Global Business and States’ Challenges to Taxable Income

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In this edition of Inside Deloitte, the authors discuss the origins of transfer pricing authority, variations in state tax authority in this area, and what the international community and the states have done recently to reinforce the proper reporting of taxable income by taxpayers. They also discuss the recent OECD developments focusing on the U.S. Treasury’s proposed regulations regarding country-by-country reporting and intercompany debt.

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Before the early 1960s, IRS enforcement efforts using IRC section 482 were primarily directed at the domestic activities of U.S. taxpayers. While the IRS focus has shifted by the second decade of the 21st century given the dramatic increase in the international footprint of U.S. companies, the pendulum has swung back to some degree with some states (though not the IRS) applying section 482 in a domestic setting. For decades, states have used numerous tools and techniques to address the revenue impacts of tax planning. In this context, state tax authorities have dedicated additional audit resources to scrutinize intercompany transactions involving debt instruments, royalties, management fees, and structural arrangements to determine if companies are reporting the correct amount of tax.

As international tax professionals focus on the October 2015 release of the OECD recommendations and actions under the Base Erosion and Profit-Shifting project, state tax professionals are no doubt wondering a few things: What will eventually be enacted by Congress (and promulgated by Treasury) as a result of BEPS that will filter down to the states? How will state legislatures and tax authorities respond to the federal reforms? And what impact will those reforms have on my company or clients?

I. Origin of IRC Section 482

Generally, domestic U.S. corporations are taxed on worldwide income, but are afforded credits or deductions for taxes paid to other countries. In keeping with that general rule, complexities often arise in the context of transactions between controlled corporations operating on a multinational basis. Under IRC section 482, the IRS has broad authority to make adjustments to income and other items arising from those transactions “in order to prevent evasion of taxes or clearly to reflect the income” of the companies involved. While the regulations under that IRC provision provide more detail on its operation, IRC section 482 itself consists of only the two following sentences, which has led to instances of broad application:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section


2The mission of the Organisation for Economic Co-operation and Development (OECD) is to promote policies that will improve the economic and social well-being of people around the world.” OECD, available at http://www.oecd.org/about/.

3IRC section 482.
936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.4

The current version of IRC section 482 has its origins in other acts going back nearly a century. The Revenue Act of 1921 provided affiliated corporations with the option of filing either separate or consolidated tax returns,5 and introduced the first predecessor of current IRC section 482 by authorizing the commissioner to consolidate the accounts of affiliated corporations to make "an accurate distribution or apportionment of gains, profits, income, deductions or capital" among the affiliates.6 Later, the Revenue Act of 1928 expanded the commissioner’s authority to make adjustments to stop tax avoidance and to make sure income was clearly reflected among the related parties, in order to determine the true tax liability.7 Next, regulations under the Revenue Act of 1934 introduced the arm’s-length standard for determining the “true net income” of a controlled corporation, providing that in determining the true net income of each controlled taxpayer, “the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.”8

Those 1934 regulations remained in place and largely unchanged until 1968, when an expansion took place in response to the growing international business climate. As noted by Treasury, the 1934-1968 period was marked by a relatively small number of U.S. companies with multinational affiliates, meaning that IRC section 482 had little impact in the international context. As such, before the early 1960s, the primary focus of the IRS’s enforcement efforts using IRC section 482 was domestic.9

In 1968, in light of the continuing expansion of international business, Treasury began the process of updating the IRC section 482 regulations. Central issues addressed in the update included the determination of a fair arm’s-length price for intercompany sales of tangible personal property, the treatment of interest on intercompany loans, and the treatment of intercompany service charges. Treasury’s review resulted in updated regulations that provided three methods to be used in valuing intercompany transfers of property, as well as a catchall provision in the event that the other three methods cannot be applied:

- the comparable uncontrolled price method;
- the resale price method;
- the cost-plus method; and
- where none of the three enumerated methods “can reasonably be applied under the facts and circumstances ... in a particular case ... some [other] appropriate method... can be used.”10

In applying the new regulations in practice, the IRS and taxpayers found it “difficult if not impossible to find comparables from which an arm’s length transfer price can be derived” for intangibles.11 Further, because intangibles tended to constitute “high profit” property, many taxpayers engaged in the “selective transfer... of the intangibles to tax haven” countries.12 To address those issues, in the Tax Reform Act of 1986, Congress added a new provision to IRC section 482 that provided for the use of the “commensurate with income standard” for determining the income from a transferred intangible.13

Since IRC section 482 is exceedingly general, the corresponding regulations “play a central role in laying out the rules to be followed in determining whether transfer prices are arm’s length.”14 The current regulations are substantially the same as the regulations finalized in 1994, with significant changes that “provide a more elaborate and detailed framework for transfer pricing analysis than did their 1968 predecessor,” such as addressing stock-based compensation (2003); services and imputation of contractual terms from economic substance (2006 and 2009); and intangible transfers outside cost sharing (2011).15

II. How States Apply IRC Section 482

States vary in their application of IRC section 482 principles. Broadly, states can adopt the IRC in its entirety, adopt the IRC in component parts, or adopt federal taxable income as a starting point for the computation of state taxable income. Where federal taxable income has been adopted as a starting point, the impact of IRC section 482 is inherent in the state taxable income calculation, either as originally filed or as corrected. Regardless of the state’s type of IRC conformity, many states have adopted the principles of IRC section 482 explicitly with the goal of scrutinizing state-level intercompany structures and transactions that may have detrimental impacts on state revenue.

As noted, IRC section 482 originated as a federal mechanism to address domestic structures and was later expanded


11 Id. section 240(d).
13 Treas. reg. section 86, Art. 45-1(b) (1935) (relating to the income tax under the Revenue Act of 1934).

16 Id. at 67-68.
17 Id. at 68.
through application to international structures and transactions to avoid federal revenue loss.\textsuperscript{16} Mechanisms through which states apply concepts from IRC section 482 include requiring combined or consolidated state filings or making broad adjustments to a taxpayer’s income.\textsuperscript{17} Those applications of the principles inherent in IRC section 482 can be complex and typically require significant training, specialization, and experience. State tax agencies often do not have the resources or knowledge to properly address transfer pricing matters and may seek outside solutions in the form of third-party contractors or outside training.

Also as noted, although many states adhere to the principles of IRC section 482, state statutes and regulations often do not explicitly adopt IRC section 482 or specifically reference it. Rather, many states create their own variations of IRC section 482, working within the boundaries available to them to create and define rules for challenging related-party structures and transactions at the state level. The following examples illustrate how some state statutes and regulations vary.

\section{A. California}

While IRC section 482-type statutes are not typically invoked in unitary combined reporting states, California does have an IRC section 482-type statute, which is designed primarily to address transactions engaged in by members of a water’s-edge group with entities outside the water’s edge (that is, foreign entities).\textsuperscript{18} Specifically, the California provision provides that if the IRS has conducted an IRC section 482 audit of a taxpayer’s business, the results of that audit are considered to be presumptively correct for California purposes. However, the provision does allow either the Franchise Tax Board or the taxpayer to overcome that presumption.

\section{B. Massachusetts}

Under Massachusetts law, the revenue commissioner may determine income by eliminating any payments made to an affiliate in excess of fair value and including fair compensation for items sold to or services performed for an affiliated corporation.\textsuperscript{19}

\section{C. New Jersey}

New Jersey’s IRC section 482-type provisions grant the director of the Division of Taxation broad authority to correct distortions in net income, net worth, and allocation (that is, apportionment) factors. Further, the regulations also contain a provision requiring arm’s-length standards to be applied to transactions involving entities related through 20 percent or greater common ownership.\textsuperscript{20} That New Jersey provision is noteworthy since most state IRC section 482-type statutes apply to affiliated corporations, which typically means 80 percent or 50 percent common ownership.

\section{III. MTC ALAS Project}

At the request of some of its member states, the Multistate Tax Commission began developing a framework for assisting member states in addressing the fundamental challenges state tax agencies face in identifying, analyzing, adjusting, and defending transfer pricing issues in the context of state tax examinations. While the MTC had been conducting audits through its joint audit program, transfer pricing issues were not consistently in the audit scope. In response to the feedback from its constituents, the MTC spent a year discussing and designing what would become the Arm’s-Length Adjustment Service (ALAS) program, which aims to hire or develop the expertise to conduct transfer pricing audits to produce enough revenue for states to justify the additional expense to support the fee-based program.

In May 2015 the MTC published ALAS’s initial design document, which included an implementation timeline and broad goals and strategies to assist member states in addressing significant issues affecting voluntary compliance and potentially revenue. The original design document projected that at least nine or 10 MTC member states would be needed to financially support the ALAS project. To date, only Alabama, Iowa, North Carolina, New Jersey, Kentucky,\textsuperscript{21} and Pennsylvania have committed to becoming charter members of the ALAS project. While the broader MTC membership voted to accept the ALAS design document in July 2015, as of this writing, the ALAS project still has not attracted the support of the additional states necessary to fully implement it. While many states have expressed interest in ALAS, some have not committed because of concerns about its pricing structure; others have expressed an interest in participating by having the MTC assist in existing, open state cases. Paradoxically, without states’ support, ALAS may remain stalled, while the failure to implement ALAS may result in few additional states willing to commit.

During an April 2016 public call, MTC leadership provided an initial outline of project goals to achieve by October 2016.\textsuperscript{22} A discussion of the outline included:\textsuperscript{23}

\begin{itemize}
\item \textsuperscript{16}IRS Notice 88-123, 1988-2 C.B. 458 at 11.
\item \textsuperscript{17}Most states empower the tax agency with broad authority to adjust income as necessary. For example, New Jersey includes authority to “make any other adjustments in any tax report or tax return as may be necessary to make a fair and reasonable determination of the amount of tax payable.” N.J.S.A. section 54:10A-10a.
\item \textsuperscript{18}Cal. Rev. & Tax. Code section 25114(b).
\item \textsuperscript{19}Mass. Gen. Laws c. 63, sections 33 and 39A.
\item \textsuperscript{20}N.J. Admin. Code section 18:7-5.10(d).
\item \textsuperscript{21}Apparently, Kentucky has reconsidered participation in ALAS under the guidance of a new revenue commissioner. Amy Hamilton, “MTC Transfer Pricing Committee Aims For Case Discussion by Fall,” \textit{State Tax Notes}, Apr. 18, 2016, p. 178.
\item \textsuperscript{22}“MTC Arm’s-Length Adjustment Service Committee Description and Work Outline for April Through October 2016,” April 4, 2016.
\item \textsuperscript{23}The outline and the following topics were discussed during an MTC-originated public call described as the “inaugural meeting of the ALAS” on April 7, 2016.
\end{itemize}
• Recommending potential changes to ALAS program design or implementation, such that states that have not signed on to the program might be more amenable to committing.

• Developing an agreement for the exchange of confidential taxpayer information among participant states and the MTC. In considering this objective, it may need to be considered that some states have already executed model information sharing agreements or that states may be concerned about disclosing taxpayer information to outside, third-party vendors to be contracted by the MTC. Ideally, the information sharing agreements would be in place by July 2016, to enable ALAS member states to have meetings and discussions of live case matters.

• Undertaking early implementation steps — including training state staff, exchanging information, and discussing pending taxpayer cases — in an attempt to inform the implementation process. State training could potentially take a form similar to the training program that the MTC mounted in the spring of 2015.

• Drafting a request for proposal to be issued to consulting firms that would provide economic analysis services, as well as drafting job descriptions and recruiting announcements for ALAS staff.

IV. Combined and Unitary State Filings

Another way states have sought to preclude companies from shifting income in an arguably distortive fashion is through adoption of unitary combined filing provisions, under which companies may be required to file combined returns, have an election to file combined returns, or be compelled to file combined returns on audit. While each state employing a unitary or combined filing regime has its own nuanced approach, a broad overview of the application of unitary combined concepts in California, Colorado, and New York is discussed below.

In California, a unitary relationship’s existence is measured by applying various tests under statutory and judicial authority. Broadly, California will find a unitary relationship when either the “three unities test” or the “contribution and dependency test” is met. The analysis under both tests tends to focus on similar factors. Importantly, under the state’s statutes, the finding of a unitary relationship under either test is conditioned first on unity of ownership, which broadly involves a commonly controlled group for which the ownership threshold is more than 50 percent.

Application of California’s three unities test generally finds the existence of a unitary relationship when there is unity of ownership, unity of operation, and unity of use. As noted, unity of ownership is found when the entities in question meet some statutorily prescribed ownership or control thresholds. Unity of operation generally may be established when various functions are shared by two or more corporations, including purchasing, advertising, accounting, or other managerial or administrative activities. Finally, unity of use may broadly be found when various bigger picture factors are established, such as a centralized executive force, major policy alignment, or vertical or horizontal integration.

Also, California’s contribution and dependency test focuses on whether in-state business operations are dependent on or contribute to out-of-state business operations. In determining whether business operations are sufficiently related for purposes of the test, California may focus on the degree of intercorporate dependence, or, for purposes of the test, the degree of intercorporate dependence in the price of goods and services sold; the intercorporate provision of some types and amounts of services; the intercorporate use of some intangibles, such as patents and trademarks; directorates in which most members are also directors or officers of an affiliated corporation; and a percentage of the highest ranking officers of the corporation also serving as directors or officers of an affiliated corporation.

Another example is in New York, which mandates a modified water’s-edge combined filing for related corporations

24Another public call was held in mid-May 2016 and the group continued to focus on issues related to information sharing among states including the review of a draft information sharing agreement.

25California may also apply another alternative test, focusing on the flow of value between the components of business operations.


29Edison California Stores Inc. v. McColgan, 30 Cal. 2d 672 (Cal. 1947) (extending the unitary business principle to the income of an enterprise conducted through controlled subsidiaries).

30Id.


32Id.

33A foreign (non-U.S.) corporation that satisfies the ownership and unitary business requirements must be in a combined report if it is treated as a domestic corporation under the IRC, or if it has U.S.
engaged in a unitary business. Two corporations are related if one corporation owns or controls, directly or indirectly, more than 50 percent of the voting power of the capital stock of the other corporation, or more than 50 percent of the voting power of the capital stock of both corporations is owned or controlled, directly or indirectly, by the same interests.34 Broadly, New York case law provides that a unitary business can be demonstrated by the following:

- a flow of value between the subject entities;
- functional integration, centralized management, and economies of scale; and
- “transactions not undertaken at arm’s length, a management role by the parent which is grounded in its own operational expertise and operational strategy, and the fact that the corporations are engaged in the same line of business.”35

V. States’ Consideration of Combination

As of this writing, more than two dozen states (and the District of Columbia) have enacted combined filing statutes, more than double the number of states with those requirements in 2005. Also, separate filing states continue to study the advantages and disadvantages of shifting to a combined filing reporting environment.

Determining the potential revenue impact of changing from a separate filing regime to a combined or consolidated regime can be difficult and produce unpredictable results. For a state with outdated data systems, changing to a combined filing regime can also burden the tax authority with substantial costs of training, forms design and updates, and increased requests for taxpayer assistance. State tax agencies must also account for the likelihood that tax return processing and auditing will become a more challenging exercise.

For example, Maryland studied the potential impact of switching to combined reporting in 2007. The General Assembly enacted corporate reporting rules requiring affiliated unitary corporations to prepare and file informational reports on a unitary combined basis, although payment of tax on that basis was not required. The goal, as was reported, was to allow the comptroller to compute the potential fiscal impact of combined reporting in Maryland, by enabling the tax agency to know what a particular group of affiliated operations would include in a unitary combined return — data to which the agency had no historical visibility. To arrive at a reasonable estimate, the legislature compelled filers — via threat of penalty ($5,000 per day for the first 30 days and $10,000 a day thereafter) — to provide a combined information report. After completing their analysis, the Maryland Business Tax Reform Commission in 2010 recommended not implementing combined filing, noting:

Combined reporting is a complex change for taxpayers, tax preparers, and the Comptroller’s office, introducing uncertainty at a time when the economy is struggling to recover from the recent recession. It would result in a shift of the tax burden, substantial in some cases, among industries and among taxpayers, resulting in winners and losers. Many of the tax avoidance measures which combined reporting is intended to prevent have already been addressed by the State through the Delaware holding company addback, the captive real estate investment trust (REIT) legislation, and other measures. Finally, members noted, the Comptroller’s study of corporate information returns for tax years 2006 and 2007, and preliminary results for tax year 2008, indicates that combined reporting would lead to increased volatility in the corporate income tax, already one of the State’s most volatile revenue sources.36

In short, combined reporting was deemed to bring considerable complexity, uncertainty, and division between winners and losers to Maryland’s tax law, while existing provisions were deemed to adequately address intercompany activity and volatility.

More recently, Rhode Island in 2011 engaged in a similar exercise. Rhode Island required some taxpayers to file a pro forma return with the corporate income tax liability calculated under Joyce and Finnigan37 sourcing methods in addition to application of both a 100 percent weighted sales factor and a traditional, equally weighted three-factor formula for two tax years, those beginning after December 31, 2010, but before January 1, 2013.38 The study results had numerous caveats, including potentially distorted results given its compressed time frame, concerns about the accuracy of filings, and the lack of audits of any of the pro forma returns. However, with those limitations in mind, the report indicated that roughly 6.6 percent of taxpayers would have paid less tax, 28.75 percent of taxpayers would have seen an

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34 N.Y. Tax Law section 210-C(2)(a) (2016); AB 8559/SB 6359 (N.Y. 2014).
37 Joyce and Finnigan are commonly used shorthand references to two California cases dealing with sales factor calculation issues in the context of a unitary combined report. Appeal of Joyce Inc., No. 66 SBE 069 (Cal. SBE Nov. 11, 1966), and Appeal of Finnigan Corp., No. 88 SBE 022 (Cal. SBE Aug. 25, 1988) (Finnigan I); [Opin. On Pet. For Rhrg, (Cal. SBE Jan. 24, 1990) (Finnigan II)].
increase in tax, and the remaining 64.6 percent of taxpayers would have seen no change.39

Similarly, Indiana is requiring a study by the legislative services agency to address "the combined reporting approach to apportioning income for income tax purposes" and "issues related to transfer pricing under the adjusted gross income tax law."40 The report must be submitted to the legislative council and to the interim study committee on fiscal policy before October 1, and is expected to include a review of the following:

- practices in other states regarding combined reporting;
- administrative costs of implementing combined reporting;
- studies and reports that have been prepared on the issue of combined reporting;
- an estimate of the fiscal impact of implementing combined reporting in Indiana; and
- issues related to transfer pricing under the AGI tax law.41

VI. Tax Havens

While some states study combined reporting, others are broadening and expanding their preexisting unitary reporting regimes. One development is states compelling filers to include unitary affiliates in the water’s-edge unitary return even though those affiliates are organized or doing business in some jurisdictions that do not meet the original definition of water’s edge. These provisions are often referred to as tax haven laws.

In 1998 the OECD published a list of criteria it used to designate a jurisdiction as a tax haven. The essential test focused on tax rates. A tax haven jurisdiction was considered to be a jurisdiction that imposed no or low effective tax rates on the relevant income. A tax haven also had to demonstrate one of the following characteristics: excluding resident taxpayers from the regime’s benefits or prohibiting beneficiaries from operating in the domestic market, a lack of transparency on tax matters, or a lack of effective exchange of tax information. Collectively, those criteria indicated that the jurisdiction enabled the facilitation of tax avoidance. In a 2000 progress report, the OECD listed countries that it considered tax havens.42 Between 2002 and 2009, the listed countries all implemented (or promised to implement) changes to their tax policies, primarily focused on increasing transparency and the free exchange of tax information, which resulted in the OECD no longer designating them as tax havens.

As adopted in 2006, the MTC’s model combined reporting statute identified tax havens both by referencing the OECD’s list and listing tax haven criteria modeled on the OECD factors. However, in 2011, recognizing that the OECD no longer designated specific countries as tax havens, the MTC eliminated its prior reference to the OECD list. The MTC model statute, as amended, now defines tax havens solely by creating a multifactor test based on the OECD criteria.43

Six states — Alaska, Montana, Oregon, West Virginia, Rhode Island, and Connecticut — and the District of Columbia have implemented tax haven laws. Of those states, Montana and Oregon adopted a blacklist of tax havens, designating specific jurisdictions as tax havens by statute.44 Connecticut, the District, Rhode Island, and West Virginia each use a variation of the MTC’s subjective criteria approach to defining tax havens rather than publish a list of designated jurisdictions.45 Alaska adopted its tax haven law years before the OECD’s 1998 report and, accordingly, employs its own unique test to determine whether a jurisdiction is a tax haven.46

VII. Addbacks: Royalties, Interest, And Management Fees

Nearly two dozen states have enacted legislation requiring some sort of intercompany expense disallowance or expense addback. While the reporting requirements of intercompany expense adjustment statutes vary by state, many statutes are similar.

Pennsylvania recently enacted an intercompany expense addback statute. For tax years beginning after December 31, 2014, taxpayers generally may not deduct intangible or interest expenses and costs paid or accrued to an affiliate entity.47 However, if the affiliated entity is subject to tax on the corresponding intangible or interest item in any U.S. state or possession, a tax credit against the taxpayer’s Pennsylvania liability is provided.48 Further, there are exceptions to the required expense addback if the intercompany transaction:

39State of Rhode Island, Dep’t of Revenue, Div. of Taxation, Tax Administrator’s Study of Combined Reporting 10 (2014).
41Id.
42The OECD list included: Andorra, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Belize, British Virgin Islands, Cook Islands, Dominica, Gibraltar, Grenada, Guernsey-Sark-Alderney, Isle of Man, Jersey, Liberia, Liechtenstein, Maldives, Marshall Islands, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, Samoa, Seychelles, Nevis, St. Christopher, St. Lucia and St. Vincent and the Grenadines, Tonga, Turks and Caicos, U.S. Virgin Islands, and Vanuatu. OECD, "2000 Progress Report: Towards (Footnote continued in next column.)

46Alaska Stat. section 43.20.145(a)(5).
48Id.
is with an affiliated entity domiciled in a foreign nation that has a comprehensive tax treaty with the United States;\(^{49}\) is with an affiliated entity that directly or indirectly paid or accrued intangible or interest expenses to an unrelated party;\(^ {50}\) or did not have as the principal purpose the avoidance of Pennsylvania tax and was done at arm's-length rates and terms.\(^ {51}\)

North Carolina's addback statute centers on making a determination whether an intercompany transaction "lacks economic substance" or is "not at fair market value."\(^ {52}\) Generally, if the intercompany transaction is found to meet either criterion, the state may redetermine the net income of the corporation by either "adding back, eliminating, or otherwise adjusting intercompany transactions" or requiring it to file a combined return with all members of its unitary affiliated group.\(^ {53}\) In determining the FMV portion of the transaction, the secretary of the Department of Revenue is required to apply the standards in the IRC section 482 regulations and, in doing so, consider all facts and circumstances relating to the intercompany transactions, including transfer pricing studies.\(^ {54}\) Further, in applying the IRC section 482 standards, the revenue secretary must also take into account federal or state case law interpreting IRC section 482 and its regulations.\(^ {55}\)

Thus, both the Pennsylvania and North Carolina expense addback statutes broadly take into consideration concepts of business purpose and arm's-length dealing, which may lead taxpayers to anticipate the need for valid transfer pricing studies to support a position to deduct intercompany intangible and interest expenses.

VIII. BEPS and the OECD

In February 2013 the OECD secretary-general published "Addressing Base Erosion and Profit Shifting" in response to perceived abuses by multinational companies to avoid paying their "fair share" of taxes by engaging in tax planning that erodes the amount of corporate tax (base erosion) in a jurisdiction relative to the operating profit disclosed in accounts and concentrating profits in low-tax jurisdictions (profit shifting). The goal of the report was to establish the case for action by showing the extent of BEPS. This first report concluded that BEPS is a significant problem for OECD member and nonmember states and that "the international common principles drawn from national experience to share tax jurisdiction may not have kept pace with the changing business environment."\(^ {56}\) The report noted that domestic rules and internationally agreed-upon standards for sharing tax jurisdiction were developed in the early 20th century and are grounded in a business environment typified by a lower degree of economic integration across borders. As such, many of those rules are unsuited to current business models characterized by high intellectual property value and rapid information and communication systems. Another report, the "Action Plan on Base Erosion and Profit Shifting," published in July 2013 and endorsed by the G-20 in September 2013, identified seven areas for further review.

In October 2015 the OECD released its final report on BEPS, including one report for each of the resulting 15 action items. The recommendations proposed for each BEPS action item are intended to form a comprehensive and cohesive approach to the international tax framework, including domestic law recommendations and international principles under model tax treaty and transfer pricing guidelines.

However, the OECD is not a lawmakers body, and participating countries must determine on their own what, if anything, will be adopted by treaties or as domestic legislation and enacted in some form that may or may not represent the OECD's original recommendation. In the United States, there is an ongoing debate between Congress and Treasury about the breadth of the administration's authority to implement some of those recommendations absent congressional assent. This debate is also occurring in a climate of expectations of fundamental tax reform or limited international tax reform. With so much to consider, it is unlikely that sweeping legislative changes will be made until after the 2016 presidential election, though regulatory action is always possible, such as Treasury's early April regulatory package on sections 7874 and 385.\(^ {57}\)

However, Treasury did take significant action in December 2015, when it released proposed regulations that require annual country-by-country (CbC) reporting by U.S. entities that are the ultimate parent entity of a multinational enterprise group with annual revenue of $850 million or more.\(^ {58}\)

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\(^ {49}\)Id. section 7401(3)(1)(3).
\(^ {50}\)Id. section 7401(3)(1)(4).
\(^ {51}\)Id. section 7401(3)(1)(2). Note that in addition to the specific expense addback requirement, Pennsylvania provides in the same statute the ability to deny a deduction regarding a fraudulent or sham transaction. (Thus, even if taxpayers can prove a valid business purpose for the intercompany intangible or interest charge, documentation of arm's-length pricing would also be required.) Id. section 7401(3)(1)(1).
\(^ {52}\)N.C. Gen. Stat. section 105-130.5A(b).
\(^ {53}\)Id.
\(^ {54}\)Id. section 105-130.5A(h); 17 N.C. Admin. Code 5E0301(a).
\(^ {55}\)17 N.C. Admin. Code 5E0301(b).

\(^ {56}\)OECD, "Addressing Base Erosion and Profit Shifting" (2013).
\(^ {57}\)Until the U.S. Congress and Treasury act, it remains to be seen exactly what provisions will be imported from BEPS and what impact they may have on those states that adopt the IRC or component parts of the IRC.
Treasury based the proposed regulations “on the standards for transfer pricing documentation and CbC reporting, including the model template developed by the OECD as part of the BEPS project.” The regulations are based on Treasury’s authority under IRC sections 6001, 6011, 6012, 6031, 6038, and 7805, rather than under its authority under IRC section 6662 for the transfer pricing documentation penalty protection regime. The CbC report will be due with the timely filed tax return (with extensions) for the parent entity of a U.S. MNE group.

The regulations are proposed to apply to tax years of parents of U.S. MNE groups that begin on or after the date of publication of the Treasury decision adopting those rules as final regulations, which is expected to occur in 2016. Thus, the regulations will apply to a fiscal year taxpayer for a fiscal year beginning after the date of publication. Calendar-year taxpayers will first apply the regulations for the 2017 tax year, provided the regulations are finalized in 2016. The new rules require the jurisdiction-by-jurisdiction level aggregation of information such as:

• revenue generated from transactions with other constituent entities of the U.S. MNE group and revenue not generated from transactions with other constituent entities of the U.S. 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 and other details related to accrued tax expense;
• stated capital;
• accumulated earnings;
• number of employees on a full-time equivalent basis in the relevant tax jurisdiction; and
• net book value of tangible assets other than cash or cash equivalents.

It is important to recognize that the CbC rules are broadly aimed at assessing high-level transfer pricing risks or other BEPS risks, which involve assessing the noncompliance risk regarding members of the MNE group and potentially performing economic and statistical analysis. Some state practitioners may be concerned about how the states will use this information once they receive it. That may mean that the initial correspondence from U.S. states as a result of those rules (via ongoing information sharing agreements with the IRS) would be in the form of information requests and not estimated billings.

The regulations also do not require that a non-U.S. ultimate parent company provide any information to the IRS. The IRS will only get CbC information for these companies from another country that provides the information. Thus, there are no provisions to compel a U.S. subsidiary of a non-U.S. MNE to produce the report when the headquarters country does not require it. The IRS and Treasury indicate that the CbC report will be exchanged with tax jurisdictions that have entered into an income tax convention or tax information exchange agreement with the U.S. Treasury also expects that the U.S. competent authority will enter into competent authority arrangements for the automatic exchange of CbC reports under those conventions or TIEAs that will further limit the permissible uses of those reports to assessing high-level transfer pricing and other tax risks and, when appropriate, for economic and statistical analysis.

Why is all of that important? Because the states generally get a vast array of information from the IRS. If the IRS is not receiving that data, it can be expected that nothing goes through to the states. Until that process begins in earnest, it is difficult to anticipate the level of participation by the states and how they will apply that information.

IX. Proposed Federal Intercompany Debt Regulations

On April 4, 2016, the IRS issued proposed Treasury regulations under IRC section 385 that would, if adopted in their current form, have a wide-ranging effect on intercompany debt, including requiring some debt instruments issued between related parties to be recharacterized as equity and establishing minimum documentation requirements that must be satisfied for intercompany debt instruments to be respected. While the proposed regulations are not intended to affect debt between members of a consolidated federal return for federal tax purposes, they may have implications for state income tax purposes, especially in states that do not fully conform to the federal consolidated return regulations. The proposed regulations were issued to address some inversion and post-inversion transactions but will have widespread implications on intercompany debt in many — perhaps unanticipated — ways. It is premature to conclude how states will apply the temporary regulations. Suffice to say that the same resource constraints that states face in the transfer pricing arena could present similar challenges as that area develops.

X. Conclusion

The globalization of business is likely to continue, bringing with it increased complexity, uncertainty, and lack of conformity in the state and international tax arenas. The states will apply those tools available and continue to study other options and information sources in their effort to compel accurate reporting of taxable income.