager when there is one.

Information request requirement

The regulations have been amended to allow the filing of a UK CbC report (for UK entities and those entities that they control) only when the relevant information to prepare a full CbC report has been requested from the overseas ultimate parent entity but has not been provided, and HMRC have been notified of this. If this is not done, the consequences are that a full CbC report for the global MNE is due in the UK, and failure will lead to the imposition of UK penalties.

Other changes

- There are penalties for failure to notify as well as for failure to file a CbC report.
- The new legislation amends the filing deadline to 12 months after the end of the *period* to which the CbC report relates (that is, the period for which the ultimate parent entity's statutory accounts are drawn up to) rather than the UK corporation tax *accounting period*. This aligns with the position for partnerships and may assist with long periods for statutory accounts purposes.

- The threshold requirement definition is amended slightly as a consequence of the removal of references to accounting periods. An MNE group that has a consolidated group turnover of EUR 750 million or more in the previous period will be required to prepare a CbC report on a global basis. If the previous period is shorter or longer than 12 months, the EUR 750 million threshold should be reduced or increased proportionately.

There is an adjustment to align the UK's local filing requirements with the G20/OECD model. Local filing is required only when the MNE's parent jurisdiction has entered into agreement with HMRC that allows for exchange of information, but has not entered into specific arrangements to exchange CbC reports.

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IRS Releases Initial List of LB&I Campaigns

The IRS Large Business and International Division (LB&I) on 31 January announced the identification and selection of 13 “campaigns” that will be the focus of the agency's enforcement efforts.

Last year, as part of its reorganization, LB&I announced that it would be implementing campaigns to identify the most serious tax administration risks, create specific plans to move toward expected compliance, and then deploy IRS resources accordingly. This initial wave of campaigns shows that LB&I is moving forward with its plan to focus on issue-based examinations and compliance. This approach is intended to make use of IRS knowledge and deploy the right resources to address those issues.

Overview

The initial 13 campaigns, as organized within LB&I's five substantive practice areas, are as follows:

- Treaty and Transfer Pricing Operations
  - Inbound Distributors
- Cross-Border Activities
  - Repatriation
  - Form 1120-F non-filers
- Withholding and International Individual
  - OVDP (Offshore Voluntary Disclosure Program) Declines – Withdrawals
- Enterprise Activities
  - IRC §48C energy credit
  - Domestic production activities deduction, multi-channel video program distributors (MVPDs) and TV broadcasters
  - Micro-captive insurance
  - Related-party transactions
  - Deferred variable annuity reserves & life insurance reserves and Industry Issue Resolution (IIR) program
  - Basket transactions
  - Land developers – completed contract method (CCM)
- Passthrough Entities
  - TEFRA (Tax Equity and Fiscal Responsibility Act of 1982) Linkage Plan Strategy
  - S Corporation Losses Claimed in Excess of Basis

The announcement stated that these campaigns were identified through LB&I extensive data analysis, suggestions from IRS compliance employees, and feedback from the tax community. LB&I's goal is to improve return selection, identify issues representing a risk of non-compliance, and make better use of limited resources.

Inbound Distributor Campaign

The initial campaign rollout includes the inbound distributor campaign. Sharon Porter, director of the Treaty and Transfer Pricing Operations Practice Area, will be the lead executive for this campaign. Its goal is to verify whether inbound distributors receive an arm's length return rather than the losses or small profits some inbound distributors, especially in the middle market, have been earning. The IRS announcement describes the inbound distributor campaign as follows:

US distributors of goods sourced from foreign-related parties have incurred losses or small profits on US returns which are not commensurate with the functions performed and risks assumed. In many cases, the US taxpayer would be entitled to higher returns in arm's-length transactions. LB&I has developed a comprehensive training strategy for this campaign that will aid revenue agents as they examine this IRC Section 482 issue. The treatment stream for this campaign will be issue-based examinations.

This campaign grew out of a pilot program called the Inbound Distributor Project, whereby the IRS determined that there was a widespread practice of not adequately compensating inbound distributors in the middle market.

Other Campaigns

The other 12 campaigns relate to non-transfer-pricing issues, although the related-party transactions campaign should be mentioned. That campaign will be overseen by the Enterprises Activities Practice Area, which generally focuses on domestic issues, and is described as focusing on transactions that provide taxpayers a means to transfer funds from a corporation to related pass-through entities or shareholders. Based on this description, we do not believe the campaign will relate to transfer pricing, even though the transactions at issue involve commonly controlled entities. Nevertheless, we will monitor this campaign and will provide updates as appropriate.

Observations

As noted in the TIGTA Audit released 3 November 2016, transfer pricing issues account for approximately 46 percent of the LB&I's international issues inventory and 71 percent of the potential total dollar adjustment amounts of all international tax issues. The focus on transfer pricing seems unlikely to change, even though only one transfer pricing campaign was announced in this initial rollout.

Going forward, therefore, we anticipate more transfer pricing campaigns to be announced as LB&I continues to transition to its new approach. The new regulations under IRC §367(d) that were issued on 15 December 2016, in T.D. 9803, along with the new IRS international practice unit released on 4 January 2017, may be harbingers of campaigns to come.

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Germany publishes new draft legislation on transfer pricing documentation

The German Federal Ministry of Finance recently published draft amendments to the transfer pricing documentation decree ("GAufzV" from its German acronym). The transfer pricing documentation decree specifies what information must be included in a taxpayer's transfer pricing documentation report, and as a decree-law, is binding on taxpayers and the tax authorities. The revised documentation decree – if it is enacted in the proposed form – would apply to all tax assessment periods from 2017 onwards.

The changes to the transfer pricing documentation decree are motivated by the German government's desire to implement BEPS Action 13, incorporated into Chapter V of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. However, as outlined below, the German Ministry of Finance includes provisions in the draft transfer pricing documentation decree that go beyond the OECD guidance.

Overview

The proposed draft transfer pricing documentation decree corresponds primarily to the OECD guidance defining the relevant information to be included in the master file and the local file. However, it also includes the following special requirements:

- A requirement to name the person who actually made the decisions regarding the intercompany transaction in question (Sec. 4 para. 1 no. 3 (b), draft TP documentation decree);
- A requirement to present the information that was available at the time when the transfer price was determined (Sec. 4 para. 1 no. 4 (b), draft TP documentation decree);
- A requirement that tax auditors must be provided access to any databases the taxpayer or its advisors used for a benchmarking analysis. Specifically, access must be provided to the version of the database used by the taxpayer/advisor at the time when the search was conducted. (Sec. 4 para. 3, draft TP documentation decree); and
- A requirement to support the weighting of allocation factors with quantitative data when applying the profit split method or a contribution analysis. (Sec. 1 para. 3 sent. 4, draft TP documentation decree).

The draft decree also limits taxpayers' ability to submit documentation such as the master file in languages other than German, by requiring a separate request by the taxpayer and approval by the tax authorities. This position contravenes the OECD's consensus position on the possibility of submitting the master file in commonly used languages, such as English.

Outlook

The draft transfer pricing documentation decree is expected to be promptly forwarded to the federal government for further discussion. Given that the proposed changes are intended to be effective for the 2017 assessment period, as well as the forthcoming German elections in the fall of 2017, the changes to the TP documentation decree may be finalized and adopted before the summer legislative break.

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New Zealand issues BEPS consultation papers

New Zealand's Minister of Revenue and the Finance Minister on 3 March released three BEPS consultation papers that address the following:

- Tackling concerns about multinationals booking profits from their New Zealand sales offshore, even though the sales are driven by New Zealand-based staff;

- Preventing multinationals from using interest payments to shift profits offshore by strengthening the interest limitation rules; and
- Implementing the multilateral instrument (MLI) to align New Zealand's tax treaties with the OECD recommendations.

In a media statement that accompanied the release of the consultation papers, the ministers acknowledged that although New Zealand's broad-base low-rate tax system operates well by global standards, it is important to ensure that the system continues to evolve to ensure that all companies operating in the country are paying their fair share of tax.

Transfer pricing and avoidance of permanent establishment (PE) status

This discussion document proposes to strengthen New Zealand's transfer pricing and source rules, prevent the abuse of tax treaties, and limit the ability to avoid PE status.

Transfer pricing: The consultation paper contains the following proposed changes to the transfer pricing rules:

- The rules would be aligned with the OECD's transfer pricing guidelines and, to some extent, with Australia's newly implemented transfer pricing rules;
- The burden of proof regarding whether the actual conditions of an arrangement are aligned with arm's length conditions would be shifted from the tax authorities to the taxpayer;
- The statute of limitations for transfer pricing issues would be increased from four years to seven years; and
- The scope of the transfer pricing rules would be extended to investors that "act together."

Avoidance of PE status: The government proposes to introduce a new anti-avoidance rule for large multinationals (those with consolidated global turnover exceeding EUR 750 million, approximately NZ$1.13 billion) that are deliberately structured to avoid having a PE (and therefore, a taxable presence) in New Zealand. This rule would deem a nonresident entity to have a PE in New Zealand if a related entity carries out sales-related activities for it in New Zealand, if some or all of the sales income is not attributed to a New Zealand PE of the nonresident, and the arrangement aims to defeat the purpose of the PE provision in the relevant tax treaty.

Administrative rules and effective dates: The administrative rules would be significantly strengthened to deal with uncooperative large multinationals. Taxes in dispute would have to be paid earlier in the dispute process when the dispute relates to transfer pricing. The commissioner would be allowed to collect tax payable by a large multinational from any wholly owned group member in New Zealand, or in the case of the new PE rule, the related New Zealand entity.

The discussion document suggests that the above proposals would apply to income years beginning on or after the enactment of the relevant legislation.

Interest deductibility limitation rules

In the discussion document on interest deductibility limitation rules, the government includes proposals to further strengthen New Zealand's thin capitalization regime rather than take the OECD approach of limiting interest deductions to a percentage of EBITDA. However, the EBITDA approach has not been definitively rejected and will be reconsidered if the proposed measures are not effective.

Broadly, it is proposed that there would be a limit on the deductible interest rate on related-party loans from a non-resident lender to a New Zealand borrower. The government is of the view that such a rule would ensure that the interest rate on such loans is roughly in line with the rate the borrower would agree to with a third-party lender. This is designed to reduce or eliminate costly disputes over an appropriate interest rate under the standard transfer pricing rules.

The discussion document includes other proposals relating to interest, including the introduction of a *de minimis* level for the inbound thin capitalization rules (provided the debt is not owner-linked) and proposals to reduce the ability of companies owned by a group of nonresidents to use related-party debt.

The discussion document suggests a delayed application date to allow businesses to arrange their affairs as required, with proposals applying to the income year beginning after the enactment of the relevant legislation.

Multilateral instrument

The third consultation document aims to explain what the MLI is and how it would operate to amend New Zealand's tax treaty network.

The MLI can be viewed as a way to facilitate a large-scale simultaneous negotiation to modify bilateral tax treaties to include treaty-related BEPS measures (otherwise known as the substantive provisions, as outlined in the BEPS final reports on actions 2, 6, 7, and 14), and to enable jurisdictions to meet the OECD's minimum standards on treaty abuse and dispute resolution. Jurisdictions may not choose to apply different articles of the MLI to different treaties, and must decide which treaties they would like to include as part of a "covered tax agreement" and their choices of articles. Following this step, jurisdictions must ascertain how the treaty would be modified by the MLI (as governed by the substantive provisions).

The substantive provisions fall into two categories: minimum standards and optional provisions. These provisions address BEPS concerns in four key areas:

1. *Preventing the granting of treaty benefits in inappropriate circumstances* through the insertion of a "principal purpose test" or equivalent provision into CTAs.
2. *Preventing the artificial avoidance of PE status* by adding a requirement to clarify the PE definition carve-outs to prevent entities structuring to avoid paying tax on its profits.
3. *Neutralizing the effects of hybrid mismatch entities* by adopting articles 3 and 4 of the MLI in relation to fiscally transparent entities and dual resident entities respectively.
4. *Providing improved mechanisms for effective dispute resolution* so that taxpayers may request the application of a mutual agreement procedure (MAP) where they believe that taxation is not in accordance with the treaty (or where the treaty does not contain a MAP). If a MAP is included in the relevant treaty, the MLI will amend the treaty to allow taxpayers to approach the competent authorities in either jurisdiction to clarify any uncertainty as to how the treaty should apply.

The MLI will be signed by a number of participating jurisdictions in June 2017, after which the MLI will go through New Zealand's domestic treaty-making process. The MLI will enter into force generally (in its own right) and for the states that have ratified it, three to four months after the fifth jurisdiction has ratified the MLI. The MLI will enter into effect to modify each bilateral tax treaty, on a phased-in basis, once both treaty partners have signed and ratified the MLI. The precise dates on which New Zealand's treaties will begin to be modified are unknown, but it is likely that the earliest modifications will occur in 2019.

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Danish courts rule on penalties for missing transfer pricing documentation

The Danish Tax Authority, SKAT, published the first two court rulings on penalties for missing or inadequate transfer pricing documentation in March 2017.

Both cases involved a request for transfer pricing documentation for income years 2008-2012, and in both cases, the taxpayer received a penalty of DKK 250,000.

The two rulings are described below.

Lower court ruling

The first ruling regarding transfer pricing documentation penalties was published on 23 March. The case involved a taxpayer that had been asked to provide transfer pricing documentation covering income years 2008-2012 to the Danish tax authorities. As required by Danish tax law, the transfer pricing documentation had to be submitted within 60 days from the request.

The taxpayer, a Danish subsidiary of a large foreign-based multinational group, submitted a transfer pricing report that covered income years up to and including 2007. The report was submitted before the deadline, but covered the wrong income years, and did not include appendices, which were referred to in the report.

Five days after the 60-day deadline expired, the tax authorities sent a letter to the taxpayer notifying it that it would be penalized for not submitting adequate transfer pricing documentation within the 60-day deadline.

Through requests for additional material from SKAT, the company provided adequate transfer pricing documentation for income years 2008-2012 approximately four months after the 60-day deadline had expired.

Based on the above, the lower court imposed a penalty of DKK 250,000. The penalty guidelines call for the imposition of a penalty of DKK 250,000 per income year. However, the penalty may be lowered to 125,000 per income year if the taxpayer subsequently provides adequate documentation. In this case, because the taxpayer had provided adequate documentation after the 60-day deadline had expired, the court ruled that the taxpayer should not be subject to the full penalty. Instead, the court assessed a penalty of DKK 250,000.

High Court ruling

The second ruling regarding transfer pricing documentation penalties was published on 27 March.

Similar to the case in the lower court ruling, this case also involved a taxpayer that received a request for transfer pricing documentation covering income years 2008-2012. As required by Danish tax law, transfer pricing documentation must be submitted to the Danish tax authorities within 60 days from the request.

The taxpayer failed to submit any transfer pricing documentation within the 60-day deadline, because the letter from the tax authorities requesting the documentation had been misplaced internally within the group.

The company ultimately provided adequate transfer pricing documentation and answered additional questions during the tax audit.

The lower court imposed a penalty of DKK 500,000, equal to DKK 125,000 for each of the four income years in question. The taxpayer appealed the ruling to the High Court.

The High Court upheld the lower court's ruling, and thereby sentenced the taxpayer to a penalty for not submitting the transfer pricing documentation in time. Surprisingly, the High Court reduced the penalty to DKK 250,000, because the court treated the missing documentation for income years 2008-2012 as a single offense.

Conclusion

The Danish penalty regime includes penalties for late preparation and late filing of transfer pricing documentation. These rulings are the first published Danish cases on penalties for late filling of transfer pricing documentation.

The rulings establish that in evaluating whether transfer pricing documentation has been filed in a timely manner, the courts also consider the content of the documentation and whether it complies with the Danish documentation rules.

In both cases, the courts applied a gentler approach in determining the amount of the penalty than the administrative guidance provides for. In other words, the courts reduced the amount of the penalty based on the specific facts and circumstances of the cases.

Companies that are subject to the Danish transfer pricing documentation requirements should carefully observe the formal requirements before submitting transfer pricing documentation to ensure penalty protection.

Taxpayers should also keep in mind that companies that are penalized for non-compliance with the Danish transfer pricing documentation requirements may be subject to an additional penalty of 10 percent of any potential income adjustment.

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2016 US APA Report shows strong interest in agreements with India, Italy

The Internal Revenue Service on March 27 released Announcement 2017-03, the advance pricing agreement (APA) annual report covering the activities of the Advance Pricing and Mutual Agreement (APMA) Program during calendar year 2016. The annual report is issued under §521(b) of Pub. L. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999, which requires the Secretary of the Treasury to report annually to the public on APAs and the APMA Program.

The annual report provides a summary of recent APA developments in the APMA Program and a statistical snapshot of the program's APA activities during 2016. While the 2016 annual report reveals a significant decrease in APA applications compared to the record number of APA applications received in 2015, the decrease may be explained by taxpayers accelerating their APA requests to file under procedures that were superseded by new procedures at the very end of 2015.

The IRS began to accept applications for bilateral APAs with India in February 2016, and the 2016 annual report shows substantial taxpayer interest in such APAs during 2016. Additionally, the first bilateral US-Italy APA, concluded in 2015, presaged increased interest during 2016 in bilateral APAs with Italy.

Transfer pricing enforcement is expected to increase throughout the world as countries adopt the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) final recommendations, including the enactment of country-by-country (CbC) reporting requirements. Consequently, the certainty provided by APAs will play an increasingly important role in transfer pricing risk management.

On August 12, 2015, the IRS released new revenue procedures governing APA and mutual agreement procedure (MAP) applications. Effective for all APA requests filed after December 29, 2015, Revenue Procedure (Rev. Proc.) 2015-41 provides guidance and instructions on filing APA requests, as well as guidance and information on the administration of APAs. Effective for all competent authority requests filed on or after October 30, 2015, Rev. Proc. 2015-40 provides procedures and guidance on requesting assistance from the US Competent Authority when the taxpayer believes the actions of the United States or a treaty country result or will result in the taxpayer being subject to taxation not in accordance with the applicable US tax treaty. The IRS is expected to release competent authority statistics separately in the near future.

Statistical highlights of the APA annual report include:

- **Incoming APA requests:** The IRS received 98 APA applications (14 unilateral, 84 bilateral, and 0 multilateral) in 2016, a significant decrease from the 183 APA applications received in 2015, which was a historical record for APMA (including its predecessor, the APA Program). As noted above, the significant decrease is likely the result of taxpayers accelerating filing their APA applications in 2015 under the old procedures – Rev. Proc. 2006-9 – prior to the effective date of Rev. Proc. 2015-41, given the significant additional information required for taxpayers to comply with the new requirements in Rev. Proc. 2015-41.

- **Decrease in completed APAs:** During the 2016 calendar year, APMA closed 86 APAs (21 unilateral, 65 bilateral, and no multilateral), compared to 110 APAs in 2015 and 101 APAs in 2014, while reporting very similar staffing levels in the APMA Program at the end of 2016 compared to the end of 2015. APA renewals accounted for 49 of the 86 APAs executed, with 17 unilateral and 32 bilateral renewals. As in 2015, renewals represented slightly more than half of all completed APAs. Twenty percent of all APAs included rollbacks, and we estimate that approximately 45 percent of new APAs included a rollback. It is likely that a significant portion of APAs with rollbacks resolved transfer pricing audit activity involving either the IRS or the tax authorities of a treaty partner.

- **Months to complete APAs:** In 2016, the median time to complete a unilateral APA and a bilateral APA was 15.4 months and 35.6 months, respectively. In 2015, the median time to complete a unilateral APA and a bilateral APA was 17.3 months and 38.2 months, respectively. Overall, the median time required to complete the 86 APAs executed in 2016 was 32.8 months, approximately one month slower than in 2015.

  Processing time for unilateral APAs declined slightly from the prior year. This is an encouraging continuing statistic from 2015, as unlike bilateral APAs, which involve treaty partners, unilateral APAs and their processing time are more controlled by APMA. Processing time for bilateral APAs also declined slightly from the prior year.

  Taxpayers renewing APAs benefitted from faster processing times for their APA requests. For renewal unilateral and bilateral APAs, the median processing time was 23.2 months, compared to the median processing time for new unilateral and bilateral APAs of 46.7 months. The median processing time required to complete new APAs increased significantly from 34.2 months in 2015 to 46.7 months in 2016.

- **Treaty partners involved in bilateral APAs:** While in prior years Japan and Canada typically accounted for the largest share of bilateral APA requests filed, in 2016 India accounted for 34 percent of bilateral APA requests filed, the largest share of any country. This is not particularly surprising, as the IRS only began accepting applications for bilateral APAs with India in February 2016. During 2016, bilateral APA requests filed involving Japan and Canada represented 31 percent and 8 percent, respectively. As noted above, Italy accounted for 4 percent of bilateral APAs filed in 2016; in 2015 the IRS announced that it had reached its first bilateral APA with Italy. Other countries accounting for meaningful percentages of filed, pending, or completed APAs with the United States are China, France, Germany, Korea, and the United Kingdom.

  Nearly three quarters of the total number of bilateral APAs executed in 2016 involved bilateral APAs with either Japan or Canada. Based on the filed APA requests during 2016 and the IRS's pending inventory of APAs, the percentage of completed APAs with Japan and Canada is expected to decrease as a percentage of the total as other countries become more active in the APA process.

- **APA inventory:** The APMA Program had 398 cases in active inventory at the end of 2016: 67 unilateral APAs, 322 bilateral APAs, and 9 multilateral APAs. In comparison, active inventory at the end of 2015 was larger, with 410 cases.

- **Term length of APAs:** Of the APAs executed in 2016, 52 cases had a five-year term, while 39 cases had terms of six years or longer. The average term length was six years. In our experience, the APMA Program and foreign competent authorities are willing to extend the standard APA term of five years when additional years are needed to address difficult results during a rollback period and/or completed APA years, or to provide some prospectivity in cases when the APA request took a long time to complete. Further, in the context of renewal APAs that were handled expeditiously, the APMA Program has shown a willingness to accept APA terms longer than five years.

- **Staffing:** As of December 30, 2016, the APMA Program was comprised of 62 team leaders, 20 economists, and 10 senior managers organized into 10 groups (seven team leader groups and three economist groups). Compared to 2015, this represents a decrease of one economist. The team leader groups are organized by country, with each group having responsibility for multiple countries. Because of the large volume of cases with certain treaty partners, some countries are the responsibility of more than one group.

- **Cancellations, revocations, and withdrawals:** No APAs were cancelled or revoked during 2016. Twenty-four APA requests (9 unilateral and 15 bilateral) were withdrawn in 2016, which is significantly higher than the 10 applications withdrawn in 2015.

- **APAs executed by industry:** In 2016, manufacturing and wholesale/retail trade accounted for 47 percent and 38 percent, respectively, of the total number of executed APAs. Within the wholesale/retail trade industry, merchant wholesalers of durable goods were most common (64 percent of such cases).

- **Covered transactions and transfer pricing methods:** Forty-four percent of the transactions covered in APAs executed in 2016 involved the sale of tangible goods, 34 percent involved the provision of services, and 20 percent involved the use of intangible property.

  In an increase from recent years, the comparable profits method (CPM) was used to evaluate approximately 89 percent of the transactions involving the transfer of tangible and intangible property in 2016. Of those transactions, 67 percent used the operating margin as the profit level indicator (PLI) and 33 percent used other PLIs, such as the Berry Ratio and Return on Assets or Capital Employed.

  For services transactions, the most frequently applied method was also the CPM (76 percent of cases). Of those services transactions applying the CPM, 43 percent used the operating margin as the PLI. In 2016, the majority of APAs that covered services transactions also included tangible or intangible transactions and were not tested under a separate PLI.

- **Adjustment mechanisms:** The majority of the transactions covered in APAs executed in 2016 target an interquartile range. Those APAs include a number of mechanisms for making adjustments to the tested party's results when the results fall outside the range or do not match the point required by the APA. Some examples of the mechanisms included in the 2016 executed APAs include an adjustment bringing the tested party's results to the closest edge of the range applied to the results of a single year, an adjustment to the closest edge of the range applied to the results over the APA term, an adjustment to the specified point or royalty rate, and an adjustment to the median of the range for a single year.

- **APA boilerplate and APMA Program contact information:** The annual report also includes the latest version of the APMA Program's model APA agreement and a link to the list of primary APMA Program contacts. Because the new APA procedures require the submission of a draft APA based on the model APA, it is surprising that the model APA has not yet been updated to reflect the new procedures. However, APMA has stated that the model APA is currently under review for future changes.

In light of the BEPS final reports and the adoption of CbC reporting requirements by many jurisdictions, the demand for APAs will undoubtedly continue to be strong. To discuss whether an APA may be advisable for your organization, please reach out to one of the contacts listed.

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Canada's country-by-country legislation comes into force, CRA releases Form RC4649

The Canada Revenue Agency (CRA) on February 3 released the prescribed form for reporting country-by-country (CbC) information, Form RC4649, *Country-by-Country Report*.
URL: http://www.cra-arc.gc.ca/E/pbg/tf/rc4649/README.html

Form RC4649 is consistent with the model CbC report templates included in the Organisation for Economic Co-operation and Development's (OECD's) October 5, 2015, final report, and requires the following information to be provided for each tax jurisdiction: revenues (unrelated and related), income, taxes paid and accrued, stated capital, accumulated earnings, number of employees, tangible assets, and certain information about each of the so-called "constituent entities," including their primary activities.

The Form RC4649 instructions provide useful guidance to assist Canadian taxpayers to understand the CRA's expectations regarding the CbC information to be reported, including definitions and detailed filing instructions.

The form was released shortly after the passage of final legislation to implement CbC reporting requirements for Canadian multinational enterprises (MNEs) in Canada's House of Commons on December 15, 2016. These requirements are in line with the recommendations of the OECD, as outlined in the October 5, 2015, final report in respect of Action 13 of the Base Erosion and Profit Shifting Action Plan, *Transfer Pricing Documentation and Country-by-Country Reporting*.

The key aspects of the Canadian CbC reporting regime are summarized below.

CbC reporting threshold

Taxpayers with total annual consolidated group revenues of more than EUR 750 million for the preceding year must file a CbC report. This threshold is consistent with the OECD recommendation.

While the OECD's December 5, 2016, *Guidance on the Implementation of Country-by-Country Reporting* recommends that an MNE group that complies with the parent country threshold (such as the USD 850 million threshold in the United States) should not be subject to a local filing obligation in any other jurisdiction, the Canadian legislation does not exempt a Canadian entity from the reporting obligation that would arise based on the Canadian threshold of EUR 750 million. Thus, it is possible that a Canadian corporation that is owned by a foreign parent could have a CbC reporting obligation in Canada, even though the parent company falls below the reporting threshold established in its home jurisdiction.

First year of CbC reporting

The legislation provides that the CbC reporting rules will apply to fiscal years of MNE groups that begin after 2015.

Because some countries have a later implementation date for CbC reporting, the Canadian CbC filing requirement could result in a Canadian subsidiary having a reporting obligation for a taxation year for which the ultimate parent company does not have a similar reporting obligation in its home country. MNEs are cautioned to consider the Canadian filing requirements, because Canada will require CbC reporting for subsidiaries (with the potential for penalties in the event of noncompliance) even if the ultimate parent entity is in a jurisdiction that does not require a CbC report.

Deadline to file CbC reports

The legislation provides that entities required to file a CbC report in Canada will be required to do so within 12 months after the end of the fiscal year. Thus, the first possible reporting deadline is December 31, 2017. For this purpose, the fiscal year refers to the financial reporting year of the ultimate parent, which may differ from the taxation year of the Canadian entity that is obligated to file the CbC report.

Parent and subsidiary filing requirement

A Canadian entity that is the MNE group's parent is obligated to file a CbC report on behalf of the group.

If the ultimate parent of the MNE group is not a resident of Canada, Canadian subsidiaries are relieved of the filing obligation provided that the ultimate parent (or an entity that is designated as a "surrogate parent entity") files a CbC report in a jurisdiction that will provide a copy of the CbC report to Canada.

Per the instructions to Form RC4649, a Canadian entity is required to file a CbC report when no surrogate parent entity has been appointed by the MNE group in instances when the ultimate parent entity of the MNE group is not obligated to file a CbC report.

Penalty for noncompliance with CbC reporting obligations

The penalty for failure to file a CbC report on time will be CAD 500 per month for up to 24 months, or CAD 1,000 per month for up to 24 months if a demand is served and not complied with. The penalty could be applied to every Canadian resident entity of the MNE group that knowingly or under circumstances amounting to gross negligence, fails to file the CbC report on behalf of the MNE group.

Next steps and issues to consider

The new CbC reporting requirements will involve an increased compliance effort to gather and prepare the required information. Certain data may not be readily available to MNEs on a global level, and some taxpayers will find it necessary to upgrade their existing information systems or introduce new internal processes to be able to retrieve and gather the required information. While the earliest filing deadline is December 31, 2017, Canadian taxpayers should be proactive in assessing their ability to comply with the requirements.

The new CbC reports are meant to provide tax authorities around the world with high-level overviews of the global operations of large MNEs to enhance transparency. While the information is intended to assist tax administrations in performing effective "risk assessments" and not as a means of identifying potential transfer pricing adjustments, tax administrations could use this information to initiate tax audits.

Neither the legislation nor RC4649 addresses certain practical considerations, such as the procedure for notifying the CRA of the designated "surrogate parent entity" nor the in-depth definitions of the reporting items.

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Transfer Pricing Implications of New US Tax Return Due Dates for C Corporations

Many US tax return due dates have changed for taxable periods beginning after December 31, 2015. This article focuses on the impact these changes will have on C corporations.

Changes to C Corporations

The changes to the tax return due dates and extension periods, as enacted by H.R. 3236, The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, affect C corporations and other entities. Under the act, C corporations generally must file on the 15th day of the fourth month after the close of their taxable year. An exception to this has been retained for C corporations using a June 30 tax year (or any short period ending in June), which are still governed by the prior law until 2026. Under prior law, C corporations were required to file by the 15th day of the third month following the close of their taxable year. For more information, please see below.

Under the new rules provided by the act, C corporations with a calendar-year-end were initially given an automatic extension of only five months to file their tax returns starting in 2016. IRC §6081(b). Nevertheless, the IRS announced on February 8 that they would now be giving calendar-year-end C corporations a six-month extension period.
URL: https://www.irs.gov/uac/rda-2017-02-08-2016-form-7004

As a result, the extended due date for these corporations (including real estate investment trusts (REITs), regulated investment companies (RICs), and other entities filing Form 1120 series income tax returns) is now October 15 rather than September 15, if the corporation timely files the appropriate extension form (Form 7004) on or before April 15.

C corporations with a June 30 fiscal-year-end (or any short period ending in June) must still follow the rule that was in place before the act, which as noted above requires that the tax return be filed on the 15th day of the third month following the close of their taxable year. In addition, these types of C corporations have not been affected by the February 8 announcement and still have an automatic seven-month extension period. Those due date and extension rules will continue to apply for fiscal years beginning after January 1, 2016, and before January 1, 2026.

A summary of the tax return due dates for C corporations follows:[6]

Taxable Year End	Due Date of Return	Extension Period
December 31	15th day of 4th month	Now 6 months (per IRS announcement)
	Due April 15	Due October 15
March 31	15th day of 4th month	6 months
	Due July 15	Due January 15
June 30	15th day of 3rd month	7 months
	Due September 15	Due April 15

Implications for transfer pricing and competent authority documents starting in 2016

These changes will have an impact on when to file various transfer pricing and competent authority documents starting in 2016, because many of those documents must be either submitted or in existence at the time when the tax return is filed. A summary of these documents and the impact of this new six-month extension for calendar-year-end C corporations is provided below:

Document	Document Due Date	Impact of New Rule
Section 6662 Documentation	Documentation must be in existence when return is filed	New due date *(Generally October 15 or January 15)*
Protective Claims: Annual Notification Requirement	Submitted no later than the date on which the taxpayer timely files a tax return	New due date *(Generally October 15 or January 15)*
Treaty Notifications: Annual Notification Requirement	Submitted no later than the date on which the taxpayer timely files a tax return	New due date *(Generally October 15 or January 15)*
APA Annual Reports	If governed by Rev. Proc. 2006-9, either the later of: (i) 90 days after the time prescribed by statute (including extensions) for filing its federal income tax return for the year covered by the report; or (ii) 90 days after the effective date of the APA	Potentially, new due date *(But check the terms of the APA)*
	If governed by Rev. Proc. 2015-41, either on or before the later of: (i) 15th day of 12th month following close of APA year; or (ii) 90 days after effective date of APA	Most likely, no impact *(But check the terms of the APA)*

[6] If the due date of a return falls on a weekend or legal holiday, then the tax return is not due until the following day that is not a weekend or holiday.

Document	Document Due Date	Impact of New Rule
Form 8975 and Accompanying Schedules A for Country-by-Country Reporting	Submitted with income tax return	New due date *(Generally October 15 or January 15)*[7]

As shown in the table above, IRC §6662 documentation, protective claim annual notifications, and treaty notification annual update letters will now generally be filed one month later than in the past. For calendar-year-end C corporations, the new due date will be October 15 if the corporation files pursuant to the new automatic six-month extension per the February 8 announcement. Similarly, for corporations with a March 31 fiscal-year-end, these same documents will now be due by January 15 if the corporation files pursuant to the automatic six-month extension. This change in due dates for March 31 filers results not from the IRS announcement but from a change in the underlying law per the act.

APA annual reports may or may not be affected by the changed due dates, but taxpayers should consult the exact language of the APA itself to determine this. Many APAs list the exact date on which the annual report is due, rather than listing the boilerplate language in the applicable revenue procedure mentioned above. As noted, special rules still apply to corporations with a June fiscal-year-end, and country-by-country reports will have the same new due dates as the tax returns with which they must be submitted.

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Italy issues rules for implementation of country-by-country reporting

Italy on 8 March published a decree implementing a country-by-country (CbC) reporting requirement in the Official Gazette. The CbC reporting requirement had been introduced in the Budget Law 2016 (also known as the Stability Law) approved on 28 December 2015.

The Stability Law introduced a mandatory reporting requirement for multinational companies into Italian tax legislation, effective 1 January 2016. The 8 March decree was originally scheduled for publication in March 2016.

The CbC reporting requirement, as stated in par. 7 of the decree and paragraph 145, Article 1 of the Stability Law, will be used by the Italian tax authorities to assess the reasonableness of the transfer pricing model, as well as to evaluate other risks concerning the erosion of the taxable base in Italy, and represents an additional instrument to support the tax authorities in their risk assessment activities.

Paragraphs n. 145 and 146 of Art. 1 of the law introduce an obligation for multinationals that exceed certain size thresholds to prepare CbC reports, through which they will report to the tax authorities information for each country in which the group operates.

The CbC reporting obligation was enacted in response to the OECD project to counter the erosion of the tax base and the shifting of profits abroad through elusive practices – the base erosion and profit shifting, or BEPS, project – which

[7] The rules for voluntary filing of country-by-country reports under Rev. Proc. 2017-23 would not be impacted by the new due dates or extension periods. Therefore, C corporations would still have to file their country-by-country reports within 12 months after the close of the taxable year that included the early reporting period even if they did file pursuant to the new extension rules.

consisted of 15 “actions,” including Action 13, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*.

The CbC report must be prepared by parent companies of multinational groups resident within Italy for tax purposes, with a consolidated turnover of over EUR 750 million.

The entity responsible for the preparation of the document is the parent company, specifically the entity with the responsibility to prepare the consolidated financial statement.

Under the decree, the CbC report covers fiscal years beginning on or after 1 January 2016, and must be filed within 12 months from the end of the reference year. For example, for entities with calendar year reporting periods, the deadline for submission will be 31 December 2017 for fiscal year 2016.

Controlled entities resident in Italy for tax purposes that are part of multinational groups subject to the obligation to file the CbC report must notify in their tax return (due nine months from the fiscal year end) the details of the group entity in charge for the preparation of the CbC report, including its tax jurisdiction.

On the basis of the law and of the provisions of Art. 2 of the decree, the CbC report obligation will be extended to both Italian tax resident subsidiaries and permanent establishments of foreign entities, part of multinational companies that fall within the scope of the CbC reporting obligation set forth by the Stability Law, in the event that the “ultimate” parent company required to prepare consolidated financial statements is resident in a state that:

- Has not introduced the obligation to file a CbC report, unless, as stated in art. 2 par. 7 of the decree, for the fiscal year beginning in 2016 only:
    - The parent company voluntarily files the CbC report in its state; and
    - The state has introduced, within the terms of presentation of the CbC report in Italy, an obligation to prepare the subject document, even if just for later periods (for example, United States consolidating entities, where the obligation applies to fiscal years beginning on or after 30 June 2016);
- Does not have in force an agreement with Italy regarding the exchange of information related to CbC reporting; or
    - Defaults on its obligation to exchange information regarding CbC reporting, or in case the parent company fails to submit the CbC report in its state of residence.

Alternatively, the CbC report can be prepared by a company other than the consolidating entity, provided that its state of residence fulfills the above-mentioned requirements and that the Italian entity identified in the tax return the identity and residence of tax jurisdiction of that other company.

As indicated in the annex to the decree, the standard content of the CbC report will reproduce the same three sample tables included in the Action 13 final report.

The Stability Law, at Article 1, paragraph 145, provides for the imposition of an administrative penalty ranging from EUR 10,000 to EUR 50,000, if the CbC report is not filed or is submitted with incomplete or incorrect information.

The decree refers to a yet-to-be-issued specific order of the Revenue Agency that will provide information on how to file the CbC report.

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IRS issues draft instructions for Form 8975

The IRS on February 24 released draft instructions for draft Form 8975, *Country-by-Country Report*, and accompanying draft Schedule A, *Tax Jurisdiction and Constituent Entity Information*, that were issued in December 2016. These draft forms and instructions are based on Action 13 of the Base Erosion and Profit Shifting (BEPS) project undertaken by the Organization for Economic Cooperation and Development (OECD). The IRS is accepting comments on the draft forms and instructions, and plans to finalize them by June 2017.

The final country-by-country (CbC) reporting regulations, found in Treas. Reg. §1.6038-4 (TD 9773), provide the basic rules and definitions to be used when filling out Form 8975 and accompanying Schedule A. Nevertheless, gaps in the regulations persist, and these draft instructions, though not final or binding authority, appear to clarify some of those issues. Of note are the following:

- **US single-member LLCs:** The draft instructions provide that US single member LLCs that are otherwise disregarded for federal income tax purposes will be treated as resident in the United States so long as they are directly owned by a US resident. Specifically, the draft instructions state, "A business entity that is a limited liability company that is organized in the United States, and is wholly owned (directly) by another business entity that has its tax jurisdiction of residence and is organized in the United States, will be considered a US business entity that has its tax jurisdiction of residence in the United States." It appears that this rule extends to a chain of US single member LLCs so long as the US LLCs are tiered directly under a US resident business entity.
- **Penalties for failure to file:** The draft instructions state that monetary penalties under IRC §6038(b) may apply. The penalty affecting foreign tax credits in IRC §6038(c) is not listed as potentially applying.
- **Examples:** The draft instructions provide various examples that help illustrate some of the rules in the final regulations.
    - **Reporting income for tiered partnerships:** In a tiered partnership or similar structure with fiscally transparent entities, which have no tax jurisdiction of residence, the CbC financial and employee data for each constituent entity is reported once in the aggregate for all such "stateless entities" and then once again at the owner's jurisdiction of tax residence. In the Example, US Corp (a tax resident of the United States) owns 90 percent of partnership P1, which in turn owns 80 percent of partnership P2. All three constituent entities have $100 of revenue and no expenses, not including the shares of revenue that P1 has through P2 and that US Corp has through either of the other partnerships. The total amount of revenue on Schedule A for the stateless entities P1 and P2 is $200, not $280. In addition, the total revenue and profit on the United States Schedule A is $262, because it only includes the $100 US Corp has outright and the $162 of revenue and profit as its share from P1.
    - **Reporting of withholding taxes:** The term "taxes paid" includes taxes paid in cash by a constituent entity to its tax jurisdiction and to all other tax jurisdictions. In the Example, Company X, a constituent entity, earns interest income from another company in tax jurisdiction Y, which is subject to withholding. The Schedule A for tax jurisdiction X should include: (i) the income taxes paid by Company X on income in tax jurisdiction X; and (ii) the withholding taxes paid to tax jurisdiction Y.
    - **Reporting of taxes paid by a PE:** Taxes paid by a PE are reported in the tax jurisdiction in which the PE is located and consequently included on the Schedule A for that tax jurisdiction. However, the taxes paid by the PE are not reported on the Schedule A of the owner's tax jurisdiction. In the example, Company X has a PE in tax jurisdiction Y. The income tax paid by Company X to tax jurisdiction X should be reported on the Schedule A for tax jurisdiction X. Nevertheless, the income tax paid to tax jurisdiction Y on income earned by the PE should go on the Schedule A for tax jurisdiction Y, not the Schedule A for tax jurisdiction X.

The following procedural clarifications are also noteworthy:

- **Electronic filing:** Electronic filing is mandatory if a taxpayer files its tax return electronically. The paper form applies only to taxpayers who are not filing electronically (for example, taxpayers filing a Form 1120-REIT). In general, all taxpayers are encouraged to file electronically to ensure the timely automatic exchange of information. The electronic filing of Form 8975 and accompanying Schedules A is expected to be on XML schema similar to the OECD's version.
  URL: http://www.oecd.org/tax/exchange-of-tax-information/country-by-country-reporting-xml-schema-user-guide-for-tax-administrations-and-taxpayers.htm

- **Naming convention for permanent establishments (PEs):** The draft instructions adopt the OECD naming convention for PEs that includes name of entity to which the PE belongs.
- **Taxpayer identification numbers (TINs):** The TIN is a mandatory field for electronic filing. Consistent with the OECD schema, if a constituent entity does not have a TIN, then the taxpayer must enter “NOTIN.”
- **Explanatory notes:** The draft instructions give more detail on how to provide explanatory notes, including codes to reference correctly the item in table 1 to which the explanation applies.

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