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U.S. INTERNATIONAL TAX DEVELOPMENTS

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by

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I. SECTION 482.

A. Altera.

1. *Altera Corporation v. Commissioner*, 145 T.C. No. 3 (2015), is a follow-on to the *Xilinx v. Commissioner case*, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010).

2. In *Xilinx*, the Tax Court held that, under the § 1995 cost-sharing regulations, controlled entities entering into qualified cost-sharing agreements ("QCSAs") need not share stock-based compensation costs because parties operating at arm's length would not do so. In an effort to overrule *Xilinx*, Treasury and the IRS in 2003 issued Treas. Reg. § 1.482-7(d)(2). The 2003 regulation requires controlled parties entering into

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QCSAs to share stock-based compensation costs. *Altera v. Commissioner* addressed that regulation, and held that it was invalid.

3. The § 482 regulations provide that in determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length within another uncontrolled taxpayer. The arm's length standard also is incorporated into numerous income tax treaties between the United States and foreign countries. In *Xilinx,* as noted, the Tax Court held that unrelated parties would not share the value of stock-based compensation in a cost-sharing arrangement. The Ninth Circuit, in *affirming*, held that the "all costs" requirement of the 1995 cost-sharing regulations was irreconcilable with the arm's length standard.

4. In issuing the new regulations, Treasury and the IRS first published a proposed version of the regulations with a notice of proposed rulemaking and a notice of public hearing. At the hearing a number of persons testified, and many written comments were submitted.

5. Several of the commentators informed Treasury that they knew of no transactions between unrelated parties, including any cost-sharing arrangement, service agreement, or other contract, that required one party to pay or reimburse the other party for amounts attributable to stock-based compensation. Some comments were based on a survey of an association's members. Some commentators represented that they had conducted multiple searches of electronic data gathering and found no cost-sharing agreements between unrelated parties in which the parties agreed to share either the exercise spread or grant date value of stock-based compensation.

6. Several commentators identified arms-length agreements in which stock-based compensation was not shared or reimbursed. Some cited the practice of the federal government, which regularly enters into cost-reimbursement contracts at arm's length. They noted that federal acquisition regulations prohibit reimbursement of amounts attributed to stock-based compensation.

7. Treasury and the IRS nonetheless issued the regulation as a final regulation. The final rule explicitly required parties to QCSAs to share stock-based compensation costs. Treasury and the IRS also added sections to Treas. Reg. §§ 1.482-1(b)(2)(i) through 1.482-7(a)(3) to provide that a QCSA produces an arm's-length result only if the parties' costs are determined in accordance with the final rule.

8. When Treasury and the IRS issued the final regulation, the government's files relating to the final rule did not contain any expert opinions, empirical data or published or unpublished articles, papers, surveys, or

reports supporting a determination that the amounts attributable to stock-based compensation must be included in the cost rule of QCSAs to achieve an arm's-length result. Those files also did not contain any record that Treasury searched any data base that could have contained agreements between unrelated parties relating to joint undertakings with the provision of services. Treasury was also unaware of any written contract between unrelated parties that required one party to pay or reimburse the other party for amounts attributable to stock-based compensation.

9. The Court considered the applicable principles of Administrative Law, including especially the Administrative Procedure Act ("APA"). Pursuant to APA § 553, in promulgating regulations through informal rulemaking, an agency must (1) publish a notice of proposed rulemaking in the Federal Register; (2) provide interested parties an opportunity to participate in the rulemaking through submission of written data, views, or arguments with or without the opportunity for oral presentation; and (3) after consideration of the relevant matter presented incorporate in the rules adopted a concise general statement of their basis and purpose.

10. The Court stated that these requirements do not apply to interpretive rules (those which merely explain pre-existing substantive law), or when an agency for good cause finds--and incorporates its findings in the rules issued--that the notice and public procedure thereon are impracticable, unnecessary or contrary to the public interest. The regulations at issue, however, were legislative (substantive) regulations, *i.e.*, those that create rights, impose obligations, or effect a change in existing law.

11. The notice and comment requirements of APA § 553 are intended to assist judicial review as well as to provide fair treatment for persons affected by a rule. There must be an exchange of views, information, and criticism between interested parties and the agency. The opportunity to comment is meaningless unless the agency responds to significant points raised by the public. The failure to respond to comments is significant only insofar as it demonstrates that the agency's decision was not based on a consideration of the relevant factors.

12. Pursuant to APA § 706(2)(A), a court must hold unlawful and set aside agency action, findings and conclusions that it finds to be arbitrary, capricious and an abusive discretion or otherwise not in accordance with the law. A court's review under this standard is narrow and a court is not to substitute its judgment for that of the agency. *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983). A reviewing court, however, must ensure that the agency "engaged in reasoned decision making." Under *State Farm*, normally an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision

that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.

13. The standard to be applied in every case under § 482 is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. *Commissioner v. First Sec. Bank of Utah*, 405 U.S. 394 (1972) (*quoting* Treas. Reg. § 1.482-1(b)(1)); *accord* Treas. Reg. §§ 1.482-1(a)(1), (b)(1) and Treasury Department technical explanations of a number treaties.

14. The IRS countered that Treasury should be permitted to issue regulations modifying--or even abandoning--the arm's-length standard. But the preamble to the final rule, stated the Court, did not justify the final rule on the basis of any modification or abandonment of the arm's-length standard, and the IRS conceded that the purpose of § 482 is to achieve tax parody. The preamble to the regulation also did not dismiss any of the evidence submitted by commentators regarding unrelated party conduct as addressing an irrelevant or inconsequential factor. The Court stated that it did not decide whether Treasury would be free to modify or abandon the arm's-length standard because it had not done so here.

15. The taxpayer contended that the final regulation is invalid because (1) it lacks a basis in fact, (2) Treasury failed rationally to connect the choice it made with the facts it found, (3) Treasury failed to respond to significant comments and (4) the final rule is contrary to the evidence before Treasury.

16. A court will generally not override an agency's "reasoned judgment about what conclusions to draw from technical evidence or how to adjudicate between rival scientific or economic theories." Treasury, however, failed to provide a reasoned basis for reaching the conclusions that support the regulation from any evidence in the administrative record. Indeed, every indication in the record pointed the other way. The Court concluded that by failing to engage in any fact finding, Treasury failed to examine the relevant data and it failed to support its belief that unrelated parties would share stock-based compensation with any evidence in the record. The Court also stated that the final rule was contrary to the evidence before Treasury when it issued the final rule.

17. Because the final regulation lacks a basis in fact, the Court held that Treasury failed to rationally connect the choice it made with the facts found, Treasury failed to respond to significant comments when it issued the final rule, and Treasury's conclusion that the final rule is consistent with the arm's-length standard was contrary to all of the evidence before it. Thus, the Court concluded that the final rule failed to satisfy the *State Farm's* reasoned decision making standard and therefore is invalid.

18. The Court closed with the statement that Treasury's *ipse dixit* conclusion coupled with its failure to respond to contrary arguments resting on solid data, epitomizes arbitrary and capricious decision making.

19. The decision was "reviewed by the Court," which means that all of the Tax Court's judges considered whether to join in with the Court's opinion, file concurring opinions, or dissent. All of the judges who participated agreed with the opinion of the Court. There were no dissenting opinions.

20. The term *ipse dixit* refers to an unsupported statement that rests solely on the authority of the individual who made it. The term describes a dogmatic statement that the speaker expects the listener to accept as valid.

21. In this regard, I cannot resist quoting a high-ranking government official as stating in 2008 "we can simply interpret arm's-length to mean what we think it should mean, and if we say it correctly, that is what it means." *See* Lee Sheppard, Tax Notes Int'l. Sept. 22, 2008, p. 970.

22. Unfortunately, this is the very issue that raises serious problems in BEPS. For example, the "special measures" exceptions to the arm's-length standard in BEPS has the U.S. government and taxpayers both concerned that it will lead to many *ipse dixit* pronouncements by foreign taxing authorities. Perhaps, these BEPS exceptions from the arm's length standard, instead of being referred to "special measures," should be called *ipse dixit* pronouncements. That's what they will be.

23. The IRS filed an appeal in *Altera* to the Ninth Circuit, the circuit that affirmed *Xilinx*.

24. The Department of Justice (DoJ) filed its appellate brief with the Ninth Circuit on June 27, 2016. The DoJ's brief largely makes the same arguments the government made, and lost on, in *Xilinx*.

25. The Government's brief asserts that the changes made to the cost sharing regulation in 2003 overcome the regulatory deficiencies that the Ninth Circuit determined in its *Xilinx* decision. The Government asserts that *Xilinx* therefore is not controlling.

26. The Government makes three arguments for the validity of the 2003 cost sharing regulation (1) the commensurate with income sentence in § 482, (2) the 1986 legislative history, and (3) an economic reality/implicit cost argument. These arguments were made by the Commissioner and, on appeal, the Government in *Xilinx* regarding years before the regulation was in effect. The Tax Court and the Ninth Circuit rejected them there.

27. An amicus brief supporting the Government in Altera asserts that "the question of comparability was not fully considered in the *Xilinx* case" and "[i]f the Xilinx litigation had included the question of whether the

controlled and uncontrolled party joint development costs were comparable, perhaps that question would have influenced the *Xilinx* outcome." Such assertions are incorrect.

(a) Xilinx submitted thirteen opening expert reports. The Commissioner submitted five. There also were numerous rebuttal reports. These expert reports (over 30 of them in total) are not listed on the Xilinx docket sheet, so the amici clearly did not read these expert reports or see the attached comparable cost sharing agreements. The amici also appear not to have read the parties' four post-trial briefs or reviewed the 2,500+ pages of the transcript. The IRS consistently asserted that all of the dozens of cost sharing agreements presented by Xilinx were not comparable to Xilinx's CSA agreement. The comparability of the transactions was a matter that was addressed extensively in examinations, cross examination and in post-trial briefs.

(b) We point this out as counsel to Xilinx in its case and in filing an Altera amicus brief.

(c) We also state that including a statement in the regulation that the IRS's litigating position in *Xilinx* produces an arm's length result does not make it an arm's length result.

(d) The regulation cannot change the *Xilinx* decision that: "If unrelated parties operating at arm's length would not share the employee stock option cost, requiring controlled parties to share it is simply not an arm's length result."

(e) Moreover, the Ninth Circuit's *Xilinx* opinion states that "[i]f the standard of arm's length is trumped, the purpose of the statute is frustrated" and that the arm's length standard is the touchstone for § 482."

(f) Furthermore, *Xilinx* was a case designated for litigation, which also diminishes the government's argument that the *Xilinx* decision does not control.

(g) We also point out that apart from the *Xilinx* decision, the 2003 cost sharing regulation is not a reasonable implementation of § 482. The Commissioner is given the authority to do only two things: clearly reflect income and prevent evasion of tax. Because stock options are not shared in uncontrolled transactions, there is no evasion of taxes and the income is clearly reflected. Although the IRS asserted that unrelated parties would include stock options in cost sharing agreements, the IRS presented no agreements *of any kind* that actually included stock option amounts. Consequently, a

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§ 482 regulation that requires a result that is demonstrably contrary to the arm's length standard exceeds the authority granted to the Commissioner in § 482. The regulation is, therefore, not a reasonable implementation of the statute.

B. Guidant.

1. *Guidant v. Commissioner*, 146 T.C. No. 5 (2016), involves a group of U.S. corporations that filed consolidated federal income tax returns during the years in issue (collectively, the "taxpayer"). During those years, the taxpayer consummated transactions with its foreign affiliates. The transactions included the licensing of intangibles, the purchase and sale of manufactured property, and services.

2. The IRS utilized § 482 to adjust the reported prices at which items were transferred between the taxpayer and its foreign affiliates. The IRS posted all of the adjustments to the taxpayer's group parent company without making specific adjustments to any of the subsidiaries' separate taxable incomes. The IRS also did not determine any portion of the adjustments that related solely to tangibles, intangibles, or services.

3. The taxpayer filed a motion for partial summary judgment asserting that the IRS adjustments were arbitrary, capricious, and unreasonable as a matter of law. The IRS did not determine "true taxable income" of each controlled taxpayer within the group as required under Treas. Reg. § 1.482-1(f)(iv), and did not make specific adjustments with respect to each transaction involving an intangible, a purchase and sale of property, or a provision of services.

4. The court denied the taxpayer's motion stating that neither § 482 nor the regulations thereunder requires that the IRS must always determine true taxable income of each separate controlled taxpayer within a consolidated group contemporaneously with the making of a § 482 adjustment. The court also held that the IRS is permitted to aggregate one or more related transactions instead of making specific adjustments with respect to each type of transaction.

5. During the examination, the IRS did not spend time or resources to determine member-specific adjustments for each of the taxpayer's U.S. controlled group members. The Service did not believe that it could independently make reliable member-specific adjustments on the basis of the information available to it. The activities of each group member and the group member's relationship with the activities of other group members were complex.

6. The court read Treas. Reg. § 1.482-1(f)(1)(iv) to require the IRS to determine both consolidated taxable income and separate taxable income

when making a § 482 adjustment with respect to income reported on a consolidated return, but also giving the IRS a certain latitude to decide when the determination of separate taxable income becomes necessary. The court stated that the regulation does not preclude the IRS from deferring making the separate taxable income determinations for each member until the time when such a determination is actually required.

7. According to the court, its reading was consistent with the underlying purpose of both the transfer pricing regulations and the consolidated return regime. The court stated that the taxpayer's suggested interpretation could completely eliminate the IRS's ability to make § 482 adjustments when the taxpayer consciously withholds or fails to maintain records or information necessary for separate-company taxable income adjustments:

> "While using the 'bottom to top' approach could theoretically yield the most reliable results, we cannot require the Commissioner to use it in cases when taxpayers cannot provide the Commissioner with reliable information for member-specific adjustments. The determination of whether the Commissioner abused his discretion by making 'top to bottom' § 482 adjustments beginning at the [consolidated taxable income] level thus depends on the facts and circumstances of a given case."

8. On the basis of the record before the court, which the court said it must construe favorably to the IRS as the party opposing the motion for partial summary judgment, the IRS's revenue agents concluded that they were unable to make reliable member-specific adjustments on the basis of the available information.

9. The court stated that while taxpayer argued that it maintained all the necessary information and records to make the separate-company taxable income determinations, it would have been too costly or otherwise difficult for the IRS to extract that information at the time of the audit from the taxpayer's accounting databases.

10. The court added that whether the IRS's decision to delay the separate-company taxable income computations constitutes an abuse of discretion under these circumstances is still in dispute and remains to be determined on the basis of the full record as developed at trial.

11. Thus, the court did not conclusively hold that the IRS's § 482 adjustments were not arbitrary, capricious or unreasonable as a matter of fact. It only held that the IRS's § 482 adjustments were not arbitrary, capricious, or unreasonable as a matter of law.

12. The taxpayer also argued that the IRS's § 482 adjustments were arbitrary, capricious and unreasonable because the Service did not make separate adjustments for each transfer of intangible property, transfer of tangible

property and provision of services. The applicable regulations in determining the arm's length consideration lets the IRS aggregate two or more separate transactions to the extent that aggregation serves as the most reliable means of determining the arm's length consideration for the transactions: Treas. Reg. § 1.482-1(f)(2)(i) provides that the combined effect of two or more transactions may be considered if the transactions, taken as a whole, are so interrelated that the consideration of multiple transactions is the most reliable means of determining the arm's-length consideration for the controlled transactions.

13. Thus, the court denied the taxpayer's motion regarding this argument as well. The court closed by stating "Whether respondent abused his discretion by aggregating transactions involving intangibles, tangible goods, and provision of services, thus, is a question of fact that should be resolved on the basis of the trial record."

14. The parties settled their dispute by agreeing to adjustments of $975 million for the 2001-2007 tax years. The IRS agreed to concede alternative adjustments under § 367(d). The case appears to have been resolved for approximately 25% of the total amount asserted, and the settlement likely was motivated by the Tax Court's decision in *Medtronic,* discussed below.

C. Other Pending Cases.

1. *Amazon.com, Inc. v. Commissioner*, T.C. Dkt. 31197-12, involves a cost sharing agreement with allocated amounts of over $1 billion for each of the two years in issue. It seems to involve some of the same issues that were litigated in *Veritas v. Commissioner*, 133 T.C. 297 (2009), *nonacq*, which is cited in Amazon's Tax Court Petition.

2. *3M Company v. Commissioner*, T.C. Dkt. No. 5816-13, filed March 11, 2013, involves the IRS's allocation of royalty income from a Brazilian subsidiary. The taxpayer asserts that the royalties in issue are not permitted under Brazilian law. *First Security Bank of Utah v. Commissioner*, 405 U.S. 394 (1972) held that if the law prevents the taxpayer from earning certain income, the taxpayer did not have the necessary control that § 482 requires, and an allocation under § 482 would be inappropriate. Subsequently, *Proctor & Gamble v. Commissioner,* 961 F.2d 1255 (6th Cir. 1992), held that this applies where foreign law is involved, as well. *Exxon Corp. v. Commissioner*, 66 TCM 1707 (1993), *aff'd*, *Texaco v. Commissioner*, 98 F.3d 825 (5th Cir. 1996), followed these cases with respect to Saudi Arabian crude pricing. Treasury and the IRS have tried to reverse these decisions with a regulation issued in 1994: Treas. Reg. § 1.482-1(h). I have long wondered how Treasury and the IRS could write a regulation *under* § 482 to overrule the Supreme Court's holding that *§ 482 does not apply in the first case*.

D. Eaton.

1. Eaton Corporation has a pending § 482 case. While the case has not yet been tried, an order in the case is sufficiently surprising that I thought I would mention it. The order, dated May 11, 2015, affirmed a prior order dated April 6, 2015. The order involves the production of documents.

2. The IRS asserts that Eaton should be charged a transfer pricing accuracy-related penalty under § 6662(h). Eaton says that the penalty should not apply because it has reasonable cause for any portion of an understatement attributable to a net § 482 transfer pricing adjustment.

3. The Court's order states that although the reasonable cause defense is an objective one, it ultimately involves all the facts and circumstances, including several factors that are particular to the taxpayer asserting the defense. The taxpayer must reasonably have concluded that a particular transfer pricing method provided a reliable measure of an arm's length result. Further, the taxpayer's experience and knowledge and the extent to which the taxpayer relied on a study or other analysis performed by a qualified attorney, accountant, or economist are relevant.

4. The order states that in asserting a reasonable cause defense, Eaton has put at issue otherwise protected information that would reveal the expertise and knowledge and state of mind of those who acted on its behalf in this matter. The court cited *Ad Inv. 2000 Fund LLC v. Commissioner*, 142 T.C. 248 (2014). Thus, documents that the IRS seeks, states the order, are directly relevant to Eaton's penalty defense.

5. The issue involves attorney-client privilege with respect to the documents at issue. The court concluded that Eaton waived privilege and work product protections to withhold the documents in dispute from discovery as a consequence of asserting that the penalty should not apply. The order further states that if Eaton does not produce the documents, the court will grant so much of the IRS's motion to compel production of documents as seeks an appropriate sanction by striking relevant portions of the petition and barring the introduction of evidence related thereto.

6. This is surprising, to say the least: attorney-client privilege is waived simply because the taxpayer asserts that a penalty should not apply. This cannot be right. In enacting penalties, did Congress really intend that privilege must be waived as the price of asserting that a penalty should not apply?

7. Imagine a typical non-tax civil or criminal case. If the defendant asserts a defense that relates to his state of mind or reasonable cause, would he be viewed as waiving privilege? I don't think so. The attorney-client

privilege is a common law privilege that's pretty deeply ingrained in our legal system. It shouldn't vary by the court involved.

E. Medtronic: § 482/367.

1. *Medtronic* is an important case involving § 482 and § 367(d). In previous motions, Medtronic sought to reduce the prices used on its tax return to pre-agreement numbers because the IRS reneged on an agreement and put the issue in play and the IRS unsuccessfully moved for partial summary judgment on an issue involving product risk.

2. The IRS's first examination of Medtronic's 2005 and 2006 tax returns began in May 2007. During the course of the examination IRS Exam proposed an initial $84 million adjustment as a result of revised calculations under a Memorandum of Understanding ("MOU") agreed to in a prior cycle. The MOU reflected an agreement that royalty rates of 44% for devices and 26% for leads would be used by Medtronic for royalties from its Puerto Rico subsidiary. (The "Puerto Rico subsidiary" or "Puerto Rico company," as I use those terms, more specifically refers to Medtronic's wholly-owned Cayman Islands subsidiary that manufactures through a branch in Puerto Rico.)

3. The prior cycle also involved the IRS's assertion that Medtronic had contributed to the Puerto Rico company workforce-in-place, goodwill and going concern value with a fair market value of $23 million. The IRS asserted that the gain should rateably be included in Medtronic's income over a 20-year period pursuant to § 367(d). Medtronic accepted the IRS's prior-cycle § 367(d) adjustment and in 2003-2006 included additional amounts totaling about $2 million in income each year.

4. In March 2009 after completing its initial examination of Medtronic's 2005-2006 returns, the IRS proposed to increase Medtronic's royalty income by an additional $455 million for 2005 and 2006. Medtronic filed a protest later in 2009. Appeals, at IRS Exam's request, subsequently returned the case to IRS Exam, which reexamined Medtronic's 2005 and 2006 tax returns. On December 23, 2010, the IRS issued Medtronic a Notice of Deficiency determining deficiencies totaling $198 million and $759 million for 2005 and 2006, respectively. These were based on IRS Exam's use of the comparable profits method.

5. On July 10 2014, the IRS amended its Answer in Tax Court to exclude royalty amounts paid by the Puerto Rico company for non-U.S. sales, and asserting that the adjustments were understated by $51 million for 2005 and $60 million for 2006.

6. Thus, the proposed deficiencies related to the royalties in issue were increased to approximately $550 million for 2005 and $810 million for 2006, or roughly a total of $1.4 billion.

7. As noted above, since the IRS reneged on the earlier-year's MOU and put the taxpayer's transfer pricing in issue, Medtronic sought a refund by using its pre-MOU prices.

8. The Notice of Deficiency also provided for alternative income inclusions under § 367(d). The IRS contended that Medtronic should include these amounts in income if the Tax Court did not sustain the IRS's § 482 allocations. The Notice of Deficiency stated "that significant value had been transferred to [the Puerto Rico company] [and] it is determined that such value transferred (exclusive of tangible assets transferred) is taxable under I.R.C. [section] 367(d))." The Notice of Deficiency stated that, accordingly, Medtronic must include in income amounts not to exceed $497 million for 2005 and $751 million for 2006.

9. <u>Opinion</u>.

   (a) The IRS's contended that the CPM was the best method to determine the arm's-length royalty rates on the intercompany sales of devices and leads and that making the § 482 adjustments did not result in an abuse of discretion. Medtronic, as noted, contended that the MOU royalty rates on the intercompany sales of devices and leads were greater than arm's-length.

   (b) The companies had entered into four separate intercompany agreements that the court considered. They were (1) the components supply agreement, (2) the distribution agreement, (3) the trademark license, and (4) the devices and leads licenses (collectively covered transactions).

   (c) The taxpayer met its burden of showing that the IRS's allocations were arbitrary, capricious or unreasonable. Medtronic argued that (1) the IRS abandoned a prior position and (2) the IRS's adjustments were unreasonable because they gave inadequate consideration to the importance of *quality* at the Puerto Rican operation.

   (d) First, the court concluded that the IRS did not abandon its position taken in the Notice of Deficiency. The court then considered the IRS's adjustments, which were made based on a Heimert report. Heimert used CPM and opined that this method would provide the Puerto Rico company with a return for its finished-product manufacturing that was consistent with the returns earned by comparable manufactures in the medical-device industry. Heimert

subtracted the operating profits attributed to the Puerto Rico company from the overall value-chain operating profits and allocated the remainder to Medtronic U.S.

(e) Heimert performed an economic analysis of the functions performed, assets used, and risks assumed by the Puerto Rico company and Medtronic U.S. The only function assigned to the Puerto Rico company was finished-product manufacturing. His analysis assumed that all of the intangibles that the Puerto Rico company needed to perform the finished manufacturing, other than assembled workforce-in-place and incremental process intangibles that the Puerto Rico company may have developed, were licensed from Medtronic U.S.

(f) This approach treated the Puerto Rico company as equivalent to many other third-party medical-device manufacturers that do not create nonroutine assets and that do not bear additional risks that would require the assignment of additional profits.

(g) Medtronic stressed that quality is critical in the medical-device industry and, in particular, to the Puerto Rico company. Numerous witnesses testified on the taxpayer's behalf about the importance of quality. Medtronic's chief executive officer during the years in issue testified that product quality is the "single greatest factor in terms of market share." Medtronic argued that the Puerto Rico company's role in quality was unique because it bore the greatest economic risk. It was exposed to being sued if there was a defect in the manufactured device.

(h) The parties disputed the level of risk attributed to the Puerto Rico company, but the court felt there was no dispute that the Puerto Rico company bore some of the risk. The court, however, specifically declined to consider which company was responsible under federal products liability law.

(i) The IRS argued that the Puerto Rico company was similar to a manufacturer of components and that it was replaceable in the process. The taxpayer contended that since the Puerto Rico company was responsible for assembling the final product, the importance of quality was vital. The court found that the Puerto Rico company not only assembled the product but that it leveraged its systems-engineering expertise to make manufacturing process design improvements to the finished medical devices, enabling a safe product to be made.

(j) The Puerto Rico company contributed throughout the design process and had a role in product development. The court found

the Puerto Rico company was an integral part of the taxpayer's operations. The Puerto Rico company's role was not only to make a safe product, but to make a product that would stand the test of time.

(k) The court found that Heimert's approach ignored valuable intangible assets that were obtained through the devices and leads licenses because the assets were not recorded on the Puerto Rico company's balance sheet. The court agreed that his approach was misleading because it ignored the value of the licensed intangibles.

10. Aggregation.

(a) Medtronic contended that the transactions in issue should not be aggregated and that aggregation would treat the Puerto Rico company more like a contract manufacturer, failing to take into account its full role. The IRS contended that aggregating transactions was required.

(b) The court held that the functions at issue in the current transactions can exist independently and that the regulations do not require that the transactions be aggregated. Transections may be aggregated under the regulations if an aggregated approach produces the "most reliable means of determining the arm's length consideration for the controlled transactions." Here, the covered transactions are accounted for and priced separately in the marketplace.

(c) Whether the IRS abused its discretion by aggregating transactions involving intangibles, tangible goods, and provision of services is a question of fact. Here, aggregating the transactions did not result in a reasonable determination of true taxable income.

11. Commensurate with Income.

(a) The court stated that the commensurate with income standard under § 482 does not replace the arm's-length standard. It cited *Altera Corp. v. Commissioner*, 145 T.C. ___ (2016), and *Xilinx, Inc. v. Commissioner*, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010). Thus, the court held that the IRS's use of CPM is not required under the § 482 commensurate with income standard and the IRS's arguments regarding that standard did not change the court's view that the IRS's allocations were unreasonable.

12. Medtronic's Method.

(a) Medtronic still had to prove that its royalties met the arm's-length standard. Otherwise, the court would need to determine the proper royalty rates.

(b) Using the comparable uncontrolled transaction ("CUT") method, Medtronic contended that royalties of 29% of net device intercompany sales and 15% of net leads intercompany sales were arm's-length. Medtronic contended that a Pacesetter agreement was the best comparable, and had an expert testify in support of those royalty rates.

(c) The court found that those royalty rates were not arm's length because appropriate adjustments had not been made to the third-party rates to account for variations in profit potential. However, the court did accept Medtronic's trademark royalty rate.

13. The Court Determines the Royalty Rates.

(a) The court stated that the IRS took an all-or-nothing approach by advocating a result based on CPM using its value-chain method and by refusing to suggest adjustments to Medtronic's CUT method for the devices and leads royalties. Because of the IRS's approach, and because the court concluded that neither party's transfer pricing analysis was reasonable, the court stated that it was left with little help from the parties to determine the proper transfer prices.

(b) The court agreed with Medtronic that the Pacesetter agreement could serve as an appropriate CUT because it involved some of the same intangibles and involved comparable circumstances. However, that agreement's rate had to be modified because it included a narrower group of intangibles.

(c) The court calculated the royalty rates and determined that an appropriate arm's-length royalty rate for devices was 44%.[1] It concluded that a reasonable royalty rate for the leads was 22%, half of the 44% that it determined for the devices royalties.

14. Transfer of Intangible Property.

(a) As stated above, the Notice of Deficiency also asserted that alternative income inclusions would be necessary under § 367(d) if the court did not sustain the IRS's § 482 allocations in their entirety.

[1] *Medtronic* is interestingly similar to *Eli Lilly v. Commissioner*, 856 F.3rd 855 (7th Cir 1988), in this regard. Both cases involved a prior cycle transfer-pricing agreement which the IRS sought not to follow in a later audit cycle by increasing the taxpayer's prices even further. At the end of the day, both courts seemed to have adjusted the taxpayer's pricing in a matter similar to that which the IRS and the taxpayer had previously agreed, with some tweaking.

(b) Section 367(a) provides general rules for the taxation of outbound transfers of property by U.S. persons to foreign corporate transferees in transactions that would otherwise qualify as nonrecognition transactions, such as § 351 transfers.

(c) The IRS contended that intangible property subject to § 367(d) "must have been" transferred to the Puerto Rico company in 2002 when it was formed. Intangible property subject to § 367(d) is defined in the statute. The court quoted the statutory definition.[2]

(d) The court stated that the IRS did not identify or allege any specific intangibles that were transferred to the Puerto Rico company. An IRS witness who was a member of the IRS's 2000-2002 Exam Team stated they did not find that any statutorily-defined intangibles were transferred to the Puerto Rico company in the relevant reorganization transaction. It was during that period that the Puerto Rico company was established in the reorganization of a § 936 subsidiary.

(e) The court stated that the gist of the IRS's argument seems to be that the Puerto Rico company could not possibly be as profitable as it was unless intangibles were transferred to it. The court was not persuaded by this argument. The court also stated that it was unclear which intangibles the IRS believes are subject to § 367(d).

(f) Thus, the court concluded that it was not persuaded that intangibles were transferred that should be subject to § 367(d).

F. New § 482 Regulations. Treasury and the IRS issued temporary and proposed regulations under § 482 at the same time they proposed the § 367 regulations discussed below. They state the new regulation is to coordinate the application of the arm's length standard and the best method rule under § 482 with other Code provisions. The coordination rules apply to controlled transactions, including those subject in whole or in part to both §§ 367 and 482.

1. Consistent Valuation of Controlled Transactions.

(a) Section 482 authorizes Treasury and the IRS to adjust the results of controlled transactions to clearly reflect the income of commonly controlled taxpayers in accordance with the arm's-length standard and, in the case of transfers of intangible property (within the meaning of § 936(h)(3)(B)), so as to be commensurate with the income attributable to the intangible.

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[2] The statutory definition does not include goodwill, going concern value and workforce in place. Presumably, Medtronic agreed to an inclusion in the prior audit cycle because the amounts were quite small.

(b) While the determinations of arm's-length prices for controlled transactions is governed by § 482, the tax treatment of controlled transactions is also governed by other Code and regulatory rules applicable to both controlled and uncontrolled transactions. Controlled transactions always remain subject to § 482 in addition to these generally applicable provisions.

(c) The new temporary regulations provide for the coordination of § 482 with those other Code and regulatory provisions. The new coordination rules thus apply to controlled transactions including controlled transactions that are subject in whole or in part to §§ 367 and 482. Transfers of property subject to § 367 that occur between controlled taxpayers require a consistent and coordinated application of both sections to the controlled transfer of property. The controlled transactions may include transfers of property subject to § 367(a) or (e), transfers of intangible property subject to § 367(d) or (e), and the provision of services that contribute significantly to maintaining, exploiting or further developing the transferred properties.

(d) Treasury and the IRS say the consistent analysis and valuation of transactions subject to multiple Code and regulatory provisions is required under the best method rule described in Treas. Reg. § 1.482-1(c). A best method analysis under § 482 begins with a consideration of the facts and circumstances related to the functions performed, the resources employed, and the risks assumed in the actual transaction or transactions among the controlled taxpayers, as well as in any uncontrolled transactions used as comparables.

(e) For example, states the preamble, if consideration of the facts and circumstances reveals synergies among interrelated transactions, an aggregate evaluation under § 482 may provide a more reliable measure of an arm's length result than a separate valuation of the transactions. In contrast, an inconsistent or uncoordinated application of § 482 to interrelated controlled transactions that are subject to tax under different Code and regulatory provisions may lead to inappropriate conclusions.

(f) The best method rule requires the determination of the arm's-length result on controlled transactions under the method, and particular application of that method, that provides the most reliable measure of an arm's-length result. The preamble also refers to the "realistic alternative transactions" rule and states that "on a risk-adjusted basis" this may provide the basis for application of unspecified methods to determining the most reliable measure of an arm's length result.

(g) Based on taxpayer positions that the IRS has encountered in examinations and controversy, Treasury and the IRS are concerned that certain results reported by taxpayers reflect an asserted form or character of the parties' arrangement that involves an incomplete assessment of relevant functions, resources, and risks and an inappropriately narrow analysis of the scope of the transfer pricing rules. In particular, Treasury and the IRS are concerned about situations in which controlled groups evaluate economically integrated transactions involving economically integrated contributions, synergies, and interrelated value on a separate basis in a manner that results in a misapplication of the best method rule and fails to reflect an arm's length result.

(h) Taxpayers may assert that, for purposes of § 482, separately evaluating interrelated transactions is appropriate simply because different statutes or regulations apply to the transactions (for example, with § 367 and the regulations thereunder applying to one transaction and the general recognition rules of the Code applying to another related transaction). Treasury and the IRS believe these positions are often combined with inappropriately narrow interpretations of Treas. Reg. § 1.482-4(b)(6), which provides guidance on when an item is considered similar to the other items identified as constituting intangibles for purposes of § 482. The interpretations purport to have the effect, contrary to the arm's length standard, of requiring no compensation for some value provided in controlled transactions despite the fact that compensation would be paid if the same value were provided in uncontrolled transactions.

2. <u>Compensation Independent of the Form or Character of Controlled Transaction</u>.

(a) New Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(A) provides that arm's-length compensation must be consistent with, and must account for all of, the value provided between parties in a controlled transaction, without regard to the form or character of the transaction. For this purpose, it is necessary to consider the entire arrangement between the parties, as determined by the contractual terms, whether written or imputed in accordance with the economic substance of the arrangement, in light of the actual conduct of the parties.

(b) Is this not the very BEPS proposal the U.S. fought (is fighting) against? I'm not sure I can reconcile the two U.S. positions here and in BEPS.

(c) The preamble says this requirement is consistent with the principles underlying the arm's length standard, which require that arm's length compensation in controlled transactions equal the compensation that would have occurred if a similar transaction had occurred between similarly situated uncontrolled taxpayers.

(d) This is the very position of the pro-BEPS countries in regard to this provision. There, the U.S. disagrees. Here, Treasury and the IRS like the argument.

3. Aggregate or Separate Analysis.

(a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(B) changes (the preamble asserts this is a "clarification") Treas. Reg. § 1.482-1(f)(2)(i)(A), which provided that the combined effect of two or more separate transactions (whether before, during, or after the year under review) may be considered if the transactions, taken as a whole, are so interrelated that an aggregate analysis of these transactions provides the most reliable measure of an arm's-length result determined under the best method rule of Treas. Reg. § 1.482-1(c).

(b) Specifically, a new clause was added to provide that this aggregation principle also applies for purposes of an analysis under multiple provisions of the Code or regulations. A new sentence also elaborates on the aggregation principle by noting that consideration of the combined effect of two or more transactions may be appropriate to determine whether the overall compensation is consistent with the value provided, including any synergies among items and services provided.

(c) The temporary regulation does not retain the statement in Treas. Reg. § 1.482-1(f)(2)(i)(A) that transactions generally will be aggregated only when they involve "related products or services."

(d) Curiously, the Obama Administration proposed a change in the statute to permit this type of aggregation (a "clarification" of the law said the explanation), but that proposal was never enacted. This would seem to raise some questions about Treasury and the IRS's changing the law by regulations when Congress has declined to act.

4. Aggregation and Allocation for Purposes of Coordinated Analysis.

(a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(C) provides that, for one or more controlled transactions governed by one or more provision of the Code and regulations, a coordinated best method analysis and evaluation of the transactions may be necessary to ensure that the overall value provided (including any synergies) is properly taken

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into account. A coordinated best method analysis of the transactions includes a consistent consideration of the facts and circumstances of the functions performed, resources employed, and risks assumed, and a consistent measure of the arm's length results, for purposes of all relevant Code and regulatory provisions.

(b) For example, situations in which a coordinated best method analysis and evaluation may be necessary include: (1) two or more interrelated transactions when either all of the transactions are governed by one regulation under § 482 or all are governed by one subsection of § 367, (2) two or more interrelated transactions governed by two or more regulations under § 482, (3) a transfer of property subject to § 367(a) and an interrelated transfer of property subject to § 367(d), (4) two or more interrelated transactions when § 367(d) applies to one transaction and the general recognition rules of the Code apply to another interrelated transaction, and (5) other circumstances in which controlled transactions require analysis under multiple Code and regulatory provisions.

(c) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(D) provides that it may be necessary to allocate the arm's length result that was properly determined under a coordinated best method analysis described in Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(C) among the interrelated transactions. An allocation must be made using the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result for each allocated amount.

5. Examples of Coordinated Best Method Analysis.

(a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(E) provides 11 examples to illustrate the new guidance. Examples 1 through 4 are materially the same as the examples in Treas. Reg. § 1.482-1(f)(2)(i)(B). Treasury and the IRS do not intend for the revisions to those examples to be interpreted as substantive. The rest of the examples are new.

(b) Example 1 is titled "Aggregation of Interrelated Licensing, Manufacturing and Selling Activities." Example 2 describes an aggregation of interrelated manufacturing, marketing and services activities. Example 3 is titled "Aggregation and Reliability of Comparable Uncontrolled Transactions," and Example 4 is described as covering non-aggregation of transactions that are not interrelated.

(c) The first new example, Example 5, is titled "Aggregation of Interrelated Patents." In the example, P owns 10 individual patents that in combination, can be used to manufacture and sell a

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successful product. P anticipates that it can earn $25 from the patents based on a discounted cash flow analysis that provides a more reliable measure of the value of the patents exploited as a bundle rather than separately.

(d) P licenses all 10 patents to S-1 to be exploited as a bundle. Evidence of uncontrolled licenses of similar individual patents indicates that, exploited separately, each license of each patent would warrant a price of $1, implying a total value for the patents of $10. The example states that it would not be appropriate to use the uncontrolled licenses as comparables for the license of the bundle of patents, because, unlike the discounted cash flow analysis, the uncontrolled licenses considered separately do not reasonable reflect the enhancement to value resulting from the interrelatedness of the 10 patents exploited as a bundle.

(e) Example 6, "Consideration of Entire Arrangement, Including Imputed Contractual Terms," states that P contributes the foreign rights to conduct a business, including foreign rights to certain IP, to newly incorporated S-1. P treats the transaction as a transfer described in §§ 351 and 367. Subsequently, P and S-1 enter into a cost sharing arrangement. P takes the position that the only platform contribution transactions ("PCTs") in connection with the second transaction (the cost sharing agreement) consist of P's contribution of the U.S. business IP rights and S-1's contribution of the rest-of-the-world rights of which S-1 had become the owner due to the prior transaction.

(f) The example states that the IRS may consider the economic substance of the entire arrangement between P and S-1, including the parties' actual conduct throughout their relationship, regardless of the form or character of the contractual arrangement that the parties have expressly adopted. In the example, the IRS determines that the parties' formal arrangement fails to reflect the full scope of the value provided between the parties in accordance with the economic substance of their arrangement. Therefore, the IRS may impute one or more agreements between P and S, consistent with the economic substance of their arrangement.

(g) Example 7 is titled "Distinguishing Provision of Value from Characterization." P developed a collection of resources, capabilities and rights ("Collection") that it uses on an interrelated basis in ongoing R&D. Under § 351, P transfers certain IP to S-1 related to the Collection. P claims a portion of the property (Portion 1) is subject to § 367(d), and that another portion (Portion 2) is not taxable under § 367. The new temporary regulations are applied to determine the value to P. Whether

Portion 2 is characterized as "property" under § 367 is irrelevant because any value in Portion 2 must be compensated by S-1 in a manner that is consistent with the new rules.

(h) Examples 8 and 9 also involve multiple transactions regarding § 351 and a cost sharing agreement.

(i) Example 10, "Services Provided Using Intangibles," states that P's worldwide group produces and markets product X and subsequent generations of products that result from research and development activity performed by P's R&D team. Through this collaboration with respect to P's proprietary products, the members of the R&D team have individually and as a group acquired specialized knowledge and expertise subject to non-disclosure agreements.

(j) P arranges for the R&D team to provide research and development services to create a new line of products, building on the product X platform to be owned and exploited by S-1 in the overseas market. P asserts that the arm's-length charge for the services is only a reimbursement to P of its associated R&D team compensation costs.

(k) Even though P did not transfer the platform or the R&D team to S-1, P is providing value associated with the use of the platform, along with the value associated with the use of the know-how, to S-1 by way of the services performed by the R&D team for S-1 using the platform and the know-how.

(l) The example states that the R&D team's use of the intangible property, and any other valuable resources, in P's provision of services must be evaluated under the § 482 regulations, including the regulations specifically applicable to the controlled services transactions in Treas. Reg. § 1.482-9.

(m) Example 11 deals with "Allocating Arm's-Length Compensation Determined Under an Aggregate Analysis." P provides services to S-1. P licenses intellectual property to S-2 and S-2 sublicenses the intellectual property to S-1. The example states that if an aggregate analysis of the service and license transactions provides the most reliable measure of an arm's-length result, then an aggregate analysis must be performed. If an allocation of the value that results from the aggregate analysis is necessary, for example, for purposes of sourcing the service income that P receives from S-1 or to determine the deductible expenses incurred by S-1, then the value determined under the aggregate analysis must be allocated using the method that provides the most reliable measure of the services income and the deductible expenses.

6. Effective/Applicability Dates. The regulations apply to taxable years ending on or after September 14, 2015. The preamble contains the usual caveat: No inference is intended regarding the application of the provisions amended by the temporary regulations under current law. The IRS may, when appropriate, challenge transactions, including those described in the temporary regulations, under currently applicable Code or regulatory provisions or judicial doctrines.

G. Annual APA Report.

1. IRS Announcement 2016-12, 2016-16 I.R.B. 1, contains the IRS's annual APA report. The IRS executed 110 APAs in 2015, of which 66 were renewals and 44 were new APAs. Of the renewals, 48 were bilateral and 18 were unilateral. Of the new APAs, 32 were bilateral and 12 unilateral.

2. Nearly three quarters of the total bilateral APAs executed in 2015 involved Japan or Canada. The report notes a milestone was achieved in 2015 with the execution of the first bilateral APA between the United States and Italy.

3. The number of pending APAs rose in 2015 due largely to the record numbers of APA requests received during the fourth quarter. Japan and Canada continued to account for more than half of the pending bilateral APA requests in 2015. Korea and Germany account for another 16% of the pending bilateral APAs requests.

4. Inbound APAs (non-U.S. parent and U.S. subsidiary) accounted for 80% of the APAs executed in 2015 and outbound APAs (U.S. parent and non-U.S. subsidiary) accounted for 20%, excluding the categories of "sister companies" and "all other relationships."

5. More than 60% of the tested parties in APAs executed in 2015 involved distribution or related functions, *i.e.*, marketing and product support. Approximately 80% of tangible and intangible property and services APAs involved use of the CPM or the TNMM transfer pricing methods.

II. SUBPART F.

A. Final Section 956 Regulations: Anti-Avoidance Rules.

1. Treasury and the IRS finalized Treas. Reg. § 1.956-1(b)(4), the anti-avoidance regulation, generally as proposed. These rules have their origin in temporary regulations issued in 1988. Previously, the temporary regulations provided that at the IRS's discretion, a controlled foreign corporation ("CFC") will be considered to hold indirectly investments in U.S. property acquired by any other foreign corporation that is controlled by the CFC if one of the principal purposes for creating, organizing, or

funding (through capital contributions or debt) the other foreign corporation is to avoid the application of § 956 with respect to the CFC.

2. As finalized, the anti-avoidance rules can also apply when a foreign corporation controlled by a CFC is funded by any means, including through capital contributions or debt. They also can apply in a partnership context. The regulations provide that for purposes of § 956, U.S. property held indirectly by a CFC includes:

   (a) United States property acquired by any other foreign corporation that is controlled by the CFC if a principal purpose of creating, organizing or funding by any means (including through capital contributions or debt) the other foreign corporation is to avoid the application of § 956 with respect to the CFC; and

   (b) Property acquired by a partnership that is controlled by the CFC if the property would be U.S. property if held directly by the CFC, and a principal purpose of creating, organizing or funding by any means (through capital contributions or debt) the partnership is to avoid the application of § 956 with respect to the CFC.

3. Example No. 3 in the final regulations illustrates that the CFCs' relative tax attributes associated with the § 956 inclusion (such as total earnings and profits, previously taxed earnings and profits, and foreign tax pools) can be taken into account in determining whether a principal purpose of the funding was to avoid the application of § 956 with respect to the funding CFC. The example also clarifies that if the funding CFC is considered to indirectly hold U.S. property pursuant to Treas. Reg. § 1.956-1(b)(4), then the CFC that actually holds the U.S. property, the funded CFC, will not considered to hold the property for purposes of § 956.

4. Treasury and the IRS expressed the view that the "tax avoidance" requirement ensures that ordinary course business transactions are not subject to the anti-avoidance rules. However, they also added two new examples to illustrate that the anti-avoidance rule should not apply to certain common business transactions. Examples 5 and 6 illustrate this point with a sale of property for cash in the ordinary course of business and the repayment of a loan, respectively, to which the anti-avoidance rules do not apply.

5. New Example 4, on the other hand, incorporates the holding in Situation 3 of Rev. Rul. 87-89, 1987-2 C.B. 195. A CFC could be treated as holding U.S. property as a result of a deposit with an unrelated bank if the unrelated bank would not have made a loan to a person related to the CFC (the U.S. parent company or a second CFC) on the same terms absent the

first CFC's deposit. The addition of Example 4 would not seem to be a change of substance in the regulations.

6. The provision requiring an exercise of the IRS's discretion was eliminated. The regulations are now self-executing. This was in the 2015 proposed regulations, as well.

7. A commenter expressed a concern that a CFC could be treated as holding duplicative amounts of U.S. property by an application of both the anti-avoidance rule of Treas. Reg. § 1.956-4(b)(4) and the new partnership obligation rules of Treas. Reg. § 1.956-4(c) (discussed below). In response, the coordination rules proposed in Treas. Reg. § 1.956-1(b)(4)(iii) was expanded in final Treas. Reg. § 1.956-1(b)(3) to prevent a CFC from being treated as holding duplicative amounts of U.S. property. A new example (Example 8) illustrates this rule.

8. The § 956 anti-avoidance rules in Treas. Reg. § 1.956-1(b) apply to taxable years of CFCs ending on or after September 1, 2015, and to taxable years of U.S. shareholders in which or with which those taxable years end, with respect to property acquired, including property treated as acquired as a result of a deemed exchange of property pursuant to § 1001, on or after September 1, 2015.

B. Final Section 956 Regulations: Factoring.

1. In 1988, Treasury and the IRS proposed Treas. Reg. § 1.956-3 to address the application of § 956 to property acquired by a CFC in certain related-party factoring transactions. The regulation was also issued as a temporary regulation. The 2015 proposed regulations proposed certain, relatively minor revisions to the proposed/temporary rules in § 1.956-3(b)(2)(ii) regarding the use of a nominee, pass-through entity or related foreign corporation. No comments were received, and the 1988 and 2015 proposed regulations were adopted as final. The 1988 proposals are effective back to 1984. However, these rules were already effective back to 1984 as temporary regulations.

C. Final Section 956 Regulations: Partnerships.

1. In 2015, Treasury and the IRS proposed a number of regulatory changes addressing § 956 in the context of partnerships. These proposed regulations were finalized generally as proposed, but with some substantive changes.

(a) Partnership Property. Under Treas. Reg. § 1.956-4(b)(2), a CFC partner's attributable share of partnership property is determined in accordance with the its liquidation-value percentage with respect to the partnership, unless the partnership agreement contains a special allocation of income (or, where appropriate, gain) regarding a

particular item or items of partnership property that differs from the partner's liquidation-value percentage in that particular taxable year. In that case, the partner's attributable share of the property is determined solely by reference to the partner's special allocation regarding the property, provided the special allocation does not have a principal purpose of avoiding the purposes of § 956. This special allocation will be changed by a newly proposed regulation when that regulation is adopted as final. This is discussed below.

(b) Partnership Obligations.

(1) New Treas. Reg. § 1.956-4(c) generally treat an obligation of a foreign partnership as an obligation of its partners for purposes of § 956. This is perhaps the most important part of the new § 956 partnership regulations. If a CFC lends funds to a foreign partnership in which the CFC's U.S. parent company is a partner, the CFC will be treated as holding an obligation of a U.S. person, and thus as having made a § 956 investment.

(2) More specifically, Treas. Reg. § 1.956-4(c)(1) generally treats an obligation of a foreign partnership as an obligation of its partners to the extent of each partner's relative share of the obligation as determined in accordance with the partner's liquidation-value percentage. The proposed regulations would have determined a partner's share of a partnership obligation in accordance with the partner's interest in partnership profits. Liquidation value was used in the proposed regulations for partnership *property*; the rule for partnership *obligations* was conformed to that rule.

(3) This rule raises interesting issues. Section 956 requires that a CFC must hold an "obligation of a U.S. person." If the entity is a corporate-type limited-liability entity checked for U.S. tax purposes into partnership status, how can a U.S. partner be an obligor on the obligation? There would not seem to be an obligation of a U.S. person. Obviously, the regulation's writers ignored this detail.

(c) Partnership Obligations: The Funded-Distribution Rule.

(1) Treasury and the IRS also finalized the special funded-distribution rule The rule will operate to increase the amount of a foreign partnership obligation that is treated as U.S. property (and a lending CFC's § 956 investment as a result of a loan to that partnership) when the following requirements are satisfied: (i) the CFC lends funds (or is a

pledger or guarantor regarding a loan) to a foreign partnership whose obligation is, in whole or in part, U.S. property regarding the CFC pursuant to Treas. Reg. § 1.956-4(c)(1); (ii) the partnership distributes an amount of money or property to a partner that is related to the CFC and whose obligation would be U.S. property if held (or treated as held) by the CFC; (iii) the foreign partnership would not have made a distribution but for a funding of the partnership through the obligation held (or treated as held) by the CFC; and (iv) the distribution exceeds the partner's share of the partnership obligation as determined in accordance with the partner's interest in the partnership.

(2) Comments suggested that taxpayers might take the position that the "but for" requirement is not satisfied in certain situations in which a CFC's earnings are effectively repatriated to a partner that is related U.S. person. For example, taxpayers might take the position that a partnership distribution could have been made without the funding by the CFC merely by establishing that a third party would have loaned the funds needed for the partnership to make the distribution.

(3) The preamble states that such a position would be inconsistent with the purposes of the rule. Accordingly, the final regulations clarify the funded-distribution rule by providing that the "but for" requirement in Treas. Reg. § 1.956-4(c)(3) will be treated as satisfied to the extent the partnership did not have sufficient liquid assets to make the distribution immediately prior to the distribution, without taking into account the obligation.

(4) When a CFC holds (or is treated as holding) multiple obligations of the foreign partnership to which this rule would potentially apply, its applicability is determined first with respect to the obligation acquired (or treated as acquired) closest in time to the distribution, and then successively to other obligations further in time from the distribution until the distribution is fully accounted for.

(d) <u>Determining the Partner's Liquidation-Value Percentage</u>.

(1) A comment recommended that a partner's liquidation-value percentage in a partnership should be determined on an annual basis, rather than upon formation and upon the occurrence of the relevant § 704 events "(revaluation events") as proposed in § 1.956-4(b)(2)(i).

(2) Treasury and the IRS state that it is appropriate for a partner's liquidation-value percentage to be determined upon a revaluation event, which may result in a significant change in the partner's relative economic interest in the partnership. Accordingly, upon a revaluation event, the partnership is required to determine the partnership's capital accounts resulting from a hypothetical book-up at that point in time even if the partnership did not actually book-up capital accounts in connection with the event.

(3) However, in light of a commenter's observation that partners' relative economic interests in the partnership may change significantly as a result of allocations of income or other items under the partnership agreement even in the absence of a revaluation event, Treas. Reg. § 1.956-4(b)(2)(i) provides that a partner's liquidation-value percentage must be determined in certain additional circumstances.

(4) Specifically, if the liquidation-value percentage determined for any partner on the first day of the partnership's taxable year would differ from the most recently determined liquidation-value percentage of that partner by more than 10 percentage points, then the partner's liquidation-value percentage must be redetermined on that day even in the absence of a revaluation event. For example, if the partner's liquidation-value percentage was determined upon a revaluation event to be 40% and, on the first day of a subsequent year before occurrence of another revaluation event, would be less than 30% or more than 50% if redetermined on that date, then the liquidation-value percentage must be redetermined on that day.

(e) <u>Rev. Rul. 90-112</u>.

(1) Another rule was changed by the Service's withdrawal of Rev. Rul. 90-112, 1990-2 C.B. 186. The ruling addressed the treatment under § 956 of U.S. property held by a CFC indirectly through a partnership and generally is consistent with the new regulations. However, the <u>ruling</u> also included a limitation on the measurement of U.S. property that is not in the final, and was not in the proposed, § 956 regulations. Specifically, the ruling provided that amount of U.S. property taken into account for purpose of § 956 when a CFC partner indirectly owns property through a partnership is limited by the CFC's adjusted basis in its partnership interest. A commenter requested that the

proposed § 956 regulations be revised to include this outside-basis limitation.

(2) Treasury and the IRS stated that including an outside-basis limitation in the regulations would be inappropriate. The rule in the regulations is based on an aggregate approach to partnerships and measures the amount of U.S. property indirectly held by a CFC partner on a property-by-property basis. An overall limitation on the amount of U.S. property a CFC partner is considered to hold indirectly through a partnership would be inconsistent with this property-by-property aggregate approach to U.S. property held by the partnership.

(3) Additionally, Treasury and the IRS expressed the view that a limitation determined by reference to a CFC partner's basis in its partnership interest would be inconsistent with § 956(a), which provides that the amount of U.S. property directly or indirectly held by a CFC is determined by reference to the adjusted basis of the U.S. property itself.

(4) They also were concerned that, under the rules of Subchapter K, adjustments may be made to outside basis through the allocation of liabilities pursuant to the regulations under § 752 that are inconsistent with the policy of § 956.

(5) Accordingly, an outside-basis limitation was not incorporated in the final § 956 regulations. Rev. Rul. 90-112 also was withdrawn/obsoleted. For tax years ending prior to the obsolescence of the revenue ruling, taxpayers may rely on the outside-basis limitation provided in that ruling.

(f) Special Allocations.

(1) The effect of special allocations also can present important issues in the context of determining liquidation value. The proposed § 956 regulations defined a special allocation as an allocation of income (or, where appropriate, gain) from partnership property to a partner under a partnership agreement that differs from the partner's liquidation-value percentage in a particular taxable year.

(2) Questions arose as to whether allocations pursuant to § 704(c) and the regulations thereunder constitute special allocations. In response to these questions, Treasury and

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the IRS revised the definition of special allocations in Treas. Reg. § 1.956-4(b)(2)(ii) to clarify that a special allocation is an allocation of book income or gain, rather than a tax allocation such as the allocations required under § 704(c). The final regulations also clarify that, for purposes of these regulations, a special allocation means only an allocation of income (or, where appropriate, gain) from a subset of property of the partnership to a partner other than in accordance with the partner's liquidation value percentage in a particular taxable year.

(3) As noted above, the new § 956 regulations provide that a partner's attributable share of an item of partnership property is not determined by reference to a special allocation with respect to the property if the special allocation has a principal purpose of avoiding the purposes of § 956.

(4) A comment requested that the final regulations provide guidance on the circumstances in which special allocations are treated as having a principal purpose of avoiding § 956. Specifically, the comment requested that the § 956 regulations be revised to include a presumption that a transaction does not have a principal purpose of avoiding § 956 if the allocation is respected under § 704(b) and is reasonable taking into account the facts and circumstances relating to the economic arrangement of the partners and the characteristics of the property at issue.

(5) The determination of whether a special allocation has a principal purpose of avoiding the purposes of § 956 must take into account all of the relevant facts and circumstances, which include factors set forth in the comment letter. However, an allocation adopted with a principal purpose of avoiding the purposes of § 956 could nonetheless be respected under § 704(b), which is not based on, and does not take into account, § 956 policy considerations. Thus, Treasury and the IRS determined that the presumption requested by that commenter would not be appropriate.

(6) Another comment noted that determining a partner's attributable share of an item of property by reference to a special allocation of income or gain regarding that property could produce results that are inconsistent with the liquidation-value percentage approach because of the forward-looking nature of special allocations. The

commenter described, but did not explicitly recommend, an alternative approach that would limit the effect of a special allocation to the portion of the liquidation value that represents actual appreciation, as opposed to initial book value. Treasury and the IRS recognize the conceptual issue highlighted by the comment but determined that such an alternative approach would entail substantial administrative complexity.

(7) Additionally, Treasury and the IRS continue to consider it appropriate, in cases in which special allocations are economically meaningful, to determine a partner's attributable share of property in accordance with the special allocations, since the allocations replicate the effect of owning, outside of the partnership, an interest in the property that is proportional to the special allocation.

(8) However, the preamble states that special allocations regarding a partnership controlled by a U.S. multinational group (an 80%-controlled partnership) and its CFCs are unlikely to have economic significance for the group as a whole and can facilitate inappropriate tax planning. Accordingly, a new rule was proposed under which a partner's attributable share of property of a controlled partnership is determined solely in accordance with the partner's liquidation-value percentage, without regard to any special allocations. This is discussed further below.

(g) Disregarded Entities.

(1) The final regulation adopted without change the proposed regulations' provision that for purposes of § 956, an obligation of a business entity that is disregarded under the check-the-box rules as an entity separate from its owner is treated as an obligation of its owner.

(2) This new rule is effective with taxable years of CFCs ending on or after November 3, 2016, and taxable years of U.S. shareholders in which or with which such taxable years end, with respect to obligations held on or after Nov. 3, 2016.

(3) The preamble to the proposed regulations suggested that this rule follows from an application of the check-the-box rules and thus does not represent a change in the law, despite its prospective effective date.

(4) Here, too, we make the observation that § 956 requires an "obligation of a U.S. person." There is no such obligation at law if the disregarded entity is a foreign corporation-type limited-liability entity. Nonetheless, the regulation now seems to deem into existence such an obligation.

(h) Multiple Inclusions Problem. Comments were received in response to a request concerning whether Treasury and the IRS should exercise their authority under § 956(e) to prescribe regulations addressing situations in which multiple CFCs serve, or are treated, as pledgors or guarantors of a single obligation in order to limit the aggregate inclusion of a U.S. shareholder with respect to a CFC under § 951(a)(1)(B) and § 956 to the unpaid principal amount of the obligation. Treasury and the IRS state that they continue to study the comments concerning multiple inclusions under § 956(d), which do not impact any of the regulations adopted. We're not sure what there is to study. Multiple inclusions of the same loan amount are simply wrong.

(i) Effective Dates.

(1) The new regulations generally are effective for taxable years of CFCs ending on or after November 3, 2016, and to taxable years of U.S. shareholders in which or with which those regulations end. Most of the rules apply to property acquired or pledges or guarantees entered into on or after September 1, 2015, including property considered acquired, or pledges or guarantees considered entered into, on or after September 1, 2015, as a result of a deemed exchange pursuant to § 1001.

(2) Two of the new rules, however, apply to obligations held on or after Nov. 3, 2016. *See* Treas. Reg. §§ 1.956-2(a)(3) and 1.956-4(e) (dealing with obligations of disregarded entities and domestic partnerships).

(3) The preamble states that no inference is intended as to the application of the provisions amended by the final regulations under prior law, including in transactions involving obligations of foreign partnerships. The IRS may, where appropriate, challenge transactions under the Code, regulatory provisions under prior law, or judicial doctrines.

D. Proposed Section 956 Regulations: Partnership Special Allocations.

1. As discussed above, new Treas. Reg. § 1. 956-4(b) provides that a CFC that is a partner in a partnership generally is treated as holding its share of U.S. property held by the partnership in accordance with the CFC partner's liquidation-value percentage in the partnership. However, if there is a special allocation of income (or, where appropriate, a gain) that does not have a principal purpose of avoiding the purposes of § 956, the partner's attributable share of that property is determined solely by reference to the special allocation. *See* Treas. Reg. § 1.956-4(b)(2)(ii).

2. The preamble states that, in general, these rules provide a reasonable means of determining a partner's interest in property held by a partnership for purposes of § 956 because they generally result in an allocation of specific items of property that corresponds with each partner's economic interest in that property, including any income or gain that may be subject to special allocations.

3. Treasury and the IRS are concerned, however, that special allocations regarding a partnership that is controlled by a single multinational group are unlikely to have economic significance for the group as a whole and can facilitate tax planning that is inconsistent with the purposes of § 956. Accordingly, the proposed regulations would revise Treas. Reg. § 1.956-4(b) so that such a partner's attributable share of each item of property of a partnership controlled by the partner would be determined solely in accordance with the partner's liquidation-value percentage, even if income or gain from the property is subject to a special allocation.

4. Specifically, under Prop. Treas. Reg. § 1.956-4(b)(2)(iii), the rule in Treas. Reg. § 1.956-4(b)(2)(ii) requiring a partner's attributable share of partnership property to be determined by reference to special allocations regarding the property would not apply in the case of a partnership controlled by the partner. For this purpose, a partner is treated as controlling a partnership if the partner and the partnership are related within the meaning of § 267(b) or § 707(b), substituting "at least 80%" for "more than 50%."

5. The regulations are proposed to be effective for taxable years of CFCs ending on or after the date of publication in the Federal Register of the Treasury Decision adopting them as final regulations, and for tax years of U.S. shareholders in which or with which such taxable years end, with respect to property acquired on or after the date the regulations are published in the Federal Register as final regulations. The preamble states that the IRS may, where appropriate, challenge transactions under currently applicable Code or regulatory provisions or judicial doctrines.

6. This proposed regulation raises some serious and interesting issues. We will illustrate them in context of LTR 200832024, which was discussed in our column of August 25, 2008.

7. LTR 200832024 describes a U.S. parent company that owns three relevant subsidiaries: US-1, F-1, and F-2. (*See Doc. 2008-17337* or *2008 WTD 156-16*). The foreign subsidiaries are country B entities. US-1 conducts a U.S. business, and F-1 conducts a foreign business. FP, an unrelated foreign corporation, will form a joint venture with US-1 and F-2. An LLP in country A will be formed. It will be a partnership for U.S. tax purposes. The three partners will contribute cash, and LLP will purchase from US-1 the U.S. business and from F-1 the foreign business.

8. The U.S. business and the non-U.S. business will be maintained in separate foreign legal entities ("FDEs") owned by LLP that will constitute disregarded entities for U.S. tax purposes. The FDEs are LLC-1 and LLC-2. They will maintain separate books and records, and funds will not be loaned or transferred between these entities. LLC-1 will own and conduct the U.S. business, and LLC-2 will own and conduct the non-U.S. business.

9. The LLP agreement specifies that F-2 will share only in the income, gains, deductions, and losses of the non-U.S. business and will have liquidation rights only in assets of the non-U.S. business. F-2 will not share in any income, gains, deductions, or losses from the U.S. business and will not have any rights to assets of the U.S. business upon the liquidation of LLP.

10. Then Treas. Reg. § 1.956-2(a)(3) said that if a CFC is a partner in a partnership that owns property that would be U.S. property if owned directly by the CFC, the CFC will be treated as owning an interest in the property equal to its interest in the partnership and that interest will be treated as an investment in U.S. property. Accordingly, the letter ruling says that a CFC that has an economic interest in U.S. property through a partnership will be considered to have an interest in U.S. property for purposes of § 956. On the other hand, a CFC that does not have any economic interest in U.S. property through a partnership, including a profits interest, a capital interest, a liquidation right, or any other interest, does not have an interest in U.S. property for purposes of § 956.

11. In the ruling, the U.S. business will be conducted in the same manner as before the formation of LLP. F-2 will not have an economic interest in the U.S. business conducted by LLC-1, including a profits or capital interest, liquidation rights, or any other interest. As part of the LLP arrangement, LLC-1 will continue the preexisting U.S. business in which F-1 did not have an economic interest before the formation of LLP.

12. Therefore, the ruling states, because F-2 will not have any economic interest in the U.S. business after the formation of LLP, no economic

interest in U.S. property is being shifted from a CFC to a non-CFC. LLC-1 will not receive any loans, other funds, or credit support from LLC-2. Thus, F-2's status as a partner in LLP will not cause F-2 to be treated as holding an interest in U.S. property under Treas. Reg. § 1.956-2(a)(3).

13. This ruling would appear to be overruled by the proposed regulation, at least if (1) it's viewed as a special allocation (instead of an "economic interest" issue), and (2) the partnership is 80% controlled under §§ 267(b) or 707(b).

14. Even if the partnership is not a controlled partnership, the special allocation, if it is such, will only be respected if it does not have a principal purpose to avoid the purposes of § 956. In this case, it might be asked what other purpose does the structure have? Is avoiding an *inappropriate* result under § 956 one of its principal purposes? Is avoiding an *inappropriate* result under § 956 really bad? Perhaps that would not be "avoiding the purposes" of § 956.

E. Section 954(c): Active Rents and Royalties Exception.

1. Treasury and the IRS adopted the 2015 proposed § 954(c) regulations without change. They address the active rents and royalties rules, and were also issued in 2015 as temporary regulations.

2. Rents and royalties generally are included in a CFC's foreign personal holding company income ("Subpart F income"). Rents and royalties derived in the active conduct of a trade or business and received from a person that is not a related person, however, are excluded from Subpart F income. The § 954 regulations provide rules for determining whether rents and royalties are derived in the active conduct of a trade or business for purposes of § 954(c)(2)(A).

3. Specifically, Treas. Reg. § 1.954-2(c) provides four alternative ways for rents to be derived in the active conduct of a trade or business, and Treas. Reg. § 1.954-2(d) provides two alternative ways for royalties to be derived in the active conduct of a trade or business. One way for a CFC to derive rents and royalties in the active conduct of a trade or business is to satisfy an "active development" test which, among other things, requires the CFC to be regularly engaged either in the "manufacture or production of, or in the acquisition and addition of substantial value to," certain property (regarding rents); or in the "development, creation or production of, or in the acquisition of and the addition of substantial value to," certain property (regarding royalties) (collectively, the "active development" tests).

4. Certain of the alternative ways (specifically, the active management and marketing tests) in which a CFC can satisfy the active rents and royalties exception require the relevant activities be performed by the CFC's own

offices or staff of employees. The active-development tests did not expressly contain this requirement.

5. In addition to the active-development test, another way for a CFC to derive active rents and royalties in the active conduct of a trade or business is to satisfy an "active marketing" test. The test, among other things, requires the CFC to operate in a foreign country an organization that is regularly engaged in the business of marketing, or marketing and servicing, the leased or licensed property, and that is "substantial" in relation to the amount of rents and royalties derived from the leased or licensed property. Pursuant to a safe harbor, an organization is "substantial" if the active-leasing or active-licensing expenses equal or exceed 25% of the adjusted-leasing or adjusted-licensing profits. The regulations generally define active-leasing expenses and active-licensing expenses to mean, subject to certain exceptions, deductions that are properly allocable to rental or royalty income and that would be so allowable under § 162 if the CFC were a domestic corporation.

6. The active rents and royalties exception is intended to distinguish between a CFC that passively receives investment income and a CFC that derives income from the active conduct of a trade or business. Accordingly, the policy underlying the active-rents and active-royalties exceptions requires that the CFC itself actively conduct the business that generates the rents or royalties. The preamble to the 2015 temporary and proposed regulations stated that, consistent with this policy, the CFC must perform the relevant activities (that is, activities related to the manufacturing, production, development, or creation of, or, in the case of an acquisition, the addition to substantial value to, the property at issue) through its own officers or staff of employees in order to satisfy the active-development test. Thus, new Treas. Reg. § 1.954-2(c)(1)(i) and (d)(1)(i) expressly provide that the CFC lessor or licensor must perform the required functions through its own officers or staff of employees.

7. Treasury and the IRS state that the policy of the active-rents and active-royalties exceptions allows the relevant activities undertaken by a CFC through its officers or staff of employees to be performed in more than one foreign country. Thus, new Treas. Reg. § 1.954-2(c)(1)(iv) and (d)(1)(ii) provide that a CFC's officers or staff of employees may be located in one or more foreign countries, and an organization that meets the requirements of the active-marketing test can be maintained and operated by the officers or a staff of employees either in a single foreign country or in multiple foreign countries collectively. An organization also can be in a single foreign country or in multiple foreign countries collectively for purposes of determining the substantiality of the foreign organization.

8. The preamble to the 2015 temporary and proposed regulations stated that in applying the active-development tests and the active-marketing tests,

questions arose as to the treatment of cost sharing arrangements under which a person other than a CFC actually conducts relevant activities. Consistent with the policy underlying the active rents and royalties exceptions that require the CFC itself to conduct the relevant activities, the final regulations clarify that cost sharing payments and PCT (buy-in) payments made by a CFC will not cause the CFC's officers and employees to be treated as undertaking the activities of the controlled participant to which the payments are made. This clarification applies for purposes of the active-development tests and the active-marketing tests, including for purposes of determining whether an organization that engages in marketing is substantial.

9. Similarly, the new regulations also provide that deductions for cost-sharing payments and PCT payments are excluded from the definition of active-leasing expenses and active-licensing expenses. Thus, cost-sharing payments and PCT payments are not active-leasing expenses or active-licensing expenses for purposes of determining whether an organization is "substantial" under the safe harbor test.

10. The rules relating to the active-development test apply to rents and royalties received or accrued during taxable years of CFCs ending on or after September 1, 2015, and to taxable years of U.S. shareholders in which or with which such taxable years end, but only with respect to property manufactured, produced, developed, or created, or, in the case of acquired property, property to which substantial value has been added, on or after September 1, 2015.

11. The rules regarding the active-marketing test, as well as the rules regarding cost-sharing arrangements, apply to rents or royalties received or accrued during taxable years of CFCs ending on or after September 1, 2015, and to taxable years of U.S. shareholders in which or with which those taxable years end, to the extent that these rents or royalties are received or accrued on or after September 1, 2015.

III. PARTNERSHIPS.

A. Transfers of Property to Partnerships with Related Foreign Partners.

1. Notice 2015-54 announced that Treasury and the IRS intend to issue regulations under § 721(c) (transfers to partnerships) to ensure that, when a U.S. person transfers certain property to a partnership that has foreign partners related to the transferor, income or gain attributable to the property will be taken into account by the transferor either immediately or periodically. The Notice also states that Treasury and the IRS intend to issue regulations under §§ 482 and 6662 applicable to controlled transactions involving partnerships to ensure the appropriate valuation of property transferred in these transactions.

2. Under the to-be-issued regulations, § 721(a) will not apply when a U.S. transferor contributes an item of § 721(c) Property to a § 721(c) Partnership (and the transfer thus will be fully taxable), unless the Gain Deferral Method set forth in the Notice is applied with respect to the § 721(c) Property.

3. A de minimis rule of $1 million applies. The de minimis amount is measured as the aggregate of built-in gain with respect to all § 721(c) Property contributed to the § 721 Partnership by related U.S. transferors. The de minimis rule is turned off if the § 721(c) Partnership is applying the Gain Deferral Method with respect to a prior contribution of § 721(c) Property by the U.S. transferor or a related U.S. transferor.

4. Section 721(c) Property is property, other than Excluded Property, with built-in gain. Excluded Property is (i) cash equivalents, (ii) any asset that is a security within the meaning of § 475(c)(2) without regard to § 475(c)(4), and (iii) any item of tangible property with built-in gain that does not exceed $20,000.

5. A partnership (domestic or foreign) is a § 721(c) Partnership if a U.S. transferor contributes § 721(c) Property to the partnership, and, after the contribution and any transactions related to the contribution, (i) a related foreign person is a direct or indirect partner in the partnership and (ii) the U.S. transferor and one or more related persons own more than 50% of the interest in partnership capital, profits, deductions or losses.

6. The requirements for applying the Gain Deferral Method are as follows:

   (a) The § 721(c) Partnership adopts the Remedial Allocation Method described in Treas. Reg. § 1.704-3(d) for built-in gain with respect to all § 721(c) Property contributed to the § 721(c) Partnership pursuant to the same plan by a U.S. transferor and all other U.S. transferors that are related persons.

   (b) During any taxable year in which there is remaining built-in gain with respect to an item of § 721(c) Property, the § 721(c) Partnership allocates all items of § 704(b) income, gain, loss and deduction with respect to that § 721(c) Property in the same proportion. For example, if income with respect to an item of § 721(c) Property is allocated 60% to the U.S. transferor and 40% to a related foreign person in a taxable year, then gain, deduction and loss with respect to that § 721(c) Property must also be allocated 60% to the U.S. transferor and 40% to the related foreign person.

   (c) The reporting requirements described in the Notice are satisfied.

(d) The U.S. transferor recognizes built-in gain with respect to any item of § 721(c) Property upon an Acceleration Event, as described in the Notice.

(e) The Gain Deferral Method is adopted for all § 721(c) Property subsequently contributed to the § 721(c) Partnership by the U.S. transferor and all other U.S. transferors that are related persons until the earlier of: (i) the date that no built-in gain remains with respect to any § 721(c) Property to which the Gain Deferral Method first applied; or (ii) the date that is 60 months after the date of the initial contribution of the § 721(c) Property to which the Gain Deferral Method first applied.

7. An Acceleration Event with respect to an items of § 721(c) Property is any transaction that either would reduce the amount of remaining built-in gain that a U.S. transferor would recognize under the Gain Deferral Method if the transaction had not occurred or could defer the recognition of the built-in gain. In addition, an Acceleration Event is deemed to occur with respect to all § 721(c) Property of a § 721(c) Partnership for the taxable year of the partnership in which any party fails to comply with all of the requirements for applying the Gain Deferral Method.

8. Upon an Acceleration Event with respect to an item of § 721(c) Property, a U.S. transferor must recognize gain in an amount equal to the remaining built-in gain that would have been allocated to the U.S. transferor if the § 721(c) Partnership had sold the item of § 721(c) Property immediately before the Acceleration Event for its fair market value.

9. In an example, USP, a domestic corporation, wholly owns FS, a foreign corporation. USP and FS form a new partnership, PRS. FS contributes cash of $1.5 million to PRS, and USP contributes the following three assets: a patent with an arm's length price of $1.2 M and an adjusted basis of zero; a security with an arm's length price of $100,000 and adjusted basis of $20,000; and machine with an arm's length price of $200,000 and an adjusted basis of $600,000.

10. Because the patent has built-in gain, it is § 721(c) Property. Although the security has built-in gain, it is excluded property because it is an asset described in § 475(c)(2). Section 721(c) Property is property other than excluded property, with built-in gain. Excluded property is cash equivalents, any asset that is a security within the meaning of § 475(c)(2), and any item of tangible property with built-in gain that does not exceed $20,000. The machine has a built-in loss and is therefore not § 721(c) Property.

11. Thus, because USP is a U.S. person and not a domestic partnership, USP is a U.S. transferor that has contributed § 721(c) Property. FS is related to

USP under § 267(b) and is not a U.S. person. Accordingly, FS is a related foreign person to USP. USP and FS collectively own more than 50% of the interest in capital, profits, deductions and losses of PRS. Therefore, PRS is a § 721(c) Partnership.

12. The de minimis property rule does not apply because the sum of the built-in gain for all § 721(c) Property is $1.2 million, which exceeds the $1 million de minimis threshold. The built-in loss in the machine does not factor into determining whether the contribution is below the de minimis threshold.

13. As a result, § 721(a) does not apply to USP's contribution of the patent to PRS unless the Gain Deferral Method is applied.

14. In Example 2, a U.S. transferor contributes § 721 Property to a § 721(c) Partnership in year 1. The property ("Asset 1") has built-in gain of more than $1 million. FS, a related foreign person, also is a partner. The partnership allocates all items of income, gain, deduction and loss with respect to Asset 1, 60% to USP and 40% to FS and adopts the Remedial Allocation Method with respect to Asset 1. The parties comply with the applicable reporting requirements under § 6038, § 6038B and § 6046A and the regulations thereunder. The parties properly apply the Gain Deferral Method with respect to Asset 1 in years 1 through 3.

15. In an unrelated transaction in year 4, USP contributes § 721(c) Property (Asset 2) with a built-in gain of $100,000 to the partnership. The partnership allocates all items of income, gain and loss with respect to Asset 2, 20% to USP and 80% to FS, but allocates deductions with respect to Asset 2, 90% to USP and 10% to FS. The partnership adopts the Remedial Allocation Method with respect to Asset 2.

16. In year 4, although Asset 2 has built-in gain of less than $1 million, the de minimis rule will not apply because the parties are applying the Gain Deferral Method with respect to Asset 1. Because the deductions with respect to Asset 2 are allocated in a different proportion from the other § 704(b) items with respect to Asset 2, the requirements for satisfying the Gain Deferral Method are not met with respect to Asset 2, and USP must recognize the built-in gain with respect to Asset 2.

17. Furthermore, because the Gain Deferral Method does not apply to Asset 2, which was contributed within 60 months of Asset 1, an Acceleration Event is deemed to occur with respect to Asset 1 and USP must recognize any remaining built-in gain with respect to Asset 1.

18. In Example 3, the facts are the same as in Example 2 except that USP does not contribute Asset 2. In year 3, the partners amend the partnership agreement so that all items of income, gain, deduction and loss with

respect to Asset 1 are now allocated 30% to USP and 70% to FS. Assume the amendment is accompanied by any consideration required by § 482 and has substantial economic effect as required by § 704(b). Because each § 704(b) item with respect to Asset 1 continues to be allocated in the same proportion to each partner, the Gain Deferral Method will continue to apply so long as the other requirements of the Gain Deferral Method are satisfied.

19. In Example 4, USP, a U.S. transferor, contributes § 721 property (Asset 1) with built-in gain of more than $1 million to a § 721(c) Partnership (PRS) in which FS, a related foreign person and USX, an unrelated U.S. person, also are partners. The parties properly apply the Gain Deferral Method with respect to Asset 1. In Year 3, USP transfers all of its assets, including its interest in PRS to USS, a domestic corporation, in the transaction to which § 381 applies. In Year 9 (a year in which there is remaining built-in gain with respect to Asset 1), PRS distributes Asset 1 to FS.

20. Although USP will no longer recognize any remaining built-in gain with respect to Asset 1 under the Gain Deferral Method following the transfer to USS, USS is a successor U.S. transferor. Therefore, provided the requirements of the Gain Deferral Method continue to be satisfied, including treating USS as a U.S. transferor, the transfer of USP's interest in PRS to USS is not an Acceleration Event.

21. Although § 704(c)(1)(B) does not apply to the Year 9 distribution, the distribution is an Acceleration Event because USS will not recognize any remaining built-in gain with respect to Asset 1 under the Gain Deferral Method following the distribution. Therefore, USS must recognize gain in an amount equal to the remaining built-in gain that would have been allocated to USS if PRS had sold Asset 1 immediately before the distribution for its fair market value.

22. In Example 5, the facts are the same as in Example 4 except that in Year 3, instead of USP transferring its assets to USS, PRS instead contributes Asset 1 to FC, a foreign corporation, in a transfer described in § 351(a). There is no distribution in Year 9.

23. For purposes of §§ 367(a) and (d), each partner in PRS that is a U.S. person is treated as having transferred its share of the § 721(c) Property directly to FC. An Acceleration Event occurs, but not to the extent of USP's and USX's shares of the § 721(c) Property. The FC stock received by PRS in the transaction is not subject to the Gain Deferral Method.

24. The Treasury Department and IRS intend to issue regulations regarding the application to controlled transactions involving partnerships of certain rules in Treas. Reg. § 1.482-7 that are currently applicable to cost sharing

arrangements. In particular, Treasury and the IRS intend to issue regulations to provide specified methods for controlled transactions based on specified methods in Treas. Reg. § 1.482-7(g), as properly adjusted in light of the differences in facts and circumstances between the partnerships and cost sharing arrangements.

25. The regulations will also provide periodic adjustment rules that are based on the principles of Treas. Reg. § 1.482-7(i)(6) for controlled transactions involving partnerships. The regulations will provide that, in the event of a trigger based on a significant divergence of actual returns from projected returns for controlled transactions involving a partnership, the IRS may make periodic adjustments to the results of those transactions under a method based on Treas. Reg. § 1.482-7(i)(6)(v), as appropriately adjusted, as well as any necessary corresponding adjustments to § 704(b) or § 704(c) allocations.

26. The Notice also states that § 482 and related penalties apply to controlled transactions involving partnerships. For example, when U.S. and foreign persons under common control enter into a partnership, the amounts of their contributions to and distributions from, the partnership are subject to adjustment in order to reflect arm's length results. Partnership allocations, including allocations under § 704(c), also are subject to adjustment.

27. Accordingly, states the Notice, the amount of a remedial allocation under the Notice for controlled taxpayers that choose a Gain Deferral Method, or the amount of gain recognized if § 721(a) does not apply, potentially will be subject to adjustment by the IRS under § 482.

28. The Notice is effective with respect to transfers occurring on or after August 6, 2015, and to transfers occurring before that date resulting from entity classification elections made under the check-the-box rules that are filed on or after August 6, 2015, that are effective on or before August 2015.

29. Finally, the Notice states that no inference is intended regarding the treatment of transactions described in the Notice under current law, and the IRS may challenge those transactions under applicable Code provisions, Treasury regulations, and judicial doctrines. For example, the IRS may challenge a partnership's adopted § 704(c) method under the anti-abuse rule on Treas. Reg. § 1.704-3(c)(a)(10).

B. <u>Partnership CFTEs</u>.

1. The IRS issued regulations that provide guidance on the allocation by a partnership of creditable foreign tax expenditures ("CFTEs"), specifically addressing the existing safe harbor rule that is used to determine whether those allocations are deemed to be in accordance with the partners'

interest in the partnership. The preamble states that the purpose of the safe harbor is to match allocations of CFTEs with the income to which the CFTEs relate.

2. <u>§ 743(b) Adjustments</u>.

(a) Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(i) of the current final regulations provides that a partnership determines its net income in a CFTE category by taking into account all partnership items attributable to the relevant activity or group of activities, including items of gross income, gain, loss, deduction, and expense, and items allocated pursuant to § 704(c). The regulations do not state whether an adjustment under § 743(b) is taken into account in computing the partnership's net income in a CFTE category.

(b) In the case of a transfer of a partnership interest that results in an adjustment under § 743(b) (because the partnership has a § 754 election in effect or because there is a substantial built-in loss), the partnership must adjust the basis of partnership property with respect to the transferee partner only (a § 743(b) adjustment). No adjustment is made to the common basis of partnership property, and the § 743(b) adjustment has no effect on the partnership's computation of any item under § 703.

(c) Treasury and the IRS believe that a transferee partner's § 743(b) adjustment with respect to its interest in a partnership should not be taken into account in computing the partnership's net income in a CFTE category because the basis adjustment is unique to the transferee partner and because the basis adjustment ordinarily would not be taken into account by a foreign jurisdiction in computing the partnership's foreign taxable base.

(d) Accordingly, Temp. Treas. Reg. § 1.704-1T(b)(4)(viii)(c)(3)(i) provides that, for purposes of computing a partnership's net income in a CFTE category, the partnership determines its items without regard to any § 743(b) adjustments that its partners may have to the basis of property of the partnership.

(e) A partnership that is a transferee partner may have a § 743(b) adjustment in its capacity as a direct or indirect partner in a lower-tier partnership. The § 743(b) adjustment of the partnership is taken into account in determining the partnership's net income in the CFTE category. Nevertheless, in the case of a § 743(b) adjustment of a partnership that is a transferee partner, it may be appropriate to alter the way in which the § 743(b) adjustment is taken into account in determining the partnership's net income in the CFTE category when the § 743(b) adjustment gives rise to

basis differences subject to § 901(m). Treasury and the IRS intend to address § 901(m) in a separate guidance project.

(f) No inference is intended from the new temporary regulation as to how a § 743(b) adjustment is taken into account for other federal tax purposes. Treasury and the IRS request comments regarding whether final regulations should provide further guidance on how to compute a partnership's net income in a CFTE category, including how other types of items or adjustments to distributive shares that are specific to a partner should be taken into account in computing a partnership's net income in a CFTE category.

3. Special Rules.

(a) For purposes of the general safe harbor, Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(ii) provides, among other rules, a special rule that reduces the partnership's net income in a CFTE category to the extent foreign law allows a deduction for an allocation (or payment of an allocated amount) to a partner, for example, because foreign law characterizes a preferential allocation of gross income as deductible interest expense. The basis for this rule is that a CFTE category should not include income of the partnership that has not been included in a foreign taxable base due to the fact that an allocation (or payment of an allocated amount) to a partner of that income results in a foreign law deduction. Because the income out of which the allocation is made was not included in the taxable base of the foreign jurisdiction that allowed the deduction, no CFTEs are imposed on that income; therefore, the allocation of that income should not be taken into account in testing whether the allocations of CFTEs of that jurisdiction match related income allocations for purposes of the safe harbor.

(b) Deductible guaranteed payments under § 707(c) reduce the partnership's net income in a CFTE category. Therefore, in the case of a guaranteed payment that results in a deduction under both U.S. and foreign law, no special rule reducing the partnership's net income in the CFTE category is necessary. However, to the extent that foreign law does not allow a deduction for a guaranteed payment that is deductible under U.S. law, Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(ii) provides another special rule that requires an upward adjustment to the partnership's net income in a CFTE category.

(c) The final regulations, however, do not expressly address situations in which an allocation or distribution of an allocated amount or guaranteed payment gives rise to a deduction for purposes of one foreign tax, but is made out of income subject to another tax

imposed by the same or a different foreign jurisdiction. For example, a partnership may make a preferential allocation of gross income that is deductible in the foreign jurisdiction in which the partnership is a resident (foreign jurisdiction X) but that is made out of income earned by a disregarded entity or branch owned by the partnership that is subject to net basis tax in the jurisdiction in which the disregarded entity or branch is located (foreign jurisdiction Y).

(d) In this case, Treasury and the IRS are aware that some taxpayers have suggested that these rules may be interpreted to provide that the income related to the preferential allocation should not be included in a CFTE category because it is not included in the foreign jurisdiction X base, even though there are foreign jurisdiction Y CFTEs that clearly relate to the income out of which the preferential allocation is made. The IRS and Treasury believe this interpretation is inconsistent with the purpose of the special rules to apply the safe harbor in a manner that matches income with the related CFTEs.

(e) Therefore, the new temporary regulations revise the special rules to address situations in which allocations (or distributions of allocated amounts) and guarantee payments that give rise to foreign law deductions are made out of income with related CFTEs.

(f) Specifically, Temp. Treas. Reg. § 1.704-1T(b)(4)(viii)(c)(4)(ii) provides that a partnership's net income in a CFTE category from which a guaranteed payment that is not deductible in a foreign jurisdiction is made is increased by the amount of the guaranteed payment that is deductible for U.S. federal income tax purposes. The amount then should be treated as an allocation to the recipient of the guaranteed payment for purposes of determining the partners' shares of income in the CFTE category, but only for purposes of testing allocations of CFTEs allocable to a foreign tax that does not allow a deduction got the guaranteed payment.

(g) For purposes of testing allocations of CFTEs attributable to a foreign tax that does allow for a deduction for the guaranteed payment, however, a partnership's net income in a CFTE category is increased only to the extent that the amount of the guaranteed payment that is deductible for U.S. federal income tax purposes exceeds the amount allowable as a deduction for purposes of that foreign tax, and the excess is treated as an allocation to the recipient of the guaranteed payment for purposes of determining the partners' shares of income in the CFTE category.

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(h) Similarly, Temp. Treas. Reg. § 1.704-1T(b)(4)(viii)(c)(4)(iii) provides that, to the extent a foreign tax allows a deduction from its taxable base for an allocation (or distribution of an allocated amount) to a partner, then solely for purposes of testing allocations of CFTEs attributable to that foreign tax, the partnership's net income in the CFTE category from which the allocation is made is reduced by the amount of the foreign law deduction, and that amount is not treated as an allocation for purposes of determining the partners' shares of income in the CFTE category. For purposes of testing allocations of CFTEs attributable to a foreign tax that does not allow a deduction for an allocation (or distribution of an allocated amount) to a partner, the partnership's net income in a CFTE category is not reduced.

(i) Finally, the current final regulations provide that the adjustment to income attributable to an activity for a preferential allocation depends on whether the allocation of the item of income (or payment thereof) "results" in a deduction under foreign law. This rule was intended to apply even if the foreign law deduction occurred in a different taxable year (for example, because the foreign jurisdiction allowed a deduction only upon a subsequent payment of accrued interest).

(j) The new temporary regulations at Temp. Treas. Reg. §§ 1.704-1T(b)(4)(viii)(c)(4)(ii) and (iii) clarify that a guaranteed payment or a preferential allocation is considered deductible under foreign law for purposes of the special rules if the foreign jurisdiction allows a deduction from its taxable base either in the current year or in a different taxable year.

4. <u>Inter-Branch Payments</u>.

(a) For taxable years beginning before January 1, 2012, the special rules under Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(ii) included a cross-reference confirming that certain inter-branch payments were not subject to the special rules. On February 14, 2012, temporary regulations were published addressing situations in which foreign income taxes had been separated from the related income (the "splitter" regulations). As a part of those regulations, the inter-branch payment rule was removed because it allowed taxpayers to separate foreign income taxes and related income. In conjunction with the removal, the cross-reference to the eliminated rule was removed from Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(ii).

(b) Treasury and the IRS have become aware that some taxpayers claim that the inclusion and subsequent removal of the cross-reference created uncertainty regarding application of the special

rules under Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(ii) to disregarded payments among branches of a partnership. As discussed above, the purpose of the special rule is to match preferential allocations and guaranteed payments to partners with CFTEs that relate to the income out of which the allocation or guaranteed payment is made, and also to ensure proper testing of CFTE allocations when no CFTEs relate to the income.

(c) The special rules accomplish this matching by treating preferential allocations and guaranteed payments as distributive shares of income, but only for purposes of allocating CFTEs attributable to taxes imposed by a foreign jurisdiction that does not allow deductions for these allocations and payments. Because an inter-branch payment is not made to a partner, it can never be treated as a distributive share, and is outside the scope of the special rules.

(d) By its terms, current Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(ii) applies only to partnership allocations that are deductible under foreign law, guaranteed payments that are not deductible under foreign law and income that is excluded from a foreign tax base as a result of the status of a partner.

(e) The inclusion and subsequent removal of the cross-reference did not change the purpose of the regulation or expand its scope to provide for reductions in income in a CFTE category if a partnership makes a disregarded payment that is deductible under foreign law. Temp. Treas. Reg. § 1.704-1T(b)(4)(viii)(c)(4)(iii) thus clarifies that the special rule for preferential allocations applies only to allocations (or distributions of allocated amounts) to a partner that are deductible under foreign law, and not to other items that give rise to deductions under foreign law. For example, the special rule does not apply to reduce income in a CFTE category by reason of a disregarded inter-branch payment, even if the amount out of which the inter-branch payment is made is not subject to tax in any foreign jurisdiction.

(f) In addition, Treasury and the IRS are aware of transactions involving several disregarded payments in which taxpayers take the position that withholding taxes assessed on the first payment in a series of back-to-back disregarded payments do not need to be apportioned among the CFTE categories that include the income out of which the payment is made. The new regulations include an example clarifying that under Treas. Reg. § 1.704-1(b)(4)(viii)(d)(1) withholding taxes must be apportioned among the CFTE categories that includes the related income. *See* new Temp. Treas. Reg. § 1.704-1T(b)(5) examples nos. 36 and 37.

5. Other Non-Substantive Clarifications. The new temporary regulations make certain organizational and other non-substantive changes that clarify how items of income under U.S. federal income tax law are assigned to an activity and how a partnership's net income in a CFTE category is determined. I will not cover these "non-substantive" clarifications.

6. Effective Date. The temporary regulations apply for partnership taxable years that both begin on or after January 1, 2016 and end after February 4, 2016. The temporary regulations also modify an existing transition rule regarding certain inter-branch payments for partnerships whose agreements were entered into prior to February 14, 2012. The current transaction rule provides that if there has been no material modification to their partnership agreements on or after February 14, 2012, then, for tax years beginning on or after January 1, 2012, these partnerships may apply the provisions of the previous final regulations. That transaction rule is modified to provide that for tax years that both begin on or after January 1, 2016 and end after February 4, 2016, these partnerships may continue to apply the previous rules but must apply the provisions of new Temp. Treas. Reg. § 1.704-1T(b)(4)(viii)(C)(3)(ii). For purposes of this transition rule, any change in ownership constitutes a material modification to the partnership agreement. This transition rule does not apply to any taxable year (and all subsequent taxable years) in which persons bearing a relationship to each other that is specified in § 267(b) or § 707(b) collectively have the power to amend the partnership agreement without the consent of any unrelated party.

IV. SECTION 367.

A. Section 367(d).

1. Treasury and the IRS released important proposed regulations on the treatment of transfers of intangible property by U.S. persons to foreign corporations subject to § 367(d). The proposed regulations eliminate the so-called foreign goodwill exception from the § 367(d) regulations, and limit the § 367(a) active trade or business exception to certain tangible property and financial assets. This would be a huge change, and one with a seriously weak legal underpinning. The new regulation is proposed to be effective immediately, even before a hearing and comments.

2. Background.

(a) The preamble to the newly proposed regulations starts with a discussion of current law regarding § 367(d) and the legislative history of § 367(d). The discussion notes that Temp. Treas. Reg. § 1.367(d)-1T(b) generally provides that § 367(d) applies to the transfer of any intangible property, but not to the transfer of foreign goodwill or going concern value ("foreign goodwill

exception"). Temp. Treas. Reg. § 1.367(a)-1T(d)(5)(i) generally defines "intangible property," for purposes of § 367, as knowledge, rights, documents, and other intangible items within the meaning of § 936(h)(3)(B). Temp. Treas. Reg. § 1.367(a)-1T(d)(5)(iii) defines "foreign goodwill or going concern value" as the residual value of a business operation conducted outside of the United States after all other tangible and intangible assets have been identified and valued. The value of the right to use a corporate name in a foreign country is treated as foreign goodwill or going concern value.

(b) In amending § 367 in 1984, Congress identified problems as arising when "transferor U.S. companies hope to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitability, to ensure deferral of U.S. tax on the profits generated by the intangible."

(c) The Senate Finance Committee stated that "The committee contemplates that ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business." The House report contains a similar statement. The Senate Finance Committee and the House Ways & Means Committee each noted that it "does not anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in an abuse of the U.S. tax system."

(d) Treasury and the IRS, however, expressed in the preamble concern regarding how taxpayers interpret § 367 and the regulations thereunder when claiming favorable treatment for foreign goodwill and going concern value.

(e) They say that under one interpretation, taxpayers take the position that goodwill and going concern value are not § 936(h)(3)(B) intangible property and therefore are not subject to § 367(d) because § 367(d) only applies to § 936(h)(3)(B) intangible property. Furthermore, these taxpayers assert that gain realized with respect to the outbound transfer of goodwill or going concern value is not recognized under the general rule of § 367(a) because the goodwill or going concern value is eligible for, and satisfies, the active trade or business exception under § 367(a)(3)(A). This, of course, is stated in the legislative history.

(f) The preamble states that under a second interpretation taxpayers take the position that, although goodwill and going concern value

are § 936(h)(3)(B) intangible property, the foreign goodwill exception applies. These taxpayers also assert that § 367(a) does not apply to foreign goodwill or going concern value, either because of § 367(d)(1)(A) (providing that, except as provided in regulations, § 367(d) and not § 367(a) applies to § 936(h)(3)(B) intangible property) or because the active foreign trade or business exception applies.

3. Reasons for Change.

(a) Treasury and the IRS say they are aware that, in the context of outbound transfers, certain taxpayers attempt to avoid recognizing gain or income attributable to high-value intangible property by asserting that an inappropriately large share (in many cases, the majority) of the value of the property transferred is foreign goodwill or going concern value that is eligible for favorable treatment under § 367.

(b) Specifically, Treasury and the IRS say they are aware that some taxpayers value the property transferred in a manner contrary to § 482 in order to minimize the value of the property transferred that they identify as § 936(h)(3)(B) intangible property for which a deemed income inclusion is required under § 367(d) and to maximize the value of the property transferred that they identify as exempt from current tax. Treasury and the IRS say that, for example, some taxpayers (1) use valuation methods that value items of intangible property on an item-by-item basis, when valuing the items on an aggregate basis would achieve a more reliable result under the arm's length standard of § 482, or (2) do not properly perform a full factual and functional analysis of the business in which the intangible property is employed.

(c) This hardly seems to me like something that would support the major change proposed in the regulations.

(d) Treasury and the IRS are also aware that some taxpayers broadly interpret the meaning of foreign goodwill and going concern value for purposes of § 367. Specifically, although the existing regulations under § 367 define foreign goodwill or going concern value by reference to a business operation conducted outside of the United States, some taxpayers have asserted that they have transferred significant foreign goodwill or going concern value when a large share of that value was associated with a business operated primarily by employees in the U.S., where the business simply earned income remotely from foreign customers. In addition, some taxpayers take the position that value created

through customer-facing activities occurring within the U.S. is foreign goodwill or going concern value.

(e) Treasury and the IRS have concluded that these taxpayer positions and interpretations raise significant policy concerns and are inconsistent with the expectation, expressed in the legislative history, that the transfer of foreign goodwill or going concern value developed by a foreign branch to a foreign corporation is unlikely to result in the abuse of the U.S. tax system. They considered whether the favorable treatment for foreign goodwill and going concern value under current law could be preserved while protecting the U.S. tax base through regulations expressly prescribing perimeters for the portion of the value of a business that qualifies for the favorable treatment.

(f) For example, states the preamble, regulations could require that to be eligible for the favorable treatment, the value must have been created by activities conducted outside the U.S. through an actual foreign branch that had been in operation for a minimum number of years and be attributable to unrelated foreign customers. Treasury and the IRS ultimately determined that such an approach would be impractical to administer.

(g) In particular, while new temporary regulations under § 482 (see below) change the application of § 482 in important respects, the preamble states that there will continue to be challenges in administering the transfer pricing rules whenever the transfer of different types of intangible property gives rise to significantly different tax consequences. The preamble states that as long as foreign goodwill and going concern value are afforded favorable treatment, taxpayers will continue to have incentives to take aggressive transfer pricing positions to inappropriately exploit the favorable treatment of foreign goodwill and going concern value, however defined, and therefore erode the U.S. tax base.

4. <u>Eliminating the Foreign Goodwill Exception and Limiting the Scope of the Active Foreign Trade or Business Exception</u>.

(a) The preamble states that the proposed regulations would eliminate the foreign goodwill exception under Temp. Treas. Reg. § 1.367(d)-1T and limit the scope of property that is eligible for the active foreign trade or business exception generally to certain tangible property and financial assets. Accordingly, under the proposed regulations, when there is an outbound transfer of foreign goodwill or going concern value, the U.S. transferor will be subject to either current gain recognition under § 367(a) or the tax treatment provided under § 367(d). This certainly would be a

major change in the law, and one that is at odds with the clear legislative history.

(b) Proposed Treas. Reg. § 1.367(d)-1(b) provides that § 367(d) applies to an outbound transfer of intangible property, as defined in proposed Treas. Reg. § 1.367(a)-1(d)(5). Proposed Treas. Reg. § 1.367(d)-1(b) does not provide an exception for any intangible property. Proposed Treas. Reg. § 1.367(a)-1(d)(5) modifies the definition of intangible property. The modified definition facilitates both the elimination of the foreign goodwill exception as well as the addition of a rule under which U.S. transferors may apply § 367(d) with respect to certain other outbound transfers of property that otherwise would be subject to § 367(a) under the U.S. transferor's interpretation of § 936(h)(3)(B). The proposed regulations make certain coordinating changes to Temp. Treas. Reg. § 1.367(d)-1T to take into account the elimination of the foreign goodwill exception and the revised definition of intangible property. The proposed regulations also eliminate the definition of foreign goodwill and going concern value under existing Temp. Treas. Reg. § 1.367(a)-1T(d)(5)(iii) because it no longer will be needed.

(c) In addition, the proposed regulations eliminate the existing rule of Temp. Treas. Reg. § 1.367(d)-1T(c)(3) that limits the useful life of intangible property to 20 years. The preamble states that if the useful life of transferred intangible property exceeds 20 years, the limitation might result in less than all of the income attributable to the property being taken into account by the U.S. transferor. Accordingly, proposed Treas. Reg. § 1.367(d)-1(c)(3) provides that the useful life of intangible property is the entire period during which the exploitation of the intangible is reasonably anticipated to occur, as of the time of the transfer.

(d) For this purpose, exploitation includes use of the intangible property in research and development. Consistent with the guidance for cost sharing arrangements in Treas. Reg. § 1.482-7(g)(2)(ii)(A), if the intangible property is reasonably anticipated to contribute to its own further development or to developing other intangibles, then the period includes the period reasonably anticipated at the time of the transfer, of exploiting (including use in research and development) such further development. Consequently, depending on the facts, the cessation of exploitation activity after a specified period of time may or may not be reasonably anticipated.

5. Modifications Relating to the Active Foreign Trade or Business Exception.

(a) The rules for determining whether property is eligible for the active foreign trade or business exception and whether property satisfies that exception currently are found in numerous regulations under § 367. The proposed regulations combine the active trade or business regulations, other than the depreciation recapture rule, into a single regulation under proposed Treas. Reg. § 1.367(a)-2. The proposed regulations retain a coordination rule to which a transfer of stock or securities in an exchange subject to § 1.367(a)-3 is not subject to Treas. Reg. § 1.367(a)-2. The proposed regulations also make conforming changes to the depreciation recapture rule, and the branch loss recapture rule.

(b) Although minor wording changes have been made to consolidate some aspects of the active trade or business regulations into a single regulation, the proposed regulations are not intended to be interpreted as making substantive changes to the active foreign trade or business regulation except as otherwise provided in the preamble.

(c) Under existing regulations, all property is eligible for the active trade or business exception, unless the property is specifically excluded. Treasury and the IRS say that, under this structure, taxpayers have an incentive to take the position that certain intangible property is not described in § 936(h)(3)(B) and therefore not subject to § 367(d) and is instead subject to § 367(a) but eligible for the active foreign trade or business exception because the intangible property is not specifically excluded from the exception.

(d) Treasury and the IRS believe that providing an exclusive list of property eligible for the active trade or business exception will reduce the incentives for taxpayers to undervalue intangible property subject to § 367(d).

(e) The proposed regulations provide that only certain types of property are eligible for the active foreign trade or business exception. However, in order for the eligible property to satisfy that exception, the property must also be considered transferred for use in the active conduct of a trade or business outside the U.S. Specifically, proposed Treas. Reg. § 1.367(a)-2(a)(2) provides the general rule that an outbound transfer of property satisfies the active trade or business exception if (1) the property constitutes eligible property, (2) the property is transferred for use by the foreign corporation in the active conduct of a trade or business

outside of the U.S., and (3) the reporting requirements under § 6038B are satisfied.

(f) Under proposed Treas. Reg. § 1.367(a)-2(b), eligible property is tangible property, a working interest in oil and gas property, and certain financial assets, unless the property is also described in one of the four categories of ineligible property. Thus, *intangible* property cannot qualify as eligible property.

(g) Proposed Treas. Reg. § 1.367(a)-2(c) lists four categories of property not eligible for the active trade or business exception, which, in general, are (1) inventory or similar property; (2) installment obligations, accounts receivable or similar property; (3) foreign currency or certain other property denominated in foreign currency and (4) certain leased tangible property. These four categories of property not eligible for the active trade or business exception include four of the five categories described in the existing regulations. The category for intangible property is not retained because it will no longer be relevant: intangible property transferred to a foreign corporation pursuant to § 351 or § 361 will not constitute eligible property under proposed Treas. Reg. § 1.367(a)-2(b).

(h) The proposed regulations also eliminate the exception in existing Temp. Treas. Reg. § 1.367(a)-5T(d)(2) that allows certain property denominated in the foreign currency of the country in which the foreign corporation is organized to qualify for the active trade or business exception if that property was acquired in the ordinary course of business of the U.S. transferor that will be carried on by the foreign corporation.

(i) Treasury and the IRS have determined that removing the exception from Temp. Treas. Reg. § 1.367(a)-5T(d)(2) is consistent with the general policy of § 367(a)(3)(B)(iii) to require gain to be recognized in an outbound transfer of foreign currency denominated property. Removing the exception will preserve the character, source, and amount of gain attributable to § 988 transactions that otherwise could be lost or changed if the gain were not immediately recognized but instead were reflected only in the U.S. transferor's basis in the stock of the foreign corporation.

(j) The general rules for determining whether eligible property is transferred for use in the active conduct of a trade or business outside of the U.S. are described in proposed Treas. Reg. § 1.367(a)-2(d). Paragraphs (e) through (h) provide special rules for certain property to be leased after the transfer, a working interest in oil and gas property, property that is re-transferred by

the transferee corporation to another person, and certain compulsory transfers of property.

(k) Proposed Treas. Reg. § 1.367(a)-2(g)(2) does not retain the portion of existing Temp. Treas. Reg. § 1.367(a)-4T(d) that applies to certain transfers of stock or securities. Treasury and the IRS have determined that Treas. Reg. §§ 1.367(a)-3 and 1.367(a)-8 (generally requiring U.S. transferors that own five-percent or more of the stock of the foreign corporation to enter into a gain recognition agreement to avoid recognizing gain on the outbound transfer of stock or securities) adequately carry out the policy of § 367(a) with respect to the transfer of stock or securities.

6. Treatment of Certain Property as Subject to § 367(d).

(a) Treasury and the IRS note that taxpayers take different positions as to whether goodwill and going concern value are § 936(h)(3)(B) intangible property, as discussed above. The proposed regulations do not address this issue. However, the proposed regulations provide that a U.S. transferor may apply § 367(d) to a transfer of property, other than certain property described below, that otherwise would be subject to § 367(a) under the U.S. transferor's interpretation of § 936(h)(3)(B).

(b) Under this rule, a U.S. transferor that takes the position that goodwill and going concern value are not § 936(h)(3)(B) intangible property may nonetheless apply § 367(d) to goodwill and going concern value. Treasury and the IRS say this rule will further sound administration by reducing the consequences of uncertainty regarding whether value is attributable to property subject to § 367(a) or property subject to § 367(d).

(c) The application of § 367(d) in lieu of § 367(a) is available only for property that is not eligible property, as defined in proposed Treas. Reg. § 1.367(a)-2(b) but, for this purpose, determined without regard to proposed Treas. Reg. § 1.367(a)-2(c) (which describes four categories of property explicitly excluded from the active trade or business exception). A U.S. transferor must disclose whether it is applying § 367(a) or (d) to a transfer of this property.

(d) To implement this new rule under proposed Treas. Reg. § 1.367(a)-1(b)(5) and the removal of the foreign goodwill exception, the proposed regulations revise the definition of the "intangible property" that applies for purposes of §§ 367(a) and (d). As revised, the term means either property described in § 936(h)(3)(B) or property to which a U.S. transferor applies § 367(d) (in lieu of applying § 367(a)). However, for this purpose,

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and consistent with the existing regulations, intangible property does not include property described in § 1221(a)(3) (generally relating to certain copyrights) or a working interest in oil and gas property.

7. Modifications to Temp. Treas. Reg. § 1.367(a)-1T.

   (a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i) (below) applies to the arm's length standard under § 482 when it is used in conjunction with other Code provisions, including § 367, in determining the proper tax treatment of controlled transactions. Proposed Treas. Reg. § 1.367(a)-1(b)(3) provides that, in cases where an outbound transfer of property subject to § 367(a) constitutes a controlled transaction, as defined in Treas. Reg.§ 1.482-1(i)(8), the value of the property transferred is determined in accordance with § 482 and the regulations thereunder.

   (b) This rule replaces existing Temp. Treas. Reg. § 1.367(a)-1T(b)(3), which includes three rules. One of these rules refers to the sale of property "if sold individually." Treasury and the IRS are concerned this could be viewed as inconsistent with Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(B), which provides that an aggregate analysis of the transactions may provide the most reliable measure of an arm's length result under certain circumstances. The other two rules are eliminated either because they duplicate language elsewhere or are no longer necessary.

8. Proposed Effective/Applicability Dates. The regulations are proposed to apply to transfers occurring on or after September 14, 2015, and to transfers occurring before that date, resulting from entity classification elections that are filed on or after that date. Removal of the exception currently in Temp. Treas. Reg. § 1.367(a)-5T(d)(2) will apply to transfers occurring on or after the date that the rules proposed are adopted as final regulations. No inferences are intended regarding the application of the provisions proposed to be amended by the proposed regulations under current law. The IRS may, where appropriate, challenge transactions under applicable provisions or judicial doctrines.

9. Comments.

   (a) The proposed regulation is impossible to reconcile, and is at odds, with the clear, relevant legislative history, as discussed by Treasury and the IRS in the regulation's preamble. Treasury and the IRS obviously have decided they don't like the foreign goodwill exception.

(b) The Obama Administration has proposed to change the law to include goodwill, going concern value and workforce-in-place in § 936(h)(3)(B). At first, the Administration's description referred to this change as a "clarification." A New York State Bar Association ("NYSBA") report dated October 12, 2010 stated that calling the change a "clarification" was inconsistent with the legislative history of § 367(d). *See* the NYSBA report at p. 8. In the two most recent Administration budgets, the assertion that this change would be a "clarification" was dropped. These proposals were never enacted.

(c) In any event, the new regulation effectively forces taxpayers to treat goodwill and going concern value as § 367(d) assets, and precludes them from qualifying for the active trade or business exception.

(d) The legislative history, as discussed in the regulation's preamble, is clear that "no gain will be recognized on the transfer of goodwill and going concern value for use in an active trade or business." The proposed regulation obviously is contrary to the statute's legislative history.

(e) One of the more interesting things about this proposed regulation is that it was issued so closely in time to the Tax Court's decision in *Altera Corporation v. Commissioner*, 145 T.C. No. 3 (2015), discussed in last month's column. The Tax Court looked to the Administrative Procedure Act ("APA") to test the validity of a regulation. The standard under the APA is "arbitrary, capricious and an abuse of discretion or otherwise not in accordance with the law." The reviewing court must ensure that the agency "engaged in reasoned decision making." There must be "an exchange of views, information and criticism between interested parties and the agency."

(f) The regulation also could have problems under the U.S. Supreme Court's 2014 decision in *Utility Air Regulatory Group v. Environmental Protection Agency*, ___ U.S. ___ (2014), which held that an administrative "agency may not rewrite clear statutory terms to suit its own sense of how the statute should operate."

B. Section 367 Coordination Rule.

1. Treasury and the IRS finalized temporary regulations that were issued in 2013 regarding indirect stock transfers and certain coordination rule exceptions. An IRS person described the temporary regulations package (which contained more than solely the coordination rules) as an "International M&A Ph.D. course." Since the temporary regulations were

finalized with virtually no changes, I will not discuss them here in detail. They are not new news.

2. In brief, the temporary regulations removed one of the exceptions to the coordination rule. The coordination rule generally provides that if, in connection with indirect stock transfer, a U.S. person ("U.S. Transferor") transfers assets to a foreign corporation ("Foreign Acquiring Corporation"), in an exchange described in § 351 or § 361, § 367 applies first to the direct asset transfer and then to the indirect stock transfer.

3. Pursuant to the exceptions to the coordination rule, §§ 367(a) and (d) will not apply to the outbound transfer of assets by the U.S. Transferor to the Foreign Acquiring Corporation to the extent those assets are re-transferred by the Foreign Acquiring Corporation to a domestic corporation in certain nonrecognition transactions, provided certain conditions are satisfied. The continuing exceptions require that the transferee domestic corporation's adjusted basis in the re-transferred assets not be greater than the U.S. Transferor's adjusted basis in those assets, and that the indirect domestic stock transfer exception rules are satisfied. This typically involves a transaction with an unrelated person.

4. There also was a so-called § 367(a)(5) exception, which was removed by the temporary regulations. The regulations are those at Treas. Reg. §§ 1.367(a)-3(d) and (e).

V. SECTION 385 REGULATIONS

A. Treasury and the IRS finalized the § 385 regulations, and included certain of the § 385 rules in temporary regulations. The big news internationally is that the regulations reserve on all aspects of their application to foreign debt issuers. Thus, they do not apply in an outbound context, such as when a U.S. parent company makes a loan to its foreign subsidiary.

B. It was this area that caused the most problems from an international tax perspective. Foreign tax credits could have been lost and other serious collateral damage would have resulted from an outbound application of the § 385 regulations. One of my partners, Adam Halpern, testified at the Treasury/IRS hearings specifically on these points. Treasury and the IRS stated that they reserved the issue for further study.

C. Thus, from an international perspective, the new § 385 regulations are focused primarily on inbound taxpayers and transactions.

D. The big news for inbound taxpayers was the removal of the general bifurcation rule. That rule permitted the IRS during an examination to bifurcate a debt instrument so that it would constitute part equity and part debt. There were no rules on how this would be done and it seemed to have been left to the discretion

of an IRS examining agent. Treasury and the IRS stated that they also reserved this issue for further study.

E. The other big news for inbound taxpayers relates to the documentation rules. Aspects of the final and temporary regulations apply to debt instruments issued after April 4, 2016. The documentation requirements, however, apply only to debt instruments issued on or after January 1, 2018.

F. The final regulations also eliminate the 30-day documentation-preparation requirement, and instead treat documentation and financial analysis under these rules (starting in 2018) as timely prepared if it is completed by the time the issuer's federal income tax return is filed.

G. Another change under the documentation requirement softens significantly the presumption that an instrument will be equity if the documentation requirements were not satisfied. Under the final regulations, if an expanded affiliated group otherwise is generally compliant with the documentation requirements, then a rebuttable presumption, rather than a *per se* recharacterization as stock, applies in the event of a documentation failure regarding a particular debt instrument.

H. The rules under proposed Treas. Reg. § 1.385-3 were generally retained in the final regulations. Those rules treat a note distributed as a dividend generally as equity. There are certain related rules, including the so-called Funding Rule, that buttress the general note-as-a-dividend rule. These rules can apply when a note is issued for related-person stock or in a related-person asset reorganization. The rules are overly broad, but were retained, except of course they will not apply if the note issuer is a foreign corporation.

I. Important new exceptions under Treas. Reg. § 1.385-3 generally exclude deposits pursuant to a cash management arrangement as well as certain advances that finance short-term liquidity needs. The final and temporary regulations also narrow the Funding Rule somewhat by preventing, in certain cases, the so-called "cascading" consequences of recharacterizing a debt instrument as stock.

J. The final and temporary regulations expand the earnings and profits exception to include all of the earnings and profits of a corporation that were accumulated while it was a member of the same expanded group and after the day that the proposed regulations were issued.

K. The final regulations remove the "cliff effect" of the $50-million threshold exception so that all taxpayers can exclude the first $50 million of indebtedness that otherwise would be recharacterized.

L. The Treasury and the IRS also provided an exception pursuant to which certain contributions of property are "netted" against distributions and transactions with similar economic effect.

M. A number of other changes were made to the proposed regulations when they were finalized or, in some cases, issued in temporary form. For example, there are some changes in determining what constitutes an expanded affiliated group. The final regulations also clarify the ability of expanded group members to satisfy the documentation rules for instruments issued under revolving credit agreements, cash pooling arrangements, and similar arrangements by establishing overall legal arrangements (Master Agreements). Further, while the four categories of documentation stated in the proposed regulations were retained, they were tweaked somewhat in response to taxpayers' comments.

VI. EUROPEAN COMMISSION: U.S. CONCERNS.

A. Apple.

1. Apple was ordered to pay a record 13 billion Euros ($14.5 billion) in purportedly unpaid taxes plus interest as a result of a European Commission assertion that the company had received state aid from Ireland. State aid requires "selective tax treatment" that would provide the beneficiary with a "significant advantage over other businesses."

2. Apple had entered into an advance pricing agreement (APA) with Ireland to provide tax certainty. This is a contract between the taxing authority and the taxpayer. A similar APA would seem to have been available to others on similar facts. Apple U.S. and the subsidiary in issue had also cost-shared development of the relevant intangibles for 30 years. The subsidiary owned the foreign rights to those intangibles. The OCED Transfer Pricing Guidelines recognized, and recognize, cost-sharing regimes. Cost-sharing, of course, also is available to others. The Commission seemingly ignored these very important facts, and has left chaos in its wake.

3. Apple and the Irish government both vowed to fight the decision, which also risks a U.S-Europe fight over taxation policies.

4. The U.S. Treasury Department has pushed against the European Commission's state aid probes, most recently with a white paper that said the European Commission had overextended its legal authority and threatened global tax reforms. The white paper states that the Commission's approach is new and departs from prior EU caselaw and Commission decisions. It states that the Commission also should not seek retroactive recoveries under its new approach. Further, the Commission's new approach is inconsistent with international norms and undermines the international tax system. I agree.

5. The white paper discusses the Apple situation. It states the Commission initiated an investigation of advanced pricing agreements provided by the Irish tax authorities regarding the attribution of profits to the Irish branch

of an Irish company that under Irish law was treated as a non-resident for Irish tax purposes because it was not managed or controlled in Ireland. The white paper also discusses the EC's attacks on certain other companies. In each case, the company had an APA with the relevant taxing authority.

6. Treasury states that the Commission's actions undermine the United States' efforts in developing transfer pricing norms and implementing the BEPS project. The Commission's actions also call into question the ability of EU member states to honor their bilateral tax treaties with the United States.

7. The white paper further states there is the possibility that any repayments ordered by the Commission will be considered foreign income taxes that are creditable against U.S. taxes owed by Apple and other U.S.-parented companies under attack. If so, the companies' U.S. tax liability would be reduced dollar for dollar by these recoveries when their offshore earnings are repatriated or treated as repatriated as part of possible U.S. tax reform. To the extent that these foreign taxes are imposed on income that should not have been attributable to a relevant EU member state, this outcome is deeply troubling, as it would effectively constitute a transfer of revenue to the EU from the U.S. government and its taxpayers.

8. Further, the white paper states that although currently there are only three cases involving transfer pricing arrangements obtained by U.S.-headquartered companies, the Commission has suggested that it is still evaluating other tax rulings and may initiate more cases. A substantial number of additional cases against U.S. companies may lead to a growing chilling effect on U.S.-EU cross-border investment.

9. Treasury states that the U.S. Congress has made similar assessments regarding the effect the Commission's investigations may have on U.S. interests. In one letter, the chairman, ranking member and other members of the U.S. Senate Committee on Finance stated that "the United States has a stake in these cases and has serious concerns about their fairness and potential impact on the U.S. fisc." They also stated that "these investigations raise serious questions about our ability to rely on bilateral tax treaties negotiated with EU member states."

10. The EC departed from its past practice of examining whether an advantage has been given and the selective nature of the measure. In the opening decisions in Apple and Amazon, the Commission found that selectivity was met simply because the ruling deviated from the arm's-length principle. In the *Starbucks* and *Fiat* final decisions, the Commission was even more explicit, stating that "where a tax measure results in an unjustified reduction of the tax liability of the beneficiary who would otherwise be subject to a higher level of tax under the reference system,

that reduction constitutes both the advantage granted by the tax measure and the derogation from the system of reference."

11. Treasury states that previously, selectivity was often considered the "decisive criterion." In the context of individual transfer pricing rulings, the selectivity is a key hurdle for the Commission to overcome because individual rulings are generally available to any taxpayer and are granted based on an application of member state tax law.

12. In these recent state aid cases, the Commission challenges neither the member states' practice of granting transfer pricing rulings or the substance of member states' actual transfer pricing laws. Rather, the Commission challenges the substance of particular member state rulings; specifically, whether the arm's-lengths prices described in the rulings were accurately determined. The Commission's challenge is based not on the arm's-length standard as enshrined in member state law, but on the Commission's own arm's-length standard, which has never before been articulated. Not only is this application of state aid law new, but taxpayers and member states could not have foreseen that the Commission would apply this new standard.

13. It seems reasonably clear that Apple did not receive special and favorable treatment compared to other multinational businesses in Europe. Many observers believe that the real purpose why these investigations started was not because there was a concern about distortion of competition in the EU market, but because the Commission wanted to take on tax avoidance as its mantra. I believe this. State aid, however, requires the Commission to separately consider if a business received an advantage and if that advantage was granted on a selective basis.

14. In my view, European Competition Commissioner Margrethe Vestager does not understand cost-sharing, or know or care about the OECD Transfer Pricing Guidelines. After all, she is the EU Competition Commissioner, not a tax expert. She also probably has no idea about the thousands of APAs that exist in the world, or their importance to tax certainty and tax transparency. Her actions may have destroyed the worldwide APA system, at least in the EU. Certainly no one in Europe can safely rely on an APA anymore.

15. As an Apple spokesperson said, the Commission is "effectively proposing to replace Irish tax laws with a view of what the Commission thinks the law should have been."

16. US House and Senate members have voiced frustration and concern about the European Commission's announcement. In a report by Dylan Moroses, at 206 TNT 169-2, he quotes House Ways and Means Committee Chair, Kevin Brady (R-Texas), calling the ruling "a predatory

and naked tax grab." Senate Finance Committee Chair, Orrin Hatch (R-Utah), called the ruling "inherently unfair." House Speaker Paul Ryan (R-Wis) called the ruling "awful" and "in direct violation of many European countries' treaty obligations." He added that what the Commission has done "sends exactly the wrong message to job creators on both sides of the Atlantic."

17. In the past, some members of Congress urged the U.S. government to consider retaliatory action under § 891 (below). The EC's Apple decision only makes matters worse.

B. EC State-Aid Assertions.

1. A bipartisan group of U.S. senators urged the U.S. Treasury on May 23 to put pressure on the European Commission ("EC") to keep it from issuing rulings that would target U.S. multinational companies in its ongoing state-aid investigations. The text of the letter can be found at 2016 TNT 100-24.

2. The four Senate Finance Committee Members expressed disappointment that EC officials have dismissed their concerns. They specifically criticized EU Competition Commissioner Margrethe Vestager, who stated that the European Commission is now using state-aid as one if its "tools" to achieve a "reform agenda." The senators' letter states that this "confirms our [the U.S. senators'] suspicion that these cases are about more than objectively enforcing existing competition policies. The retroactive effect of the state aid investigations contradicts the notion of reform, and any retroactive application of a 'reform agenda' is improper and plainly undermines legal certainty and the rule of law."

3. The Senators also accused the EC of establishing its own transfer pricing rules and of ignoring the national practice and law of its member states. As a result, the Senators said that they believe the U.S. needs to determine for itself the implications of the EC being the final arbiter of how its member states apply international tax standards as part of their own tax laws and what actions should be taken in response.

4. An EC policy document on state aid specifically refers to the collection of "back taxes as to be eligible for foreign tax credits" in non-EU countries. The senators' letter states that this demonstrates the EC's intended result is to have U.S. taxpayers "foot the bill." This helps form the basis for the Senators' view that the EC's actions are a direct threat against U.S. interests.

5. Stephanie Soong Johnston (TNI Dec. 21, 2015, p. 1020) quoted Bob Stack of the U.S. Treasury Department discussing the European Commission's other ongoing state aid investigations in one of her reports. Stack

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expressed concern that in these investigations the European Commission is effectively saying, "We are the final arbiter in the EU whether the transfer pricing judgments of the member states are correct or not." Stack added, "And if that's true, it has much broader implications for [the U.S.'s] dealings with [its] treaty partners in the EU."

6. Stack pointed out that 4 of 5 companies involved in these ongoing investigations are U.S. taxpayers. He said that when the EU is applying the law, "It just seems to defy mathematics that the only people who run afoul of it happen to be U.S. taxpayers." Stack said the U.S. government has expressed its concerns to the Commission and continues to advocate for U.S. companies. American taxpayers may end up footing the bill for any state aid the Commission orders countries to recover from the companies in question.

7. Johnston quoted Stack as saying he wasn't aware of any auditor, attorney, tax advisor, or government that would have said a few years ago that if the transfer pricing is wrong in a tax ruling, it's considered state aid. He asked, "Does it meet our notions of fairness?"

C. More on EU State Aid Assertions.

1. A bipartisan group of Senators, including the chairman and ranking member of the Senate Finance Committee wrote to the U.S. Department of Treasury urging the Administration to consider retaliatory tax hikes in response to the European Commission's state aid assertions. They stated "It alarms us that the EU Commission is using a non-tax forum to target U.S. firms essentially to force its member states to impose taxes, looking back as far as 10 years, in a manner inconsistent with internationally accepted standards in place at the time. By all accounts, these cases have taken the member states, companies, and their advisors by surprise." They urge the Administration to consider retaliatory action under § 891.

2. Mindy Herzfeld reported on the EU Commission's newest state-aid attack, "Belgian Excess Profits, the Commission Strikes Again." Tax Notes International Jan. 25, 2016. She notes that the Commission's Belgian decision differs from earlier Commission's attacks finding illegal state aid in other tax rulings. In contrast to its earlier actions, the EU Commission's latest decision invalidates a key provision of the Belgian corporate income tax law, implemented via ruling practice.

3. The Commission's attack on the Belgian excess profits ruling system raises yet additional serious concerns. The EC communique states: "The Commission's in-depth investigation showed that by discounting 'excess profits' from a company's actual tax base, the scheme derogated from … the arm's-length principle *under EU state aid rules*." This has caused some practitioners to ask, "Can there be several arm's-length principles?

Or is this just the way the European Commission would like the arm's-length principle to be applied?" There certainly shouldn't be more than one arm's-length standard.

4. Bob Stack met with EU officials in Brussels to personally deliver the message that recent European Commission state aid investigations unfairly target American companies. EU Competition Commissioner Margrethe Vestager stated that she is not singling out American companies. However, most multinational enterprises that have been targeted are American.

D. More on EC State Aid Assertions: Treaties.

1. In another report by Herzfeld (TNI Dec. 14, 2015, p. 879), she discussed the Commission's investigation regarding whether certain rulings granted by Luxembourg concerning finance branches constitute illegal state aid. In this investigation, the Commission apparently believes that it has the power to overrule a country's interpretation of internationally agreed upon tax rules. Bob Stack suggested in testimony to the House Ways & Means Tax Policy Subcommittee that the U.S. needs to question the value of its bilateral tax treaties with EU members if those agreements can seemingly be overturned by an administrative commission with supranational authority.

2. The structure in question involves a Luxembourg company allocating assets to a U.S. branch that Luxembourg deems to constitute a permanent establishment in the U.S. but which the U.S. does not recognize as subject to U.S. tax. This would seem to me more like an issue the two countries should resolve than one on which the overarching European Commission should be focused.

E. More on EC and Treaties.

1. In November, the European Commission found that the limitation on benefits article in the Netherlands treaty with Japan violated (infringes on) the fundamental freedoms of the Treaty on the Functioning of the European Union. The case may find its way to the EU Court of Justice.

2. As discussed in an excellent report by Mindy Herzfeld (TNI Jan. 4, 2016, p. 13), the decision could have implications for the United States. The Japan-U.S. treaty is similar to virtually all U.S. treaties with EU countries. The LOB article in the Japan-Netherlands treaty contains a derivative benefits clause that EU members thought might protect them from EU challenges.

3. According to the Commission, an EU state cannot, under a treaty with a third country, agree to more favorable treatment for companies held by shareholders resident in its own territory than for comparable companies

held by shareholders who are resident elsewhere in the EU and the European Economic Area ("EEA"). An EU state also cannot agree to provide better conditions for companies traded on its own stock exchange than for companies traded on stock exchanges located elsewhere in the EU and the EEA.

4. The Commission's holding not only affects all U.S. treaties with EU member countries but conceivably also could implicate BEPS Action #6, which states that treaties should have a limitation on benefits provision or a more general anti-abuse rule based on the principal purpose of transactions or arrangements (the "PPT" rule). The U.S. Senate has already rejected proposed treaties containing PPT rules.

5. More likely, however, the U.S.'s treaties with EU countries can be amended to satisfy the Commission's decision if it is upheld in the Court of Justice, or if the Netherlands agrees to renegotiate its treaty with Japan and others follow this course of action. The U.S.'s treaties with EU countries would remain in effect. They simply would need to be renegotiated.

F. EU Anti-Tax Avoidance Directive.

1. The EU Council approved the EU Anti-Tax Avoidance Directive ("ATAD"). This is a significant development. It contains a number of BEPS-related provisions.

2. The European Commission's original proposals covered six key areas, including controlled foreign company (CFC) rules, a switchover clause, exit taxation, interest limitation rules, hybrid mismatches and a general anti-avoidance rule ("GAAR"). The Directive also defines terms such as permanent establishment, tax havens and minimum economic substance.

3. The switchover clause was removed as a part of a compromise agreement. The rule would have required member states to apply a credit system instead of offering an exemption for certain types of foreign income that originate from third countries.

4. Other compromises move the proposal nearer to the final BEPS Reports. For example, the hybrid rule, which previously required the primary response to be inclusion in income rather than denial of a deduction, has been resolved in favor of the BEPS approach.

5. The interest deductibility provision in the ATAD became controversial. BEPS recommends implementing a fixed-ratio approach that can be supplemented by a worldwide group ratio, which allows an entity to exceed the fixed ratio in certain circumstances.

6. To resolve concerns and reach consensus on ATAD, the Directive provides a transition period of five years to implement Article 4 of the ATAD. This means that EU member states would be able to incorporate the interest-deduction limitation rules in national legislation effective 2024, rather than the general 2019 deadline. The compromise also permits member states to implement a grandfather clause to facilitate the transition to the new interest limitation rules.

7. Member states will have until December 31, 2018 to incorporate the directive into their national laws and regulations, except for the exit taxation rules. They will have until December 31, 2019 to implement those rules.

8. Certain U.S. congresspersons were concerned that the EU was moving full speed ahead to implement the OECD's BEPS recommendations and that this will make it more difficult for American companies to compete in the global market. One Congressman said that "we must be doing more to ensure that American companies are able to compete in the global marketplace and not suffer a slanting of the playing field against them."

VII. FOREIGN TAX CREDITS.

A. The U.S. Supreme Court denied cert in *Salem Financial*, *Bank of New York Mellon*, and *AIG* cases regarding creditable foreign taxes and economic substance.

B. New Foreign Tax Credit Guidance.

1. Treasury and the IRS issued a surprising notice seeming directly related to the Apple state-aid issue. While Notice 2016-52 seems focused on EU state-aid adjustments, it is more broad then simply dealing with that issue. The Notice states that following a foreign-initiated adjustment, such as under the EU state-aid rules, a U.S. parent company may attempt to change its ownership structure or cause the relevant § 902 corporation to make an extraordinary distribution so that the subsequent tax payment creates a high-tax pool of post-1986 undistributed earnings. This high-tax pool then can be used to generate substantial amounts of foreign taxes deemed paid, without repatriating and including in U.S. taxable income the earnings and profits to which the taxes relate.

2. Treasury and the IRS state that regulations will treat these transactions as foreign tax credit splitter transactions under § 909. Accordingly, two new splitter arrangements are described in the Notice.

3. The Notice sets forth a number of definitions including what constitutes a "specified foreign-initiated adjustment." A specified foreign-initiated adjustment is a foreign-initiated adjustment (or series of related adjustments to more than one taxable year) that results in additional foreign income tax liability that is greater than $10 million, regardless of

whether the liability is actually paid in one or more taxable years (due, for example, to an installment plan).

4. Under the first new splitter arrangement, a "covered transaction" generally means any transaction or series of related transactions that meet the following conditions:

   (a) the transaction or series of related transactions results in covered taxes being paid by a payor that is a § 902 corporation and that is not the § 902 corporation that would have been the payor of the covered taxes (the predecessor entity) if the covered taxes had been paid or accrued in the relation-back year; and

   (b) the predecessor entity (or a successor of the predecessor entity) was a covered person with respect to the payor immediately before the transaction or series of related transactions, or, if the payor did not exist immediately before the transaction or series of related transactions, the processor entity was a covered person with respect to the payor immediately after the transactions or series of related transactions.

5. The following exceptions apply: (1) the transaction or series of related transactions results in the transfer of the earnings and profits of the predecessor entity to the payor pursuant to § 381; or (2) the taxpayer demonstrates by clear and convincing evidence that the transaction or series of related transactions were not structured with a principal purpose of separating covered taxes from the post-1986 undistributed earnings of the predecessor entity that include the earnings to which the covered taxes relate.

6. The Notice sets forth the following example. USP, a domestic corporation, wholly owned CFC1. CFC1 wholly owns CFC2. Both CFCs are residents of country X. CFC1 wholly owns a disregarded entity ("DE"), which is organized in country X and treated as a corporation for country X tax purposes. CFC1 does not earn any income or pay any foreign taxes, other than through DE. For years 1 through 5, DE earns $200 of earnings and profits with respect to which it accrues and pays no foreign tax. These earnings and profits constitute CFC1's pool of post-1986 undistributed earnings, which equals $1,000 as of the end of year 5. In year 6 (a year in which DE earns no income), CFC1 transfers all of its interest in DE1 to CFC2 in exchange for CFC2 stock in a transaction that qualifies under § 351. In year 8, after exhausting all effective and practical remedies to minimize its liability for country X tax, DE1 pays $200 in foreign income taxes to country X to settle a series of related adjustments proposed by country X with respect to years 1-5. The result is a § 909 splitter arrangement, and the related income equals $1,000.

7. The Notice also describes a second new splitter arrangement. It states that taxpayers could achieve a result similar to the arrangement described above by using distributions, to, in effect, move post-1986 undistributed earnings from one § 902 corporation to another before the first § 902 corporation makes a tax payment pursuant to a specified foreign-initiated adjustment.

8. A "covered distribution" is any distribution with respect to the payor's stock to the extent the distribution:

    (a) occurred in a taxable year of the payor to which the covered taxes relate or any subsequent taxable year up to and including the taxable year immediately before the taxable year in which the covered taxes are paid;

    (b) resulted in a distribution or allocation (for example, pursuant to Treas. Reg. § 1.312-10) of the payor's post-1986 undistributed earnings to a § 902 covered person; and

    (c) was made with a principal purpose of reducing the payor's post-1986 undistributed earnings that included the earnings to which the covered taxes relate in advance of the payment of covered taxes.

9. A distribution will be presumed to have been made with the tainted principal purpose if the sum of all distributions that would be covered distributions without regard to the principal purpose requirement is greater than 50% of the sum of:

    (a) the payor's post-1986 undistributed earnings as of the beginning of the payor's taxable year in which the covered tax is paid; and

    (b) the sum of all distributions that would be covered distributions without regard to the principal purpose requirement. A taxpayer may rebut this presumption with clear and convincing evidence.

10. The Notice sets forth the following example. USP, a domestic corporation, wholly owns CFC1. CFC1 wholly owns CFC2. Both CFCs are resident in country X. For each of years 1 through 9, CFC2 earns $100 of earnings and profits with respect to which it does not accrue or pay any foreign tax. In year 11, CFC2 distributes $750 of its post-1986 undistributed earnings to CFC1. In year 12, after having exhausted all available and practical remedies to minimize its liability for country X tax, CFC2 pays $20 of foreign income tax to country X with respect to each of years 1 through 9 to settle related audit adjustments proposed by country X. The result is a splitter arrangement.

11. The Notice states that no inference is intended as to the treatment of transactions described in the Notice under current law, and that the IRS

may challenge these transactions under applicable Code provisions or judicial doctrines. In addition, no inference is intended as to whether (1) payments made pursuant to any particular foreign-initiated adjustment, including those arising under EU state-aid rules, qualify as payments of creditable foreign income taxes, or (2) taxes paid by a U.S. person pursuant to a foreign-initiated adjustment to the tax liability of a subsidiary § 902 corporation are eligible as a direct foreign tax credit under § 901.

12. Treasury and the IRS request comments on the rules described in the Notice. In particular, Treasury and the IRS solicit comments on whether transactions addressed in the Notice would be more appropriately addressed pursuant to the rules under § 905(c) providing that additional payments of tax be accounted for through adjustments to the pools of post-1986 foreign income taxes and post-1986 undistributed earnings of § 902 corporations that are not the same entity as the payor of the tax.

13. Treasury and the IRS also are considering whether an objective test, rather than a subjective test based on taxpayer intent, should be used to determine when the transactions described above are treated as splitter arrangements. Accordingly, they solicit comments on this issue.

C. Foreign Tax Credit Issues.

1. In *Vento* v. *Commissioner*, 147 T.C. No. 7 (2016), the taxpayers (three sisters) did not file U.S. federal income tax returns for 2001 but instead filed income tax returns with the Virgin Islands Bureau of Internal Revenue. The taxpayers subsequently conceded they were not bona fide residents of the Virgin Islands for 2001. They sought to credit against their U.S. tax liabilities for that year, under § 901, payments made with their Virgin Islands tax returns and estimated payments they made to the U.S. Treasury for 2001 that were later "covered into" the Virgin Islands Treasury under § 7654.

2. The Court held that the taxpayers could not credit against their U.S. income tax under § 901 the amounts paid as tax to the Virgin Islands for that year. The taxpayers failed to establish that their determination that they were subject to Virgin Islands tax rather than U.S. tax for 2001 was based on a reasonable interpretation of applicable law and that they had exhausted all effective and practical means of securing a refund of the amounts paid to the Virgin Islands. Consequently, the taxpayers did not meet their burden of proving that the amounts in issue were "taxes paid" within the meaning of Treas. Reg. § 1.901-2(e).

3. The taxpayers claimed that, because there was no clear authority on determining residency in the Virgin Islands for 2001, the position that they were bona fide residents of the Virgin Islands and thus were required to

pay Virgin Islands income tax for that year was a reasonable interpretation of applicable law. The Court stated that there was no evidence the taxpayers relied on the advice of competent advisors in taking the position that they were bona fide residents of the Virgin Islands as of December 31, 2001.

4. Moreover, the concerns expressed by the IRS and Congress in 2004 about perceived abuses of the standards for determining bona fide residence then in effect gave the taxpayers reason to know, before the expiration of the period of limitations for claiming a refund of the Virgin Islands tax, that their claims of bona fide Virgin Islands residence might be erroneous.

5. In sum, the taxpayers had not demonstrated on the basis of advice obtained in good faith from competent advisors or otherwise that they paid Virgin Islands tax for 2001 in reliance on a reasonable interpretation of the relevant law. The record also did not detail the efforts they made in pursuing their refund claim, and provided no evidence of any attempt by two of the taxpayers to pursue their claim for a refund of the tax they had paid to the Virgin Islands despite being on notice of the possible error in the legal interpretation on the basis of which they paid the tax.

6. Therefore, the Court felt the taxpayers had also failed to demonstrate that they exhausted “all effective and practical remedies” to reduce their liabilities for Virgin Islands tax.

7. Even if the amounts were otherwise creditable under § 901, the Court rejected the taxpayers’ argument that the § 904 limitation does not apply to taxes paid to the Virgin Islands. The Court agreed with the IRS that the taxpayers had failed to demonstrate that they had a § 904 limitation for 2001 sufficient to allow them to credit the amounts in issue.

8. The Court stated that its conclusion was reinforced by a more fundamental point that the taxpayers’ arguments missed: Congress did not intend taxes paid by U.S. citizens or residents to the Virgin Islands to be eligible for the foreign tax credit.

9. The imposition of Virgin Islands tax on the income of U.S. individuals need not result in the type of double taxation that the foreign tax credit is designed to prevent. The coordination rules of § 932 allow taxpayers to avoid that possibility and thus supplant the foreign tax credit regime.

10. The taxpayers’ rather unusual situation might have given them an opportunity to slip through a crack in the statutory framework. The literal terms of § 932(a)(3) do not deny the taxpayers the credits in issue because none of them earned as much as a dollar of Virgin Islands income. The Court stated that it could not imagine, however, that, while Congress did not intend to allow a foreign tax credit for Virgin Islands taxes paid by

bona fide residents of the Virgin Islands or by non-Virgin Islands residents with Virgin Islands income, it nonetheless intended to allow a credit under § 901 for amounts paid as tax to the Virgin Islands by a taxpayer who is not a bona fide resident of the Virgin Islands, has no Virgin Islands income for the year in question, and thus did not actually owe tax to the Virgin Islands for that year.

11. In any event, the Court stated that it did not need to decide the case solely on the basis of Congress' intent to allow credits under § 901 for taxes paid by U.S. individuals to the Virgin Islands. Here, the taxpayers had failed to establish that (1) the amounts in issue were "taxes paid," within the meaning of Treas. Reg. § 1.901(2)(e) or (2) the claimed credits do not exceed their applicable § 904 limitations.

VIII. OTHER DEVELOPMENTS.

A. F Reorganizations.

1. The IRS published final regulations regarding F reorganizations. F reorganizations under § 368(a)(1)(F) involve a "mere change" in the identity, form, or place of organization of one corporation. F reorganizations can be wholly domestic, wholly foreign, or cross border.

2. The new regulations adopt regulations that were proposed in 2004. They also include rules on outbound F reorganizations (domestic transferor corporation and foreign acquiror corporation) by adopting, without substantive change, proposed regulations that were issued in 1990. These regulations, adopted as § 367 regulations, were previously in effect as temporary regulations.

3. Based on prior caselaw, the 2004 proposed regulations would have imposed four requirements for a transaction to qualify as an F reorganization. First, all the stock of the resulting corporation, including stock issued before the transfer, would have had to be issued in respect of stock of the transferor corporation. Second, a change in the ownership of the corporation in the transaction would not have been allowed, except for a change that had no effect other than that of a redemption of less than all of the shares of the corporation. Third, the transferor corporation would have had to completely liquidate in the transaction, although it did not need to legally dissolve. Fourth, the resulting corporation would not have been allowed to hold any property or possess any tax attributes immediately before the transfer, other than a nominal amount of assets to facilitate its organization or to preserve its existence.

4. These requirements would have prevented a transaction that involves the introduction of a new shareholder or new equity capital into the corporation from qualifying as an F reorganization, with one exception:

the proposed regulation would have allowed the resulting corporation to issue a nominal amount of stock not in respect of stock of the transferor corporation to facilitate the organization of the resulting corporation. This was intended to facilitate qualification of a transaction as an F reorganization in situations where, for example, the resulting corporation's governing law requires two or more shareholders and the transferor corporation has only one shareholder.

5. The final regulations generally adopt the regulations proposed in 2004, but with certain changes. The preamble states that like the 2004 proposed regulations, the final regulations are based on the premise that it is appropriate to treat the resulting corporation in an F reorganization as the functional equivalent of the transferor corporation and to give its corporate enterprise roughly the same freedom of action as would be accorded a corporation that remains within its original corporate shell.

6. Under the final regulations, *six* requirements apply. Four of the six requirements are generally adopted from the 2004 proposed regulations. The fifth and sixth requirements address comments received with respect to the proposed regulations regarding "overlap transactions," for example, transactions involving the transferor corporation's transfer of its assets to a potential successor corporation other than the resulting corporation in a transaction that could also qualify for nonrecognition treatment under a different provision of the Code.

7. Under the fifth requirement, immediately after the F reorganization, no corporation other than a resulting corporation may hold property that was held by the transferor corporation immediately before the F reorganization if the other corporation would, as a result, succeed to and take into account the items of the transferor corporation described in § 381(c) (corporate attributes in a reorganization). The sixth requirement is that immediately after the F reorganization, the resulting corporation may not hold property acquired from a corporation other than a transferor corporation if the resulting corporation would, as a result, succeed to and take into account the items of the other corporation described in § 381(c).

8. <u>F Reorganization "in a Bubble</u>."

   (a) The 2004 proposed regulations also contained an independently important rule: an F reorganization may be a step, or series of steps, before, within, or after other transactions that effect more than a mere change, even if the resulting corporation has only a transitory existence following the mere change. In some cases, an F reorganization sets the stage for later transactions by alleviating non-tax impediments to a transfer of assets. In other cases, prior transactions may tailor the assets and shareholders of the transferor corporation before the commencement of the F reorganization.

(b) Treasury and the IRS concluded that step transaction principles generally should not apply to recharacterize the F reorganization in such a situation because F reorganizations involve only one corporation and do not resemble sales of assets. This view is consistent with an important previous ruling, Rev. Rul. 96-29, and is included in the final regulation.

(c) However, the preamble states that notwithstanding this rule, *in a cross-border context*, related events preceding or following an F reorganization may be related to the tax consequences under certain international provisions that apply to F reorganizations. For example, such events may be relevant for purposes of applying certain rules under § 7874 (inversions) and for purposes of determining whether stock of the resulting corporation should be treated as stock of a controlled foreign corporation for purposes of § 367(b). The preamble cites, for example, § 2.03(b)(iv), Example 2 in Notice 2014-52; and Rev. Rul. 83-23, 1983-1 C.B. 82. Notice 2014-52 is the controversial anti-inversion notice issued last fall.

(d) The final regulations also adopt a provision of the 2004 proposed regulations that the qualification of a reorganization as an F reorganization would not alter the treatment of other related transactions. For example, if an F reorganization is part of a plan that includes a subsequent merger involving the resulting corporation, the qualification of the F reorganization as such will not alter the tax consequences of the subsequent merger.

9. Outbound F Reorganization.

(a) If a domestic corporation is the transferor corporation and the acquiring corporation is a foreign corporation in an F reorganization, then, under new Treas. Reg. § 1.367-1(e), the taxable year of the transferor corporation will end with the close of the date of the transfer and the taxable year of the acquiring corporation will end with the close of the date on which the transferor's taxable would have ended but for the occurrence of the transfer. Treas. Reg. § 1.367-1(e) is retroactive to 1987.

(b) Further, under new Treas. Reg. § 367(a)-1(f), in every F reorganization where the transferor corporation is a domestic corporation and the acquiring corporation is a foreign corporation, there is considered to exist:

(i) a transfer of assets by the transferor corporation to the acquiring corporation under § 361(a) in exchange for stock (or stock or securities) of the acquiring corporation and the

assumption by the acquiring corporation of the transferor corporation's liabilities;

(ii) a distribution of stock (or stock or securities) of the acquiring corporation by the transferor corporation to the shareholders (or shareholders and security holders) of the transferor corporation; and

(iii) an exchange by the transferor corporation's shareholders (or shareholders and security holders) of their stock (or stock and securities) of the transferor corporation for stock (or stock and securities) of the acquiring corporation under § 354(a).

10. For purposes of this rule, it is immaterial that the applicable foreign or domestic law treats the acquiring corporation as a continuance of the transferor corporation. Treas. Reg. § 1.367(a)-1(f) is retroactive to 1985.

B. Over-the Counter Currency Option Contracts.

1. *Wright v. Commissioner*, ___ F.3d ____ (6th Cir. 2016), addressed whether foreign currency options constitute foreign currency contracts under § 1256. Under § 1256, a foreign currency contract is a § 1256 contract subject to § 1256's mark-to-market rules. The taxpayer claimed a large tax loss by marking-to-market a euro put option. The option was a part of the series of transfers of mutually offsetting foreign currency options that the taxpayer executed over a period of three days.

2. The Tax Court held that the put option was not a foreign currency contract under § 1256. The Sixth Circuit reversed, stating that while the Tax Court's disallowance of the taxpayer's claimed loss makes sense as a matter of tax policy, the plain language of the statute clearly provides that a foreign currency option can be a foreign currency contract.[3]

3. The Sixth Circuit started with a discussion of forwards (bilateral private contracts), futures (similar to forwards, but highly standardized to enable them to be traded on a regulated exchange) and options (unilateral contracts under which the obligated party need not deliver the foreign currency unless the party holding the option exercises it by a specific date).

[3] While the decision came as somewhat of a surprise to many tax advisors as the Tax Court previously had held in supporting the IRS that over-the-counter (OTC) currency option contracts did not constitute foreign currency contracts, *see Summit v. Commissioner*, 134 T.C. 248 (2010) and IRS Notice 2007-71, 2007-2 C.B. 472, it should be noted that the court's holding only affects the timing of the gain or loss regarding a currency option under § 1256's mark-to-market rules. It does not change the character of the gain or loss, which is ordinary under § 988.

4. Section 1256(g)(2) defines a "foreign currency contract" as a contract that requires the delivery of, or the settlement of which depends on the value of, a foreign currency that is a currency in which positions are also traded through regulated futures contracts.[4] The Tax Court held that a foreign currency option does not meet the "delivery" or "settlement" requirement under § 1256(g)(2) because a foreign currency option does not require delivery or a settlement unless and until the holder exercises the option.

5. The Sixth Circuit stated that the plain language of the statute does not provide that a foreign currency contract must require either a delivery or a settlement. Rather, the statute provides that a foreign currency contract is a contract that requires delivery of a foreign currency or a contract the settlement of which depends on the value of a foreign currency. In the view of the Sixth Circuit, the IRS's argument, and the Tax Court's holding, were contrary to the plain language of the statute.

6. The Tax Court determined that when Congress added the "settlement" prong to § 1256 in 1984, it did so in order to allow cash-settled forward contracts to come within the definition of foreign currency contract. The IRS argued that Congress added that prong to the definition not to remove the delivery requirement but to allow that requirement to be met with a cash settlement, and thus that the contract must require either a settlement or delivery of the currency.

7. The Sixth Circuit stated that however this may be, the plain language of § 1256 clearly establishes that the taxpayer's euro put option meets the "settlement" prong of § 1256(g)(2). According to the court, Congress may have wanted to create a different result when it added the "settlement" prong to § 1256. The House report indicates that Congress amended § 1256 to allow a contract that provides for settlement in an amount determined by the value of the foreign currency, rather than the actual delivery of the foreign currency, to meet the "delivery" requirement of the foreign currency contract definition.

8. However, if Congress had wanted to expand the definition of a foreign currency contract to include only those contracts, Congress could have amended the statute to provide that a foreign currency contract is a contract "which requires delivery of, or which requires a settlement which depends on the value of, a foreign currency." Congress did not amend § 1256 in this way.

9. The court stated that the fact tax policy did not appear to support allowance of the taxpayer's claimed loss is not sufficient to judicially reform the statutory language for two reasons. First, the court's attempt to

[4] I will not discuss the requirements of traded in the interbank market and arm's length determined by reference to the price in the interbank market as the court did not address them.

reform § 1256 might unintentionally permit other tax-avoidance schemes. Second, Congress provided two escape hatches to guard against the type of adverse tax policy outcome at issue here.

10. In particular, Congress allowed the IRS to prescribe regulations to exclude any type of contract from the "foreign currency contract" definition if the inclusion of this type of contract would be "inconsistent with the purposes of § 1256." Section 1256(g)(2)(B). The IRS therefore could prevent future taxpayers from relying on § 1256 to mark-to-market foreign currency options by issuing a regulation that excludes foreign currency options from the definition of foreign currency contracts.

11. Interestingly, I urged Treasury and the IRS in a comment letter some years ago to write regulations under § 1256(g)(2)(B), but my arguments for regulations under that section were rejected. In fact, it was at my suggestion that § 1256(g)(2)(B) was added to the Code. I didn't specifically have currency options in mind, but rather other multinational-corporation approaches to currency management.

12. The court said that Congress also allows the IRS to prevent taxpayers from claiming tax losses based upon transactions involving offsetting foreign currency options by challenging specific transactions under the economic substance doctrine.

13. In conclusion, the court stated that the statutorily provided bases for dealing with tax shelters that may violate the underlying policy of the Internal Revenue Code make it doubly inappropriate for the court to try to achieve such a result by torturing the plain language of the statute. [to come]

C. <u>Domestic Disregarded Entities: New Reporting Rules</u>.

1. Treasury and the IRS proposed regulations that would treat a domestic disregarded entity ("DRE") wholly owned by a foreign person as a domestic corporation separate from its owner for the limited purposes of the reporting, record maintenance and associated compliance requirements that apply to 25% foreign-owned domestic corporations under § 6038A. The preamble states that these changes are intended to provide the IRS with improved access to information that it needs to satisfy its obligations under U.S. tax treaties, tax information exchange agreements and similar international agreements, as well to strengthen the enforcement of U.S. tax laws.

2. Some disregarded entities are not obligated to file a U.S. federal tax return or to obtain an employer identification number ("EIN"). The regulation's preamble says that in the absence of a return filing obligation (and associated record maintenance requirements) or the identification of a

responsible party as required in applying for an EIN, it is difficult for the U.S. to carry out the obligations it has undertaken in its tax treaties, tax information exchange agreements and similar international agreements.

3. Section 6001 provides that every person liable for any tax imposed by the Code, or for the collection thereof, shall keep records, render statements, make returns and comply with the rules and regulations as Treasury and the IRS may from time-to-time prescribe. In addition, whenever in the judgment of Treasury and the IRS it is necessary, they may require any person, by notice served on that person or by regulations, to make returns, render statements, or keep records as they deem sufficient to show whether or not that person is liable for tax.

4. The Code also requires many categories of persons to file returns, even if no tax is owed in a particular year. For example, all corporations organized in the U.S. must file annual income tax returns, which may include schedules requiring the identification of owners exceeding specified ownership thresholds. Moreover, foreign corporations engaged in a trade or business in the U.S. must file annual income tax returns.

5. The preamble states that all entities, including disregarded entities, must have an EIN to file a required return. An entity also must have an EIN in order to elect to change its classification. An entity that accepts its default classification and is not required to file a return need not obtain an EIN. Because a domestic single-member LLC is classified as a disregarded entity by default rather than by election and has no separate federal tax return filing requirements, there is typically no federal tax requirement for it to obtain an EIN.

6. Thus, as noted above, the proposed regulations would amend Treas. Reg. § 301.7701-2(c) (part of the check-the-box regulations) to treat a domestic disregarded entity that is wholly owned by one foreign person as a domestic corporation separate from its owner for the limited purposes of the reporting and record maintenance requirements under § 6038A.

7. Because the proposed regulations would treat the affected domestic entities as foreign-owned domestic corporations for the specific purposes of § 6038A, they would be reporting corporations within the meaning of § 6038A. Consequently, they would be required to file Form 5472 with respect to reportable transactions between the entity and its foreign owner or other foreign related parties.

8. To ensure that these entities report all transactions with foreign related parties, the proposed regulations specify as an additional reportable category of transaction for these purposes any transaction within the meaning of Treas. Reg. § 1.482-1(i)(7) (with these entities being treated as separate taxpayers for the purpose of identifying transactions and being

subject to requirements under § 6038A) to the extent not already covered by another reportable category. The term "transaction" is defined in Treas. Reg. § 1.482-1(i)(7) to include any sale, assignment, lease, license, loan, advance, contribution, or other transaction of any interest in or a right to use any property or money, as well as the performance of any services for the benefit of, or on behalf of, another taxpayer.

9. For example, under the proposed regulations, contributions and distributions would be considered reportable transactions with respect to these entities.

10. The penalty provisions associated with failure to file Form 5472 and failure to maintain records would apply to these entities as well.

11. The regulations are proposed to be applicable for taxable years ending on or after the date that is 12 months after the date the regulations are published as final regulations.

D. Section 305(c).

1. Section 305 applies to actual and deemed distributions by a corporation of its own stock and rights to acquire its stock. Section 305(a) provides the general rule that the receipt of these distributions or rights does not require an amount to be included in gross income of the recipient. However, under §§ 305(b)(1) through (b)(5) certain actual and deemed distributions of stock and stock rights are treated as distributions or property to which § 301 applies. In this case, they can be characterized as dividend distributions.

2. Section 305(c) also authorizes Treasury and the IRS to prescribe regulations to treat changes in the conversion ratio of instruments convertible into stock and other events having similar effects as distributions to shareholders whose proportionate interests in the assets or earnings and profits of the corporation are increased by these events. Under Treas. Reg. § 1.305-7(b), adjustments pursuant to a bona fide, reasonable adjustment formula that has the effect of preventing dilution of the interests of the stockholders is not considered to result in a deemed distribution of stock.

3. Treasury and the IRS have concluded that a deemed distribution of a right to acquire stock should be viewed as the distribution of additional rights to acquire stock, the amount of which is the fair market value of the right. Under the terms of a convertible instrument, a distribution of cash or property to actual shareholders may increase the amount of shares the holder of the convertible instrument would receive upon conversion. Similarly, a distribution of cash or property to actual shareholders may increase the number of shares the holder of other rights to acquire stock,

such as warrants or options, would receive upon exercise. In either case, the increase is an applicable adjustment resulting in a deemed distribution of additional rights to acquire stock to the holders of the rights to acquire stock.

4. Under the proposed regulations, the amount of the deemed distribution would be excess of (1) the fair market value of the right to acquire stock immediately after the applicable instrument over (2) the fair market value of the right to acquire stock without the applicable adjustment.

5. When an applicable adjustment is or results in a deemed distribution under Prop. Treas. Reg. § 1.305-7(c)(1) or (2), the deemed distribution occurs at the time the applicable adjustment occurs, in accordance with the instrument setting for the terms of the right to acquire stock, but in no event later than the date of the distribution of cash or property that results in the deemed distribution.

6. Thus, the proposed regulations deal with the amount and the timing of the relevant income. They do not address what constitutes a bona fide and reasonable anti-dilution adjustment, which often can be the most important question.

(a) <u>Withholding on Deemed Payments to Foreign Persons</u>.

i. Perhaps more relevant in an international context, the proposed regulations also deal with these deemed distributions under the withholding tax rules of §§ 1441 and 1442 and the FATCA withholding tax rules under §§ 1471 through 1474.

ii. The regulations' preamble says that withholding agents have complained that ambiguities in the current law have made it difficult for them to satisfy their withholding obligations regarding § 305(c) distributions. In particular, withholding agents are concerned that these deemed distributions often occur when there is no cash payment that corresponds to the deemed distribution, which makes it difficult for them to satisfy their withholding obligation on the date of the deemed distribution.

iii. Under current Treas. Reg. § 1.1441-2(d)(1), a withholding agent does not have an obligation to withhold on a payment when it lacks control over, or custody of, money or property of the recipient, or knowledge of the facts giving rise to the payment. This general exception does not apply when in relevant part, the payment is a distribution with respect to stock.

iv. Prop. Treas. Reg. § 1.1441-2(d)(4)(i) would clarify that a withholding agent has an obligation to withhold on a deemed distribution (as defined in Prop. Treas. Reg. § 1.305-1(d)(7)) that is made on a security. The proposed regulations would clarify that an issuer of a security on which a deemed distribution is made and any person that holds directly or indirectly (for example, through an account maintained for an intermediary) a security on behalf of the beneficial owner of the security, or a flow-through entity that owns directly or indirectly a security, is considered to have custody of or control over the deemed distribution made on the security and, therefore, is a withholding agent with respect to the distribution.

v. However, the proposed regulations also would allow a withholding agent (other than the issuer of the specified security) to benefit from a new exception in Prop. Treas. Reg. § 1.1441-2(d)(4) for deemed distributions (as defined in Treas. Reg. § 1.305-1(d)(7)) of stock or a right to acquire stock on a specified security.

vi. Under this new exception, a withholding agent (other than the issuer of the specified security) would have an obligation to withhold on a deemed distribution only if before the due date (not including extensions) for filing Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, with respect to the calendar year in which the deemed distribution occurred either (1) the issuer meets its reporting requirements under Treas. Reg. § 1.6045B-1 (by furnishing an issuer statement) or publicly reporting the information required under that section) or (2) the withholding agent has actual knowledge that a deemed distribution has occurred, in which case the obligation to withhold would not arise until January 15 of the year following the calendar year of the deemed distribution.

vii. If the requirements of Prop. Treas. Reg. § 1.1441-2(d)(4)(i) have been satisfied, a withholding agent would have an obligation to withhold on a deemed distribution. Except as provided in Treas. Reg. § 1.1441-5 regarding the time to withhold for partnerships and trusts, under Prop. Treas. Reg. § 1.1441-2(d)(4)(ii), a withholding agent would be required to satisfy its withholding obligations by withholding on the earliest of (1) the date on which a future cash payment is made regarding the security; (2) the date on which the security is sold, exchanged, or otherwise

disposed of (including a transfer of the security to another account not maintained by the withholding agent or a termination of the account relationship); or (3) the due date (not including extensions) for filing Form 1042 with respect to the calendar year in which the deemed distribution occurred.

viii. Under this approach, a withholding agent that continues to directly or indirectly hold or own the security when the requirements of Prop. Treas. Reg. § 1.1441-2(d)(4)(i) are satisfied generally would be able to satisfy its withholding obligation by withholding on future cash payments on the security (for example, an interest payment on a convertible bond).

ix. If, however, the security is disposed of before sufficient cash payments have been made on the security, the withholding agent would be required to withhold at the time of disposition and could do so by, for example, withholding on the proceeds from the disposal, liquidating other property held in custody for the beneficial owner, or obtaining other funds directly or indirectly from the beneficial owner to satisfy the withholding.

x. If there are insufficient future cash payments on the security and the security has not been disposed of or transferred before the due date (not including extensions) for filing Form 1042 regarding the calendar year in which the deemed contribution occurred, then, to avoid having to pay the tax out of the withholding agent's own funds, the withholding agent may apply current Treas. Reg. § 1.1461-2(b) in order to collect the withheld amount. Under these rules, the withholding agent can satisfy the tax by withholding on other cash payments made to the same beneficial owner or by liquidating other property held in custody for the beneficial owner for over which it has control. The proposed regulations amend Treas. Reg. § 1.1461-2(b) to clarify that a withholding agent may obtain the property from which to withhold under these rules through additional contributions obtained directly or indirectly from the beneficial owner.

xi. The proposed regulations also would add a sentence to current Treas. Reg. § 1.1461-2(b) to clarify that a withholding agent that satisfies its obligation to withhold under Treas. Reg. § 1.1461-2(b) will not be subject to any penalties for failure to deposit or failure to pay when it

deposits the amounts obtained in this manner by the due date (not including extensions) for filing Form 1042 regarding the calendar year in which the deemed distribution occurred. The preamble states these clarifications reflect the IRS's interpretation of the current regulations in applying these penalties.

xii. When the requirements of Prop. Treas. Reg. § 1.1441-2(d)(4)(i) are satisfied after a withholding agent has terminated its relationship with the beneficial owner of the security, the withholding agent would remain liable for any underwithheld amount regarding the deemed distribution. In order to avoid having to pay the tax due out of the withholding agent's own funds, before terminating an account relationship, the withholding agent should make arrangements with the beneficial owner to ensure that the withholding agent can satisfy any tax due, such as by retaining funds or other property of the owner.

xiii. Prop. Treas. Reg. § 1.1441-2(d)(4)(iii) would provide that a withholding agent may treat certain foreign entities (qualified intermediaries, withholding foreign partnerships, withholding foreign trusts, and U.S. branches treated as U.S. persons) as assuming primary Chapter 3 withholding responsibilities for a deemed distribution on a specified security only if (1) the withholding agent provides the foreign entity with a copy of the issuer statement described in Treas. Reg. § 1.6045B-1(b)(1) within 10 days of the issuer furnishing the statement to the holder of record or its nominee or (2) the issuer has met the public reporting requirements under Treas. Reg. § 1.6045B-1(a)(3).

xiv. The foreign entity would have an obligation to withhold on the deemed distribution only if it receives a copy of the issuer statement or if the issuer has met the public reporting requirements by the due date for filing Form 1042 regarding the calendar year in which the deemed distribution occurred.

xv. A withholding agent that fails to provide a copy of the issuer statement to a foreign entity (in the absence of public reporting) would not be permitted to treat the foreign entity as having assumed primary withholding responsibilities for the deemed distribution and would therefore have to withhold and report based on the information that is has regarding the recipient of the deemed distribution.

xvi. Under Prop. Treas. Reg. § 1.1441-3(c)(5), a withholding agent (other than the issuer of the specified security) would be permitted to rely on the information that an issuer provides on an issuer statement described in Treas. Reg. § 1.6045B-1(b)(1) or on a public website described in Treas. Reg. § 1.6045B-1(a)(3) to determine the proper amount of withholding on a deemed distribution on a specified security unless it knows that the information is incorrect or unreliable.

xvii. The proposed regulations would modify the regulations under Chapter 4 (FATCA) to provide guidance similar to the rules described above.

(b) Substitute Dividends.

i. Treas. Reg. § 1.861-3(a)(6) provides that a substitute dividend payment made to a transferor in a securities lending transaction or a sale-repurchase transaction is sourced in the same manner as a dividend on the transferred securities. The regulations define a substitute dividend payment as "a payment made to the transferor of a security in a securities lending transaction or sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction." The proposed regulations would modify Treas. Reg. § 1.861-3(a)(6) to clarify that a substitute dividend payment includes a deemed payment made in the amount (as determined under Treas. Reg. § 1.305-7(c)(4)) of a deemed distribution.

ii. The proposed regulations provide that the general exception to withholding in Treas. Reg. § 1.1441-2(d)(1)(i) does not apply for deemed payments (as defined in Treas. Reg. § 1.861-3(a)(6)). However, Prop. Treas. Reg. § 1.1441-2(d)(4) would allow a withholding agent to benefit from the same exception to withholding that would apply to deemed distributions (as defined in Treas. Reg. § 1.305-1(d)(7)) on a specified security for deemed payments defined in Treas. Reg. § 1.861-3(a)(6).

iii. Thus, the withholding agent would have an obligation to withhold on such a deemed payment only if, before the due date (not including extensions) for filing Form 1042 with respect to the calendar year in which the deemed distribution on the specified security occurred, either

(1) the issuer meets the reporting requirements under Treas. Reg. § 1.6045B-1 (by furnishing an issuer statement or publicly reporting the information required under that section) or (2) the withholding agent has actual knowledge that a deemed distribution has occurred, in which case the obligation to withhold with not arise until January 15 of the year following the calendar year of the deemed distribution or deemed payment.

(c) Other Rules and Effective Date.

i. The proposed regulations also modify the rules under § 6045B to facilitate broker reporting of a security's adjusted basis to the holder of the security.

ii. The § 305 regulations generally would apply to deemed distributions occurring on or after the date of publication of the proposed regulations as final. The taxpayer, however, may rely on the proposed regulations for deemed distributions occurring prior to that date.

E. Section 367: Stock/Asset Coordination.

1. Treasury and the IRS finalized temporary regulations that were issued in 2013 regarding indirect stock transfers and certain coordination rule exceptions. An IRS person described that regulations package (which contained more than solely the coordination rules) as an "International M&A Ph.D. course." I included diagrams of most of the regulation's examples. Thus, I will discuss them here only briefly. Moreover, the temporary regulations were finalized with virtually no changes. Thus, there is nothing new to discuss.

2. In brief, the temporary regulations removed one of the exceptions to the coordination rule. The coordination rule generally provides that if, in connection with indirect stock transfer, a U.S. person ("U.S. Transferor") transfers assets to a foreign corporation ("Foreign Acquiring Corporation"), in an exchange described in § 351 or § 361, § 367 applies first to the direct asset transfer and then to the indirect stock transfer.

3. Pursuant to the exceptions to the coordination rule, §§ 367(a) and (d) will not apply to the outbound transfer of assets by the U.S. Transferor to the Foreign Acquiring Corporation to the extent those assets are re-transferred by the Foreign Acquiring Corporation to a domestic corporation in certain nonrecognition transactions, provided certain conditions are satisfied. The continuing exceptions require that the transferee domestic corporation's adjusted basis in the re-transferred assets not be greater than the U.S. Transferor's adjusted basis in those assets, and that the indirect domestic

stock transfer exception rules are satisfied. This typically involves a transaction with an unrelated person.

4. There also was a so-called § 367(a)(5) exception, which was removed by the temporary regulations. The regulations are those at Treas. Reg. §§ 1.367(a)-3(d) and (e).

F. Section 245.

1. ILM 201640018 involves a US-parented corporate structure in which Sub E owns Sub 1, which owns Sub 2, which owns Sub 3, which owns Sub 4. Sub 4 owns Sub 5 and Sub 6. All are U.S. corporations. Under a plan, Sub 4 and Sub 5 were redomiciled in Country U and Sub 6 became a RIC (regulated investment company).

2. The purpose of the plan was to increase the U.S. Group's after-tax return on Business O investments by claiming an 80% dividends-received deduction ("DRD") with respect to income attributable to certain interest and capital gain derived from the investments. The taxpayer calculated the post-transaction yield on the investments at 130% of the pre-transaction yield, with the increased yield due to a decrease in the taxpayer's U.S. federal income tax liability. However, the revised structure would result in an improved after-tax yield only if a DRD were allowed. If a DRD were not allowed, the taxpayer's after-tax return would decrease because of the costs associated with the restructuring.

3. Under the plan, Sub 6 RIC would not pay U.S. federal income tax. It would invest in Business O investments and make distributions to its sole shareholder, Sub 4, during Year Y. Thus Sub 6 RIC would not pay U.S. federal income tax on its interest or capital gain income because its income would be offset by a dividends-paid deduction under §§ 852(b)(2)(D) and 852(b)(3)(A).

4. Sub 4 would not pay U.S. federal income tax. It will be a foreign corporation. It would not be subject to federal income tax on the distributions that it received from Sub 6 RIC, and Sub 6 would not be required to withhold tax on its distributions to Sub 4 during Year Y. §§ 871(k) and 881(e).

5. Sub 3 would not pay U.S. federal income tax. Sub 3 would not have an inclusion under § 951(a)(1) with respect to Sub 4 as a result of the distributions from Sub 6 RIC. The Sub 6 RIC distributions received by Sub 4 would constitute Subpart F income. However, Sub 3 would dispose of its Sub 4 stock before the close of a Sub 4's taxable year ending in Year Y and Sub 4 would remain a CFC after the disposition.

6. Sub 2 would pay, at most, a small amount of U.S. federal income tax. Sub 2 would have a Subpart F inclusion with respect to Sub 4 in Year Y

because Sub 2 would hold all of the stock of Sub Y on the last day of Sub 4's taxable year. However, Sub 2's pro rata share of Sub 4's Subpart F income would be reduced by the amount of Sub 4's distribution to Sub 3 during Year Y.

7. Sub 3 would claim an 80% DRD. Sub 4 would distribute the amounts that it received from Sub 6 RIC to Sub 3 during Year Y before Sub 3 disposed of its Sub 4 stock. Sub 3 would include the distribution in income as a dividend, and treat the entire amount as a U.S.-source dividend for purposes of § 245. Thus, Sub 3 would offset the dividend income with an 80% DRD. §§ 245 and 861(a)(2)(B).

8. Sub 4 (a Country U corporation) would change its taxable year at the outset of the transaction so that its taxable year would differ from the U.S. Group's taxable year.

9. On Date X in Year Y, Sub 6 RIC would distribute its Year X and Year Y income to Sub 4, and, in turn, Sub 4 would distribute the funds to Sub 3. Thus, by changing Sub 4's taxable year to a year different from the U.S. Group's taxable year, the US. Group would be able to defer including the income attributable to Sub 6 RIC's Year X earnings in the U.S. Group's income until Year Y.

10. The taxpayer asserted that its U.S. federal income tax position is consistent with the form of the transaction and the literal language of the Code. The taxpayer stated that its business purpose for the transaction was to maximize the return on its investments.

11. Section 245 allows a corporation a DRD on dividends received from qualified foreign corporations. Section 316 generally defines the term "dividend" as any distribution of property made by a corporation to its shareholders out of earnings and profits. Treas. Reg. § 1.312-6(b) provides that income exempted from taxation by statute is included in E&P. Sub 4 increased its E&P by the amount of the distributions it received from Sub 6 RIC. The taxpayer asserted that Sub 4's distributions to Sub 3 were dividends within the meaning of § 316 because the distributions were made out of E&P and that the dividends qualified for the § 245 DRD.

12. Section 245(a)(1) limits the amount of the § 245 deduction to an amount equal to the percent (specified in § 243) of the U.S. source portion of the dividends. The U.S. source portion of any dividend is an amount which bears the same ratio to the dividends as the post-1986 undistributed U.S. earnings bears to the total the post-1986 undistributed earnings.

13. During the years that the taxpayer engaged in the transaction, § 245 did not contain an explicit limitation that would have prevented distributions

from a RIC from being taken into account in determining the "U.S.-Source Portion" of a dividend paid by a qualified 10-percent owned foreign corporation. Section 326 of the Protecting Americans from Tax Hikes Act of 2015 added § 245(a)(12) to the Code to provide that, with respect to dividends received on or after December 18, 2015, for purposes of the definition of post-1986 undistributed U.S. earnings in § 245(a)(5)(B), a domestic corporation does not include a RIC or a real estate investment trust. Accordingly, distributions from Sub 4 attributable to distributions from Sub 6 RIC explicitly would not be eligible for the § 245 DRD under the revised statute. The Joint Committee on Taxation stated that "no inference is intended with respect to the proper treatment under § 245 regarding dividends received from RICs or REITs before that date."

14. Section 245(a)(5) limits the definition of "post-1986 undistributed earnings" to:

    (a) income of the foreign corporation which is effectively connected with the conduct of a trade or business within the United States and is subject to tax under the Code, or

    (b) any dividend received (directly or through a wholly-owned foreign corporation) from a domestic corporation at least 80% of the stock of which (by vote and value) is owned (directly through the wholly-owned foreign corporation) by the qualified 10-percent owned foreign corporation.

15. The funds that Sub 4 received from Sub 6 RIC are not "post-1986 undistributed U.S. earnings" within the meaning of § 245(a)(5)(A) because Sub 4 did not have income that was effectively connected with the conduct of a trade or business within the United States, and subject to U.S. federal income tax.

16. Pursuant to § 245(a)(5)(B), post-1986 undistributed U.S. earnings includes a dividend received from a domestic corporation. Section 854(a) states that a capital gain dividend received from a RIC shall not be considered a dividend for purposes of determining whether a shareholder is entitled to the DRD under § 243.

17. Section 854(b)(1) applies to distributions from a RIC other than those to which § 854(a) applies. It states that in computing any deduction under § 243, there shall be taken into account only the portion of the dividend reported by the RIC as eligible for the deduction in written statements furnished to its shareholders.

18. The shareholder of a RIC is only eligible for the § 243 DRD with respect to those distributions that are designated by the RIC as dividends eligible for such a deduction. The amount that a RIC designates for a taxable year

generally cannot exceed the amount of dividends the RIC receives from domestic corporations that would be eligible for the DRD if RICs were permitted to claim the DRD. Sub 6 RIC generally held only debt instruments and its income therefore constituted interest income and capital gain rather than dividends.

19. Sub 6 RIC did not issue a statement to Sub 4 that qualified any of the Sub 6 RIC distributions as dividends eligible for a DRD. Accordingly, Sub 4 could not claim a § 243 DRD with respect to Sub 6 RIC's distribution due to the application of §§ 854(a) and (b). If Sub 3 had directly held the Sub 6 RIC shares, it could not have claimed the § 243 DRD, either. Because Sub 3 would have been precluded from claiming a DRD under § 243 on direct distributions from Sub 6 RIC, the taxpayer inserted a foreign corporation between Sub 3 and Sub 6 RIC in order to claim a DRD under § 245 regarding dividends attributable to the Sub 6 RIC distributions. Section 854 does not discuss whether or not RIC distributions are taken into account in calculating the amount of dividends eligible for the DRD under § 245.

20. Although the Sub 6 RIC distributions to Sub 4 were not dividends eligible for the DRD under § 243, Sub 4 treated them as dividends received from a domestic corporation in calculating Sub 4's post-1986 undistributed U.S. earnings for purposes of § 245(a)(5)(B). According to the taxpayer, even though a member of the U.S. Group would not have been eligible to claim a DRD with respect to the interest income and capital gains derived from the Business O investments if it had received it directly, and likewise would not have been eligible to claim a DRD if it had received distributions from Sub 6 RIC attributable to that income, distributions attributable to the income are dividends eligible for the 80% § 245 DRD if funneled through Sub 4.

21. In addition to the general principles of Treas. Reg. § 1.1502-13(a) of the consolidated return regulations, Treas. Reg. § 1.1502-13(h) provides that if a transaction is engaged in or structured with a principal purpose to avoid the purposes of Treas. Reg. § 1.1502-13 (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of Treas. Reg. § 1.1502-13.

22. In the subject transaction, as in example 1 of Treas. Reg. § 1.1502-13(h), instead of carrying out a direct transaction, the consolidated group carried out a multiple-step plan that included an intercompany transaction in order to alter the group's consolidated taxable income. In each case, the taxpayer used a combination of steps to get a tax result that distorted the intended results of the consolidated return regulations.

23. The legal memorandum then discussed a number of cases involving economic substance and concluded that the taxpayer failed to satisfy the

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objective prong of the economic substance test. Moving Sub 4 to Country U, funneling funds to Sub 4 as a Country U corporation, and moving Sub 4 stock from Sub 3 to Sub 2, did not give the taxpayer any reasonable expectation of economic profit over and above the profit it could expect if a member of the U.S. Group directly invested in Business O investments or invested in a RIC that invested in the Business O investments. The taxpayer took these steps to avoid the application of § 854, which prevents Sub 3 from offsetting its income attributable to Sub 6 RIC's distributions with respect to the § 243 DRD and to avoid an inclusion under § 951 with respect to Sub 3.

24. The legal memorandum states that the Service also concluded, in the alternative, that the taxpayer failed to satisfy the objective prong of the economic substance test regarding its funneling of investment funds and its investment returns through a Country U corporation. The taxpayer did this to circumvent the application of § 854. Routing funds through Sub 4 did not give the taxpayer any reasonable expectation of economic profit over and above the profit it could expect if a member of the U.S. Group directly invested in Business O investments or invested in a RIC that invested in Business O investments.

25. The Service also held that the taxpayer failed to satisfy the business-purpose prong of the economic substance test. The taxpayer's stated business purpose for the transaction was to invest in Business O investments so as to maintain safety and soundness. However, the taxpayer did not provide a plausible business purpose for moving Sub 4 to Country U, funneling funds through Sub 4 as a Country U corporation, and moving the Sub 4 stock from Sub 3 to Sub 2.

26. Funneling the funds and investments through a Country U corporation also did not enhance the taxpayer's profit potential on the Business O investments (other than through tax savings) and did not serve any other non-tax business purpose.

27. The legal memorandum also discussed the step-transaction doctrine, including utilizing a conduit analysis.

G. ETI.

1. *DreamWorks Animation SKG, Inc.* v. *the United States*, ___ Fed. Cl. ____ (Ct. Cl. 2016), involved the question as to whether DreamWorks was entitled to continue tax benefits under Section 101(d) of the American Jobs Creation Act of 2004 ("AJCA") regarding extraterritorial income DreamWorks recognized in 2007, 2008 and 2009 from a licensing agreement that it entered into in 2006.

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2. From the 1970s to the 2000s, Congress provided tax exemptions for domestic corporations like DreamWorks that sold products abroad. The tax exemptions were challenged before the World Trade Organization as protectionist. In 2004, the extraterritorial income tax exemption was repealed by the AJCA.

3. Congress included several provisions in AJCA regarding implementing the repeal of the extraterritorial income tax exemption. AJCA § 101(c), titled "Effective Date," provided that the repeal would apply to "transactions after December 31, 2004."

4. Congress also included a transition provision titled "Transition Rule for 2005 and 2006." AJCA § 101(d) stated that "in the case of transactions during 2005 or 2006, the amount includable in gross income by reason of the amendments made by this section shall not exceed the applicable percentage of the amount which would have been so included but for this subsection."

5. Finally, AJCA included a "grandfather" or "savings" provision in § 101(f) which stated that "the amendments made by this section shall not apply to any transaction … which occurs pursuant to a binding contract … which is in effect on September 17, 2003 and at all times thereafter."

6. DreamWorks argued that the transition rule in § 101(d) applied to extraterritorial income generated from any transaction entered into during 2005 and 2006 regardless of when the income was recognized. Thus, DreamWorks argued that the extraterritorial income it recognized in 2007, 2008 and 2009 from a licensing agreement that it entered into in 2006 was covered by the transition rule.

7. The government argued in its motion for summary judgment that the transition rule did not provide for the continued tax benefit DreamWorks sought. According to the government, the transition provision was intended to provide only for the orderly implementation of the repeal of the extraterritorial income tax exemption for a period of two years only and it was not intended to provide a long-term tax break. Put another way, the government argued that the transition rule was not intended to serve as a savings provision for extraterritorial income generated from transactions entered into in 2005 and 2006 and recognized in later years in order to protect taxpayers from AJCA's repeal of the extraterritorial income tax exemption. Rather, the government asserted that the extraterritorial income benefits under the transition rule expired at the end of 2006. As such, the government argued that DreamWorks was not entitled to refunds based on extraterritorial income that it recognized in 2007, 2008, and 2009.

8. The Court held for the government, and rejected DreamWorks' motion for summary judgment. The Court felt that the legislative history confirmed that the government was right.

IX. TREATIES.

A. New Competent Authority Procedures.

1. Rev. Proc. 2015-40 contains updated competent authority procedures. The principal differences between the revenue procedure and the proposed version of the revenue procedure published with Notice 2013-78 include:

    (1) The revenue procedure narrows the scope of requests to which mandatory pre-filing procedures apply to requests involving taxpayer-initiated positions. A competent authority request that does not involve a taxpayer-initiated position does not require mandatory pre-filing, although the pre-filing procedures are optional in such a case.

    (2) Taxpayers will not be required to expand the scope of a competent authority request to include interrelated issues as a condition of receiving competent authority assistance. Taxpayers may still be required to provide information that will allow the U.S. competent authority to evaluate the appropriateness of the relief sought under the applicable U.S. tax treaty in light of the taxpayer's positions on interrelated issues.

2. An example of an interrelated issue assumes that a competent authority request is made concerning a company's ongoing license of intangible property to a second company in the same controlled group and that the intangible property covered by the license had been sold in an earlier taxable year by the second company (the licensee) to the first company (the licensor). In such a case, the U.S. competent authority may consider the assumptions underlying the valuation of the intangible property when it was previously sold in evaluating the ongoing license.

3. A second example involves a cost sharing agreement. If a competent authority issue presented by the taxpayer involves the valuation of a platform contribution transaction in a cost sharing agreement, the U.S. competent authority also may consider whether the intangible development costs incurred pursuant to the arrangement were properly shared.

4. The U.S. competent authority may request that the taxpayer amend its request to include interrelated competent authority issues that the U.S. competent authority identifies. The U.S. competent authority also may recommend that the taxpayer file a bilateral or multilateral APA request to cover the competent authority issues and the identified interrelated

competent authority issues. As noted above, if the taxpayer declines to amend its competent authority request, the U.S. competent authority will still endeavor to reach a resolution, but will take into account the taxpayer's positions on interrelated issues in determining the extent to which it will provide relief for the competent authority issues in the request.

(1) The revenue procedure clarifies that the U.S. competent authority may consult with taxpayers with respect to certain additional issues that may arise in connection with competent authority requests, such as issues relevant to the determination of foreign tax credits and repatriation payments. This is a helpful clarification that is discussed further below.

(2) The U.S. competent authority will not condition assistance on the taxpayer's notification of the U.S. competent authority, or on obtaining its concurrence, regarding signing a standard Form 870 with IRS Examination. Similarly, a taxpayer will not be required to obtain the U.S. competent authority's agreement prior to entering into a closing agreement or similar agreement with IRS Examination, but in these cases the assistance provided by the U.S. competent authority will be limited to seeking correlative relief from the foreign competent authority, thus potentially not eliminating double taxation.

5. This is a big improvement over the proposed competent authority procedures. Under the proposed procedures, the U.S. competent authority would not accept an Exam resolution if the U.S. competent authority had not agreed to the terms of the resolution prior to its execution. Tax Executives Institute ("TEI") among others commented adversely with respect to this issue as proposed in Notice 2013-78.

6. Appeals and Competent Authority.

(a) Other changes from the proposed version in Notice 2013-78 were made. In general, these changes are very helpful in eliminating some of the surprising harshness of the competent authority procedures as proposed in Notice 2013-78. The major exception: the rules dealing with the interrelationship of competent authority and Appeals. These rules remain a major problem, and would seem to strip Appeals of its historic and impartial role when an issue might ultimately go to competent authority.

(b) A taxpayer may request a simultaneous Appeals procedure ("SAP") review, which is a review of a competent authority issue under the jurisdiction of the U.S. competent authority with the assistance of IRS Appeals. For a competent authority issue that is

initially under the jurisdiction of IRS Appeals, that is, a protest was filed, the U.S. competent authority will decline to provide assistance unless the taxpayer, in connection with certain requirements in the revenue procedure, effectively severs the issue from its protest and then timely files a U.S. competent authority request with respect to the issue.

(c) SAP review is described as an optional aspect of the U.S. competent authority process "whereby IRS Appeals works jointly with the U.S. competent authority and the taxpayer toward the development of the U.S. competent authority's position on an underlying U.S.-initiated adjustment prior to the U.S. competent authority's consultations with the foreign competent authority."

(d) The revenue procedure states that the procedure is intended to facilitate the U.S. competent authority's unilateral consideration of a resolution of the competent authority issue before it presents its position to the foreign competent authority. A taxpayer may request SAP review as part of its competent authority request or in a separate written submission filed no later than 60-days after the taxpayer receives notification that the U.S. competent authority has accepted its competent authority request.

(e) The U.S. competent authority in its sole discretion will decide whether to accept the taxpayer's request for SAP review after consulting with IRS Appeals and after considering whether SAP review would unduly burden tax administration, including the competent authority process.

(f) If the U.S. competent authority accepts a request for SAP review, it will notify the taxpayer and coordinate with both the taxpayer and IRS Appeals on process and timeframe. The manner in which SAP review is conducted will be determined by the U.S. competent authority on a case-by-case basis after consulting with IRS Appeals. In general, IRS Appeals will begin SAP review by reviewing the positions previously taken on the competent authority issues by IRS Examination and the taxpayer and consulting with the taxpayer and the U.S. competent authority. IRS Appeals will conduct its review and consultations in accordance with standard IRS Appeals practices except that the U.S. competent authority will participate in meetings held between IRS Appeals and the taxpayer. IRS Appeals and the U.S. competent authority will consult on whether other exceptions to standard IRS Appeals practices may be appropriate in a given case.

(g) The U.S. competent authority will consider the points raised in SAP review before deciding upon the position it will present to the

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foreign competent authority. Any discussion with respect to the positions taken in SAP review, whether written or oral, are not binding on the taxpayer, the U.S. competent authority or IRS Appeals.

(h) At any point during SAP review, the U.S. competent authority in its sole discretion may terminate the review with regard to one or more competent authority issues after consulting with IRS Appeals. The standard competent authority process will then apply to any issues removed from SAP review.

(i) The taxpayer also may withdraw its request for SAP review with regard to one or more competent authority issues at any time during the process. The U.S. competent authority, in turn, will decide whether to continue SAP review for any competent authority issues the taxpayer chooses to retain. The standard competent authority process will then apply to any competent authority issues removed from SAP review.

(j) A taxpayer that initially presents a competent authority issue to IRS Appeals (that is, the taxpayer filed a protest) may still request U.S. competent authority assistance only if it satisfies the following conditions: (1) the taxpayer files it competent authority request no later than 60-days after its opening conference with IRS Appeals; (2) the competent authority request shows that the taxpayer has properly severed the competent authority issue from the issues in the protest that remain under the jurisdiction of IRS Appeals; (3) the taxpayer has not invoked an alternative dispute resolution program under the jurisdiction of IRS Appeals with respect to the competent authority issue; and (4) the taxpayer has not executed with IRS Appeals a Form 870AD, closing agreement, or any other similar agreement containing the competent authority issue.

(k) If, during the course of reviewing the taxpayer's issues and after the 60-day period described above has begun, the IRS Appeals representative determines that a potential competent authority issue exists that had not been identified by IRS Examination, the deadline for filing the competent authority request under the provisions discussed above will be 60-days after the date the taxpayer is first notified that a potential competent authority issue exists.

(l) The U.S. competent authority may accept the competent authority request as to some or all of the severed issues. If the competent authority accepts the request with respect to only particular severed issues, the U.S. competent authority will assume jurisdiction over

only those severed issues, and IRS Appeals procedures will continue to apply to the other severed issues. The taxpayer also may request SAP review with respect to the competent authority issues severed from the IRS Appeals protest, and the U.S. competent authority will consider whether to accept the request for SAP review.

(m) The revenue procedure does not limit the ability of a taxpayer to obtain IRS Appeals review of a competent authority issue set forth in its competent authority request if, with respect to that competent authority issue: (1) the U.S. competent authority rejects the request or terminates the process; (2) the taxpayer withdraws its request for competent authority assistance; (3) the competent authorities do not reach a resolution; or (4) the taxpayer does not accept the terms of the competent authority resolution.

(n) If, prior to the effective date of the revenue procedure, either: (1) the IRS has issued a 30-day letter notifying the taxpayer of the right to request IRS Appeals consideration of a competent authority issue; or (2) the competent authority issue is before IRS Appeals, the procedures and time frames set forth in Rev. Proc. 2006-54 (the predecessor to Rev. Proc. 2015-40) will apply to the competent authority issue.

(o) The rules applicable to the interrelationship of competent authority and Appeals as described in Notice 2013-78 were the subject of substantial criticism by commenters. The proposed version of the revenue procedure had a 30-day period to exit Appeals. This is now a 60-day period. TEI stated in its comments that the short deadline would put tremendous pressure on the first Appeals conference and would inevitably restrict the ability of Appeals officers to perform their normal role. The taxpayer will also be under pressure to quickly make tough decisions regarding whether it wishes to continue with the normal Appeals process and therefore forego an opportunity to pursue a later competent authority case or to immediately move to a competent authority case for mutual agreement procedure issues that are involved in the Appeals process. While 60 days is a longer period than 30 days, TEI's comments still stand, in my view.

(p) TEI also stated that the procedures represent a significant diminution of the role of Appeals and would jeopardize Appeals' independence. As a result, stated TEI, taxpayers would be denied an independent review by Appeals regarding unagreed issues if they wish to seek relief from double taxation in those cases. My observation: this is as true as it was when TEI made its comments.

(q) Regarding the proposed change, TEI recommended that the role of the U.S. competent authority be advisory and that Appeals remain the primary decision maker regarding issues that are subject to the Appeals proceeding. Obviously, this recommendation was not accepted.

7. Other Changes.

(a) The U.S. competent authority is available for informal consultations with taxpayers (including consultations in which the taxpayer chooses to be anonymous) regarding any competent authority issue. These consultations are available even when the issues are not themselves competent authority issues. For example, states the revenue procedure, the taxpayer may consult the U.S. competent authority on foreign tax credit issues, which may cover, when appropriate, considerations surrounding administrative or other steps that might be available to the taxpayer in the foreign jurisdiction.

(b) This appears to be a very helpful watering down of the strong language used in the proposed revenue procedure. The proposed revenue procedure referred to the steps the taxpayer must take to establish that a foreign tax paid, or to be paid, will qualify as a compulsory payment for foreign tax credit purposes. Commentators, including TEI, were concerned that the language in the proposed revenue procedure would make pursuing this competent authority consultation one of the required steps that the taxpayer must take to establish that amounts paid to a treaty country constitute compulsory payments for foreign tax credit purposes. The "required" steps specified in this competent authority consultation presumably also would need to be taken. The relevant § 901 regulation, however, provides that a remedy is effective and practical only if the cost and risk are reasonable in light of the amount at issue and likelihood of success.

(c) Most U.S. treaties contain a limitation on benefits ("LOB") article that enumerates objective tests to determine whether a resident of a treaty country is entitled to benefits under the treaty. Most LOB articles also provide that a resident may be granted treaty benefits at the discretion of the U.S. competent authority if the resident does not qualify for those benefits under the relevant objective test.

(d) The U.S. competent authority will not issue a determination regarding whether an applicant satisfies an objective LOB test. Also, the U.S. competent authority will not accept a discretionary LOB request unless the applicant, as part of its request, represents

that, and explains why, it does not qualify for the requested benefits under the treaty's LOB provision.

(e) The U.S. competent authority typically will not exercise its discretion to grant benefits in certain specified cases: (1) the applicant or any of its affiliates is subject to a special tax regime in its country of residence with respect to the class of income for which benefits are sought (such as a regime for interest income that permits a notional interest deduction with respect to equity); (2) no or minimal tax will be imposed on the item in both the country of residence of the applicant and the country of source, taking into account both domestic law and the treaty provision ("double non-taxation"); (3) the applicant bases its request solely on the fact that it is a direct or indirect subsidiary of a publicly-traded company in a third country and the relevant withholding rate provided in the tax treaty between the U.S. and the country of residence of the applicant is not lower than the corresponding withholding rate in the tax treaty between the U.S. and the country of residence of the parent company or any intermediate owner.

(f) There are a number of other provisions in the revenue procedure including coordination with litigation, reasons for denial or termination of assistance, treaty arbitration provisions, filing protective claims with the competent authority, treaty notifications, and the like. The new revenue procedure is effective for competent authority requests filed on or after October 30, 2015.

B. Competent Authority Statistics.

1. The IRS released its annual competent authority statistics for 2015. Part 1 presents statistics concerning cases involving the allocation and attribution of business profits, and Part 2 presents statistics under all other treaty articles.

2. During 2015, 193 APMA allocation cases were resolved, an unusually high number. Foreign-initiated cases (171) accounted for nearly 90% of the total, a skewing significantly higher than in the two previous years.

3. Excluding the 5 cases that were withdrawn by the taxpayer, 97% of the remaining 188 APMA cases resulted in full relief. Only 3 cases were resolved with less than full relief, and only 3 resulted in no relief.

4. Of the 171 foreign-initiated APMA cases, the taxpayer withdrew its case in 4, there was no relief in 2, and partial relief in 3. In each of the other 162 cases, full relief resulted. In 25, the foreign country withdrew the adjustment.

5. Of the 22 U.S.-initiated APMA cases, the taxpayer withdrew its case in 1, there was no relief in 1, and in each of the other 20, full relief resulted. In 9, IRS Exam withdrew its adjustment.

6. Processing time for APMA cases increased over previous three years to 27.7 months for U.S.-initiated adjustments and 32.7 months for foreign-initiated adjustments.

C. Starr International: Treaty Issue – Part I[5]

1. A federal district court held in *Starr International Co. v. United States*, ___ F. Supp. 2d ____ (D.D.C. 2015), that the IRS's decision to deny discretionary treaty benefits in the form of a lower dividend withholding tax rate was judicially reviewable, finding that the decision is not committed exclusively to the agency's discretion. This is an important case of first impression.

2. Starr transferred its insurance business to AIG in the 1970s and became the largest holder of AIG common shares. At that time Maurice Greenberg was the chairman of the board of both companies, and AIG's CEO. For the next several decades, Starr funded discretionary compensation plans for AIG executives. In 2004, Starr moved its headquarters from Bermuda to Ireland and began to take advantage of the U.S.-Ireland tax treaty, which reduced Starr's U.S. withholding tax rate on AIG dividends to 15%.

3. The next year, amidst an investigation by New York's Attorney General, Greenberg stepped down as CEO of AIG, and Starr ceased funding AIG's executive compensation plan. Starr relocated its headquarters to Switzerland, allegedly to protect its assets from an AIG lawsuit claiming that Starr was contractually obligated to continuing funding the plan. In fact, a lawsuit did arise with AIG unsuccessfully claiming ownership of the AIG shares held by Starr. 648 F. Supp. 2d 546 (S.D.N.Y. 2009).

4. Under the U.S.–Swiss treaty, a Swiss company receiving dividends from a U.S. company is automatically entitled to halve its withholdings under certain enumerated circumstances, such as when the Swiss company does significant business in Switzerland or is listed on a recognized stock exchange. This is the treaty's Limitation on Benefits article. If a company is not automatically entitled to those benefits under the treaty it "may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income arises so determines after consultation with the competent authority of the other Contracting State."

[5] After reading the facts, the reader should fast forward to Starr – Part II.

5. In 2007, Starr requested benefits under this discretionary relief provision by a letter to the U.S. competent authority. In doing so, Starr acknowledged that it was not entitled to treaty benefits under any of the enumerated, mandatory categories. In March 2010, not having received a response to its letter but wishing to preserve its right to a refund, Starr sent a 2007 tax return form to the IRS contending that it had overpaid $38 million in taxes. In October 2010, the U.S. competent authority denied Starr's request to apply the treaty to reduce Starr's 2007 withholding tax. Curiously, Starr was later issued a treaty-based refund for its 2008 withholding taxes.

6. Starr filed in court in September 2014, claiming the IRS had erroneously denied its request for benefits under the treaty. Starr contends that the IRS abused its discretion because (1) Starr was not treaty shopping when it relocated to Switzerland, (2) the IRS failed to consult with the Swiss competent authority for denying Starr's request, and (3) the IRS had no legal basis for issuing Starr a 2008 refund while denying its 2007 refund based on the same material facts.

7. The IRS has raised two main defenses to Starr's claims: that the U.S. competent authority's decision is committed to agency discretion by law and, alternatively, that the court lacks jurisdiction under the political-question doctrine.

8. <u>Analysis</u>.

    (a) Before deciding whether the committed-to-agency-discretion exception to judicial review barred the court from hearing Starr's claim, the court said it needed to decide whether the exception even applied. Starr brought its case under provisions of the United States Code and not the Administrative Procedure Act ("APA"). The question was whether the committed-to-agency-discretion exception is limited to suits brought under the APA.

    (b) The committed-to-agency-discretion exception is linked closely to language in the APA, which states that agency action is generally reviewable "except to the extent that…it is committed to agency discretion by law." The IRS cited this provision of the APA claiming that denials of the tax benefits in issue are "committed to agency discretion by law."

    (c) The court held that the exception is not limited to suits brought under the APA and that the IRS may thus attempt to invoke. The APA does explicitly carve out an exception to judicial review for action that is committed to agency discretion by law. Under these principles, "A matter committed to agency discretion is not

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reviewable because courts lack judicially manageable standards by which to evaluate it."

(d) Other courts have considered the committed-to-agency-discretion exception in the context of tax disputes not brought under the APA. Specifically, courts have applied this exception – and found judicial review unavailable – in interest-abatement suits, in which taxpayers sought reductions in interest on late taxes by arguing that the IRS caused any delays.

(e) Starr cited *Tax Analysts & Advocates v. Shultz*, 376 F. Supp. 889 (D.D.C. 1974), in arguing that an IRS decision to deny tax-treaty benefits is judicially reviewable. There an interest group challenged an IRS revenue ruling related to gift-tax treatment of contributions to political organizations, and the IRS claimed that its ruling was committed to the sole discretion of the agency unless challenged in a refund suit. Acknowledging that the committed-to-agency-discretion exception is a very narrow exception, the court rejected the IRS's defense because it cited no law which commits IRS action to IRS discretion.

(f) *Tax Analysts* thus held that the committed-to-agency-discretion exception to judicial review does not categorically apply to all IRS decisions, but it did not foreclose the possibility that the exception could apply to some IRS decisions.

(g) Having found that the committed-to-agency-discretion exception to judicial review may be invoked in tax-refund suits, the court next addressed whether the treaty at issue precludes judicial review. Absent an express statutory prohibition on judicial review, courts have been extremely hesitant to find such a bar. The mere fact that a statute grants broad discretion to an agency does not render the agency's decision completely non-reviewable under the committed-to-agency-discretion exception unless the statutory scheme, taken together with other relevant materials, provides absolutely no guidance on how that discretion is to be exercised.

(h) Having found that the discretionary provision of the treaty is not categorically non-justiciable, the court turned to its "language, structure and history." The court stated that the treaty text alone left entirely open what the competent authority may consider when she "so determines" whether to grant or deny the benefits. Such broadly permissive language may indicate an intent to render agency action unreviewable.

(i) Many statutes, however, afford agencies significant autonomy while remaining subject to judicial review. Permissive language

alone may not be enough to demonstrate that a decision has been committed to agency discretion. Without such clear and convincing evidence, the general presumption favoring judicial review of administrative action is controlling.

(j) Neither Starr nor the IRS considered the discretion a provision in a vacuum: both looked to the Treasury Department's Technical Explanation of the treaty. The court said that technical explanations serve as an analog to legislative history for treaty ratification, and courts consult these explanations when construing treaty language.

(k) Here, the Technical Explanation provided that the

> "[discretionary] provision is included in recognition of the fact that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by the third country residents in an enterprise of a Contracting State is warranted by sound business practice or long-standing business structures and does not necessarily indicate a motive of attempting to derive unintended Convention benefits."

(l) In other words, stated the court, the treaty is designed to ensure that legitimate Swiss and U.S. businesses do not pay full taxes in both countries, while also preventing companies from "treaty shopping" by changing their citizenship purely to obtain preferential tax treatment. The Technical Explanation thus clarifies, to a large degree, the applicable legal standard when the Treasury evaluates a claim for benefits under the discretionary provisions. The Technical Explanation, which was transmitted to the Senate before it consented to the treaty, thus put the Senate on notice of how the IRS would endeavor to exercise its authority under the discretionary provision.

(m) So, too, the testimony offered to the Senate Foreign Relations Committee by the Treasury Department's Deputy Assistant Secretary for International Tax Affairs. He said that, when implementing the discretionary provision, the IRS would seek to determine whether entities "can establish a substantial non-treaty-shopping motive for establishing themselves in their country of residence.

(n) Moreover, the IRS effectively acknowledged in its formal letter denying Starr's refund for the 2007 tax year that it relies on the standard described in the Technical Explanation to make determinations under the discretionary provision.

(o) Although the treaty does not expressly preclude judicial review, the discretionary provision may still be nonjusticiable if any standards the court might apply are so broad and vague that judicial review would be "conceptually equivalent to … no review at all." While the discretionary provision says that the competent authority "may" grant benefits if she "so determines," the Technical Explanation elaborates that she "*will* base a determination … on whether the establishment, acquisition or maintenance of the person seeking benefits under the Convention, or the conduct of such person's operations, has or had one of its principal purposes the obtaining the benefits under the Convention."

(p) The court stated that courts routinely face somewhat amorphous and open-ended standards. The D.C. Circuit has held the phrase "in the interest of justice" provides sufficient guidance to allow at least some minimal judicial review.

(q) Put simply, the committed-to-agency-discretion exception to judicial review is extremely narrow where, as here, no presumption of unreviewability applies. The Technical Explanation provides meaningful standards that would enable the court to determine whether the IRS abused its discretion in denying treaty benefits. Because this inquiry is not directionless, the court held that denials of tax benefits under the discretionary provision are not committed to the IRS's unreviewable discretion.

(r) The IRS also argued that the court may not review the U.S. competent authority's decision to deny Starr benefits under the treaty because to do so would run afoul of the political-question doctrine. That doctrine, like the committed-to-agency-discretion principle, is a "narrow exception" to the federal courts' duty to decide cases properly before them.

(s) The Supreme Court recently explained that a political question exists where there is "a textually demonstrable constitutional commitment of the issue to a coordinate political department; or a lack of judicially discoverable and manageable standards for resolving it.'" The court stated that it had already determined that the discretionary provision—read in conjunction with the Technical Explanation—provided a sufficiently manageable standard for judicial review. That being so, the propriety of denying Starr's request for benefits under the treaty is also not committed to the Executive Branch's unfettered discretion.

(t) The IRS argued that judicial review under the discretionary provision's consultation requirement would impinge on the

Executive Branch's allegedly exclusive authority to "formulate and implement foreign policy." The court said that requirement is not presently implicated, because the treaty does not condition the *denial* of treaty benefits on prior consultation with Swiss officials. The relevant treaty official needs "consult with the competent authority of the other contracting state" only when a claimant would be "*granted* the benefits of the convention."

(u) The decision to award or deny tax-treaty benefits does not require a policy determinations or diplomatic value judgments. Assessing litigants' entitlement to relief under federal law is, rather, "a familiar judicial exercise."

(v) The case will next proceed to a determination as to whether the U.S. competent authority abused its discretion in denying Starr the requested relief.

D. Starr International – Part II

1. In *Starr International* – Part II, the government asked the court to reconsider its prior ruling. The government contended that the court misapprehended a key aspect of the treaty provision at issue: the requirement that the IRS "consult" with its Swiss counterparts prior to any final decision to grant treaty benefits. The government argued that separate-of-powers principles prevent the court from forcing the IRS to consult with the Swiss authorities or dictating the outcome of any consultation because doing so would impinge on the Executive's authority to conduct foreign relations.

2. The court agreed to revisit certain aspects of its prior ruling. The court's earlier decision focused primarily on whether the treaty and surrounding materials supplied a manageable standard for assessing whether Starr met certain criteria required to obtain treaty benefits. The court reaffirmed its holding that such a standard exists and that, therefore, the IRS's determination that Starr did not meet the applicable criteria is subject to judicial review. The court also stood by its ruling that interpreting the terms of the treaty in a manner necessary to determine whether Starr met the applicable criteria would not offend the political-question doctrine. ____ F. Supp. ____ (D.D.C. 2016).

3. The court previously found that the "consultation" requirement was not presently implicated because consultation is required only before a decision to grant treaty benefits whereas here the IRS denied benefits to Starr.

4. With the benefit of additional briefing and argument on what treaty consultation typically entails, however, the court nonetheless concluded

that justice required it to revise its finding. The court said it was not particularly swayed by the government's argument that the court cannot force the IRS to consult with its Swiss counterparts. The government had never represented that the IRS would refuse to consult were the court to determine that it abused its discretion in denying Starr treaty benefits. As government counsel acknowledged at oral argument "That is not going to happen." Thus, the court stated that its power in that regard was beside the point.

5. The court said that more persuasive was the government's contention that the court lacked the power to dictate the outcome of the consultation process. As the court now understood it, treaty consultation is a diplomatic exchange that can affect the ultimate outcome of a decision whether to award benefits, and the extent of those benefits, in numerous ways. As such, it would impinge upon the Executive's prerogative to engage in that process if the court were to render consultation meaningless or dictate its outcome. The court stated that ordering the IRS to issue Starr a specific monetary refund would do precisely that.

6. Starr was not left without a potential remedy, however. Anticipating that it might reach today's result, the court sought supplemental briefing on whether Starr could pursue a claim to set aside the IRS's decision to deny treaty benefits under the judicial-review provision of the Administrative Procedure Act ("APA"). The court then held that Starr may bring such a claim. Accordingly, the court granted in part the government's motion for reconsideration; vacated its order granting Starr's motion to strike the government's defenses and denying the government's motion to dismiss the complaint; and dismissed Starr's complaint without prejudice.

7. Although the court found that Starr may not pursue monetary relief, it stated that it would allow Starr to amend its complaint to seek to have the IRS's decision set aside under the APA. In the interests of efficiency, the court also granted in part the government's motion for a scheduling order on its counterclaim against Starr, which alleges that the IRS erroneously issued a refund for the 2008 tax year on the basis of an improperly submitted return.

E. New U.S. Model treaty.

1. On February 17, 2016, Treasury released its revised 2016 Model Income Tax Treaty, which is the baseline text Treasury will use when it negotiates future tax treaties. The U.S. model income tax convention was last updated in 2006. A draft version of these new model treaty provisions was released for public comment in May 2015. As a result of comments, Treasury made a number of significant revisions to the proposed model treaty provisions.

2. Special Tax Regimes.

(a) Treasury received several comments on the proposed rules that would deny reductions in withholding taxes under a treaty for deductible related-party payments when the beneficial owner of the payment pays little or no tax on the related income as a result of a "special tax regime" ("STR").

(b) Some countries have implemented preferential regimes to attract highly mobile income by allowing resident companies to pay no or very little tax on their net income. Consistent with the BEPS initiative, the STR provisions are intended to mitigate instances of double non-taxation in which a taxpayer uses provisions in a tax treaty, combined with STRs, to pay no or very low tax in either treaty country. The preamble to the model treaty states that the new STR provisions also reflect the U.S.'s preference for addressing BEPS concerns through changes to objective rules that apply on a prospective basis, rather than introducing subjective standards that could call into question agreed treaty benefits or applying wholly new concepts to prior years.

(c) Comments on the May 2015 Draft expressed concern that the proposed definition of STR was too broad and would result in uncertainty as to when treaty benefits would be denied. In response to these comments the STR provisions have been significantly revised to both limit and clarify their application:

- The scope of when the STR provisions can apply has been narrowed to cases in which the resident benefits from an STR with respect to a particular related-party interest payment, royalty payment, or guarantee fee that is within the scope of Article 21 (Other Income).

- The definition of STR has been tightened to provide an exclusive list of the circumstances in which a statute, regulation, or administrative practice will be treated as an STR. The regime must provide preferential treatment to interest, royalties, or guarantee fees as compared to income from sales of goods or services.

- This preferential treatment must be in the form of either a preferential rate for the income, a *permanent* reduction in the tax base with respect to the income (as opposed to preferences that merely defer the taxation of income for a reasonable period of time), or a preferential regime for companies that do not engage in an active business in the residence state.

- Regimes that provide "notional interest deductions" ("NIDs") with respect to equity are no longer treated as STRs. Instead, Article 11 (Interest) includes a new rule that would allow a treaty partner to tax interest in that country in accordance with the domestic law if the interest is beneficially owned by a related person that benefits from an NID.

- A country seeking to invoke the STR provisions must consult with the other country first and then notify the other country of its intention through a diplomatic note and issue a written public notification.

- In response to comments on how to determine when a payee that benefits from an STR is "related to the payor" of an item of income, the 2016 Model provides that the STR provisions will only apply when the payee is a "connected person" with respect to the payor of the income and provides a definition of that term.

- The exceptions from the STR provisions for collective investment vehicles such as U.S. regulated investment companies and U.S. real estate investment trusts that are designed to achieve a single level of current tax (at either the entity level or the shareholder level) were clarified.

- The 2016 Model provides an exception for preferential regimes that are generally expected to result in a rate reduction that is at least 15%, or 60% of the general statutory rate of company tax in the source country, whichever is lower. The model treaty also provides language that would be included in an instrument reflecting an agreed interpretation between the two treaty countries.

3. Payments by Expatriated Entities.

(a) The 2016 Model Treaty contains provisions that would reduce the benefits of corporate inversions by denying treaty benefits for U.S. withholding taxes on U.S. source dividends, interest, royalties and certain guarantee fees paid by U.S. companies that are "expatriated entities," as defined under the Internal Revenue Code.

(b) In response to comments, Treasury made several revisions to the proposed version of these provisions. First, the 2016 Model provisions will apply only when the beneficial owner of a dividend, interest payment, royalty, or guarantee fee characterized

as other income is a connected person with respect to the expatriated entity.

(c) Second to provide certainty about the scope of the rule notwithstanding any future changes to U.S. law, the model treaty fixes the definition of "expatriated entity" to the meaning it has under § 7874(a)(2)(A) as of the date the bilateral treaty is signed.

(d) Third, the 2016 Model provides that, under certain circumstances, pre-existing U.S. subsidiaries of the foreign acquiror will not be considered expatriated entities for purposes of the treaty.

4. Revised Limitation on Benefits ("LOB") Article.

(a) The 2015 Draft included a number of proposed changes to Article 22 dealing with the LOB provisions. The 2016 Model contains significant revisions to the proposed changes in response to comments.

(b) LOB rules are designed to prevent "treaty shopping." While protecting the U.S. treaty network from abuse is the overarching objective of Article 22, Treasury also recognizes that multinationals often have operations disbursed in many subsidiaries around the globe. Accordingly, the 2015 Draft proposed to include for the first time in the U.S. model a "derivative benefits" test as an additional method of satisfying the LOB provisions. The 2016 Model retains a version of this test that was modified in response to comments and adds a second new test, a "headquarters company" test. In addition, a number of the pre-existing LOB provisions were tightened to prevent abuse by third-country residents.

i. Active-Trade-or-Business Test

(a) The May 2015 Draft proposed a new limitation on the ability of connected entities to aggregate their activities for purposes of satisfying the LOB test regarding income that is derived by a company in connection with the active conduct of a trade or business in its country of residence (the active-trade-or-business test).

(b) The change to the active-trade-or-business test in the Draft was motivated by a concern that the existing active-trade-or-business test can, in certain circumstances, allow third-country residents to treaty shop through an entity that has an active trade or business in a treaty country with respect to

income, in particular intra-group dividends and interest, that does not in fact have a nexus to the activities of the treaty partner.

(c) After further consideration, Treasury determined that the treaty-shopping concern is not driven by the division of activities among connected persons. Rather, states the preamble, the concern arises from the standard applied to determine whether income is "derived in connection with" an active trade or business in the residence country.

(d) To more directly address this concern, the active-trade-or-business test of the 2016 Model requires a factual connection between an active trade or business in the residence country and the item of income for which the benefits are sought. Specifically, the 2016 Model requires that the treaty-benefitted income "*emanates* from, or is incidental to," a trade or business that is actively conducted by the resident in the residence state.

(e) The technical explanation of the 2016 Model, which Treasury plans to release this spring, will provide guidance on when an item of income, in particular an intra-group dividend or interest payment, is considered to emanate from the active conduct of a trade or business of a resident. Treasury is considering an example that involves dividends and interest paid by a commodity-supplying subsidiary that was acquired by a company whose business in the residence state depends on a reliable source for the commodity supplied by the subsidiary. The dividends and interest would be considered to emanate from the active trade or business of the parent. The preamble states that another possible example could involve dividends and interest paid by a subsidiary that distributes products that were manufactured by the parent country in its state of residence. In contrast, the mere fact that two companies are in similar lines of business would not be sufficient to establish that dividends or interest paid between them are related to the active conduct of a trade or business.

(f) Treasury invited comments regarding additional examples for potential inclusion in the technical

explanation that would illustrate dividend or interest income that should be considered to emanate from an active trade or business in the residence state.

ii. *Derivative Benefits*

(a) The 2016 Model allows companies to qualify for treaty benefits under a "derivative benefits" test, which is based on a broader concept of the longstanding "ownership-and-base erosion" test. While a form of derivative benefits is included in most U.S. treaties with countries in the European Union, those treaties limit third-party ownership to seven or fewer "equivalent beneficiaries," which generally must be resident in a member country of the European Union or the North America Free Trade Area.

(b) In contrast, the derivative benefits rule in the 2016 Model contains no geographic restriction, instead requiring only that 95% of the tested company's shares be owned directly, or indirectly, by seven or fewer persons that are equivalent beneficiaries.

(c) In response to comments received on the 2015 Draft, the 2016 Model allows certain categories of qualified persons in the state of source to be treated as equivalent beneficiaries provided that these persons in the aggregate do not own more than 25% of the tested company.

(d) The treaty would restrict intermediate ownership to companies resident in the same state as the company seeking benefits or in a country that has a comprehensive income tax treaty in force with the source country that contains rules addressing STRs and NIDs that are analogous to the rules in the 2016 Model Treaty.

(e) Derivative benefits provisions in existing U.S. treaties require, in order to qualify as an equivalent beneficiary with respect to income referred to in Article 10 (Dividends), 11 (Interest), or 12 (Royalties), that the third-country resident must be entitled, either under a comprehensive convention for the avoidance of double taxation between its country of residence and the source country or

otherwise, to a rate of tax with respect to the particular category of income that is less than or equal to the rate applicable under the tax treaty pursuant to which benefits are being claimed.

(f) Companies that fail to satisfy this rate comparison test today are not entitled to treaty benefits, and therefore are generally subject to a 30-percent gross basis withholding tax on U.S. source payments of dividends, interest (other than interest of a portfolio nature), and royalties. Treasury received comments suggesting the elimination of this so-called "cliff effect." In response to these comments, the 2016 Model removes the cliff effect, and instead entitles a resident of the treaty partner to the highest rate of withholding to which its third-country resident owners would be entitled.

(g) Under existing treaties that include a derivative benefits test, subsidiaries of private companies are unable to qualify for benefits regarding dividends under the derivative benefits test because individual shareholders are only entitled to a 15% rate on dividends, and therefore the cliff effect described above would preclude any reduction in dividend withholding.

(h) The 2016 Model allows certain companies relying on derivative benefits to qualify for the 5% rate of withholding on dividends even if the company's shareholders are individuals who would not be entitled to the 5% rate. To achieve this, the definition of equivalent beneficiary in the 2016 Model has been modified to allow individual shareholders to be treated as companies for purposes of the rate comparison test with respect to dividends, provided that the company seeking to qualify under the derivative benefits has sufficient substance in its residence country to indicate that the individual shareholders are not simply routing income through a corporate entity in order to benefit from the lower company rate.

iii. Headquarters Companies

(a) Comments on the 2015 Draft requested that the LOB article include a rule that would entitle

companies to claim treaty benefits in situations in which they serve as the active headquarters company of a multinational corporate group. In response, the 2016 Model treaty LOB provision includes a headquarters-company rule that is based on analogous tests found in some existing U.S. tax treaties, but with important modifications.

(b) Most significantly, the 2016 Model requires the headquarters company to exercise *primary* management and control functions (and not just supervision and administration) in its residence country regarding itself and its geographically diverse subsidiaries. The new provision also differs from existing headquarters company provisions by including a base erosion test.

(c) Furthermore, a headquarters company is only entitled to benefits regarding dividends and interest paid by members of its multinational corporate group. In the case of interest, the benefit is limited to a 10% cap on withholding in the source state, which is consistent with the general rate of withholding on interest that is permitted under the OECD's model income tax convention.

(d) The new headquarters company test is analogous to the active-trade-or-business test, which (as described above) generally entitles a company to treaty benefits without regard to the residence of its owners when the company derives income from the source state that emanates from, or is incidental to, the company's trade or business in the residence state. Treasury concluded that locating the strategic, financial, and operational policy decision-making for a multinational group in a country establishes sufficient nexus to that country regarding interest and dividends paid by members of the multinational corporate group for the company to qualify for treaty benefits, as well as equivalent-beneficiary status for purposes of the derivative benefits test regarding dividend and interest income.

iv. *Rules for Intermediate Ownership*. Comments requested that the rules for intermediate ownership contained in various ownership-based LOB tests in the 2015 Draft be

relaxed. In response to these comments, Treasury modified the intermediate ownership rules for subsidiaries of publicly-traded companies and the general ownership-base erosion test in the 2016 Model. They permit as an intermediate owner any company that is a resident of a country that has in effect a comprehensive tax treaty that contains rules addressing STRs and NIDs.

5. Mandatory Binding Arbitration. Article 25 (Mutual Agreement Procedure) of the 2016 Model contains rules requiring that certain disputes between tax authorities be resolved through mandatory binding arbitration. The "last-best offer" arbitration approach in the 2016 Model is substantially the same as the arbitration provision that is found in four U.S. treaties in force and three additional U.S. tax treaties that await the advice and consent of the Senate.

6. Subsequent Changes in Law.

(a) Article 28 (Subsequent Changes in Law) was added to the 2016 Model to address situations in which, after the treaty is signed, one of the treaty partners changes its overall corporate tax system to no longer impose significant tax on cross-border income of resident companies.

(b) In response to comments, the scope of Article 28 has been narrowed to address only changes in the laws governing the taxation of companies. To address concerns regarding individuals, the 2016 Model contains discrete rules in other articles that address the availability of tax treaty benefits for individuals who are taxed on a remittance, fixed fee, "forfeit," or similar basis.

(c) Article 28 requires the treaty partners to consult to determine if amendments to the treaty are necessary to restore an appropriate allocation of taxing rights between the two countries, consistent with the purpose of the treaty to eliminate double taxation without creating opportunities for non-taxation.

(d) The 2016 Model explicitly provides that it is only after these consultations fail to progress that a treaty partner may issue a diplomatic note stating that it will cease to grant certain benefits under the treaty for payments to companies.

(e) The 2015 Draft provided that the rule would be triggered if the general rate of company tax fell below 15%. In order to better effectuate the policy underlying Article 28, the 2016 Model provides that Article 28 is triggered if a treaty partner's general

rate of company tax falls below the lesser of 15%, or 60% of the other country's general statutory rate of company tax.

7. BEPS.

(a) A number of the key recommendations regarding bilateral income tax treaties in the BEPS reports have been fundamental parts of U.S. tax treaty policy for many years. For example, U.S. tax treaties have long contained robust LOB provisions and rules at determining when treaty benefits should be available for payments to fiscally transparent entities.

(b) The 2016 Model incorporates certain other BEPS recommendations for the first time:

- A revised preamble for tax treaties that makes clear the intentions of the treaty partners that the purpose of the tax treaty is the elimination of double taxation with respect to taxes on income without creating opportunities for non-taxation or reduction in taxation through tax evasion or avoidance.

- A rule intended to protect against contract-splitting abuses of the 12-month permanent establishment threshold for building sites or construction or installation projects.

- A 12-month ownership requirement for the 5% withholding rate for direct dividends, with refinements in the 2016 Model to impose a 12-month residence requirement to prevent companies from circumventing the ownership period as well as to allow the payee company to take into account certain prior ownership.

(c) The 2016 Model did not adopt other BEPS recommendations regarding the permanent establishment threshold, notably the revised rules relating to dependent and independent agents and the exception for preparatory and auxiliary activities. Treasury is working with the other OECD countries to create a common global understanding regarding profit attribution that will address the concerns raised by the BEPS permanent establishment recommendations. Treasury also is interested in developing ways to mitigate the compliance burdens on business and tax administrations that the new permanent establishment rules could create.

8. Other Provisions. There is a new "tested group" provision in the 2016 Model Treaty and rules regarding gross income in the LOB article. The

tested group rules apply to the base erosion tests under certain treaty provisions. A tested group includes members in a tax consolidation, fiscal unity or similar regime that requires the group to share profits, and group relief or other loss sharing regimes. Under the LOB gross income provision, gross income generally does not include dividends that are effectively exempt from tax, whether through deductions or otherwise. Further, a tested group's gross income generally does not take into account transactions between companies in a tested group.

F. Creditable Tax: Treaty Interpretation.

1. In *Eshel v. Commissioner*, ____ F.3d ____ (D.C. Cir. 2016), reversed and remanded a Tax Court decision regarding creditability of a French social security tax. The Tax Court erred in finding that the taxpayer was precluded by § 317(b)(4) of the Social Security Amendments of 1977 ("SSA") from claiming foreign tax credits for those taxes. The court said that the lower court resorted to American dictionaries rather than analyzing the text of the relevant totalization agreement and the shared expectations of the contracting governments in reaching its decision.

2. With Congress's blessing, U.S. presidents have entered into so-called "totalization agreements" with foreign governments to limit social-security taxing rights to the country where the work is being done. The agreements allow overseas workers from both countries to obtain social security benefits based on the period for which they make social security contributions to foreign governments.

3. *Eshel* involves the totalization agreement between the U.S. and France. Specifically, the issue on appeal was whether two French taxes enacted into law after the totalization agreement was adopted "amend or supplement" the French social security laws covered by the agreement, and thus fall within the agreement's ambit.

4. In 1987, the U.S. and France entered into the totalization agreement in issue. The agreement identifies the laws of each country under which qualifying taxes may be paid. It also covers taxes paid under "legislation which amends or supplements the laws specified." The first tax in issue was enacted in 1990 and the other in 1996.

5. The Tax Court granted summary judgment for the Commissioner. The Tax Court turned to four American dictionaries to define "amend" and "supplement," and on the basis of those dictionaries concluded that the phrase should mean formally altering on or more of these laws by striking out, inserting, or substituting words; adding something to make up for a lack or deficiency in one or more of those laws; or adding something to extend or strengthen the French social security system as a whole.

6. A totalization agreement, however, is not a domestic statute. It is an executive agreement with a foreign country, initiated by the State Department, negotiated by the Social Security Administration, signed by the president and a foreign government, and effective only after submission to Congress.

7. International executive agreements and treaties are primarily "compacts between independent nations," and it is "[a court's] responsibility to read them in a manner consistent with the shared expectations of the contracting parties."

8. The Tax Court should have started with the totalization agreement's plain text. The appellate court said that, here, the agreement's text provides powerful evidence of its meaning. Article 1 defines certain terms, but does not define "amends or supplements." For undefined terms, Article 1 directs that "Any term not defined in its Article shall have the meaning assigned to it under the laws which are being applied." The agreement defines "laws," as the "laws and regulations specified in Article 2." Article 2 laws are the laws covered by the agreement: the eight enumerated types of French laws, two U.S. laws, and "legislation which amends or supplements the laws specified."

9. Thus, whether the 1990 and 1996 legislation "amends or supplements" the enumerated French laws is fundamentally an inquiry into the content and meaning of the Article 2 laws, in this case, the French laws. For that reason, determining the meaning of "amending or supplementing" the French laws should have at least in part been informed by French law.

10. The court stated that the problems with the Tax Court's approach did not stop there. The Tax Court also improperly divorced "amends and supplements" from its textual object. Rather than asking whether the newer laws amend or supplement "the laws specified" in Article 2, the Tax Court considered whether those new taxes amend or supplement the "French social security system as a whole."

11. In resolving difficult questions of foreign law and in attempting to ascertain the views of a foreign government on an agreement to which it is a party, courts are empowered to "insist on a complete presentation by counsel." If the litigant's submissions come up short, the court may choose to "request a further showing by counsel, or engage in its own research, or direct that a hearing be held, with or without oral testimony, to resolve the issue." Courts also may request amicus submissions from the United States providing its official position on the interpretation of an agreement with a foreign government, and can ask the State Department to provide the views of the foreign government.

X. INVERSIONS.

A. Notice 2014-52.

1. In Notice 2014-52, the Treasury Department and the IRS state they intend to issue regulations that will address transactions that are structured to avoid the purposes of §§ 7874 and 367 by (1) for purposes of § 7874, disregarding certain stock of a foreign acquiring corporation that holds a significant amount of passive assets; (2) for purposes of §§ 7874 and 367, disregarding certain non-ordinary course distributions (including transactions such as dividends, redemptions, spinoffs, etc. during a three-year look-back period); and (3) for purposes of § 7874, providing guidance on the treatment of certain transfers of stock of a foreign acquiring corporation (through a spin-off or otherwise) that occur after an acquisition.

2. The Notice also describes regulations that Treasury and the IRS intend to issue that will address certain tax avoidance by (1) preventing the avoidance of § 956 through post-inversion acquisitions by controlled foreign corporations (CFCs) of obligations of (or equity investments in) the new foreign parent corporation or certain foreign affiliates (treating such loans in effect as though they were made to the U.S. shareholder for purposes of § 956); (2) preventing the avoidance of U.S. tax on pre-inversion earnings and profits of CFCs through post-inversion transactions that otherwise would terminate the CFC status of foreign subsidiaries and/or substantially dilute the U.S. shareholders' interest in those earnings and profits (by utilizing § 7701(l)'s multiple-party financing-transaction rules in a novel and questionable manner); and (3) limiting the ability to remove untaxed foreign earnings and profits of CFCs through related-party stock sales subject to § 304.

3. The new Notice has been the subject of much discussion questioning its legal underpinning. Section 7874(c)(4), for example, is used to support certain changes regarding so-called non-ordinary distributions. Under the Notice, these distributions, even those that occurred 3 years before the inversion transaction, "will" be treated as a part of a plan a principal purpose of which is to avoid the purposes of § 7874. The statute says certain transactions can be disregarded "if" they are part of such a plan. Changing "if" to "will" reminds me of the case, *Utility Air Regulatory Group v. Environmental Protection Agency*, ___ U.S. ___ (2014), which held that an administrative "agency may not rewrite clear statutory terms to suite its own sense of how the statute should operate."

4. Treasury and the IRS also ask for comments regarding earnings stripping through the use of intercompany debt, although no rule was stated to be imminent in this regard. Any future guidance will be prospective only, but

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to the extent it applies only to inverted groups, it will apply to groups that completed inversions on or after September 22, 2014.

5. The new rules are generally applicable to inversion completed on or after September 22, 2014.

6. The U.S. Chamber of Commerce issued the following statement on the Obama Administration's announcement on tax inversions:

7. There are three main reasons for a company to change its tax domicile: first, to remove future foreign source income from a secondary level of U.S. taxation, the territorial issue; second, to avoid the highest tax rate in the industrialized world on all income earned abroad; and, third, to access accumulated cash in the former U.S. foreign subsidiary via a series of loans through the new foreign parent.

8. Treasury's actions today will close off the third option and thus make inversions less profitable—but not unprofitable—for inverting companies that wanted to bring the cash held abroad back to the U.S. Inverting companies will still receive all of the benefits of the first two reasons for inverting. Moreover, if companies want to use the accumulated cash in the former foreign subsidiary, they can still do so. They just must use the proceeds abroad to create income and jobs abroad. In fact, the Administration just assured that deferred income in the once foreign subsidiary will never come back to the U.S. to help create income, jobs, and economic growth here.

9. The Administration's vain attempt to lock corporations in to an obsolete tax system will only serve to further lock capital out.

10. Rather than piecemeal, onerous actions, the Administration should undertake comprehensive tax reform that lowers rates for all businesses and shifts to an internationally competitive system that welcomes investment and produces the economic growth this country needs.

B. 25% Requirement: Regulations.

1. Treasury and the IRS issued final regulations regarding when an expanded affiliated group will be considered to have substantial business activities in a foreign country. Initially, Treasury and the IRS proposed a 10% safe harbor based on assets, employees, and revenue. Later, Treasury and the IRS eliminated the 10% safe harbor and transmuted the substantial business activities requirement into a facts and circumstances test. Temporary and proposed regulations were issued in 2006, but later withdrawn. Temporary and proposed regulations were issued in 2009, but later withdrawn.

2. Temporary and proposed regulations were again issued in 2012. These regulations changed everything by implementing a highly controversial 25% minimum-threshold requirement with respect to assets, employees and revenue to satisfy the substantial business presence test. These are the proposed regulations that were adopted as final. A public hearing was not requested or held, although comments were received. Most comments were rejected, however.

3. Under § 7874(a)(2)(B), a foreign corporation is generally treated as a surrogate foreign corporation if pursuant to a plan (or a series of related transactions): (1) the foreign corporation completes after March 4, 2003 the direct or indirect acquisition of substantially all the properties held directly or indirectly by a domestic corporation ("acquisition"); (2) after the acquisition, at least 60% of the stock by vote or value of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation; and (3) after the acquisition, the expanded affiliated group that includes the foreign corporation ("EAG") does not have substantial business activities in the foreign country in which, or under the laws of which, the foreign corporation is created or organized ("relevant foreign country"), when compared to the total business activities of the EAG. Similar provisions apply if a foreign corporation acquires substantially all the properties constituting a trade or business of a domestic partnership.

4. Under the bright-line rule a company can satisfy the substantial business activity provision (and avoid the anti-inversion rules) only if at least 25% of the EAG's employees, assets and income are located or derived in the relevant foreign country.

5. Many commenters criticized this approach on the grounds that there is insufficient support for this bright-line rule in the legislative history. Some commenters recommended reverting to a general facts and circumstances test, along with a safe harbor, given the difficulty of formulating a bright-line rule that produces appropriate results in all circumstances. Some commenters suggested that the failure to satisfy the bright-line rule could establish a rebuttable presumption that an EAG does not have substantial business activities in the relevant foreign country.

6. Treasury and the IRS rejected these comments and concluded that the bright-line rule is consistent with § 7874 and its underlying policies. In addition, states the preamble, the bright-line rule has proven more administrable than a facts-and-circumstances test that has the benefit of providing certainty in applying § 7874 to particular transactions.

7. Most comments were rejected, and the proposed regulations were adopted with only minor changes. They are effective with respect to acquisitions completed on or after June 3, 2015, although the 2012 temporary

regulations apply to acquisitions completed after June 7, 2012. Thus, the change in date is not significant.

C. Notice 2015-79.

1. Notice 2015-79 (Nov. 19, 2015), announces additional regulations that Treasury and the IRS intend to issue in respect of inversions. The notice also announces corrections and clarifications to the rules announced in Notice 2014-52.

2. For purposes of the notice, the term "inversion transaction" means a transaction described in § 7874(a) in which the domestic entity shareholders' ownership continuity percentage (the "ownership percentage") is at least 60 but less than 80.

3. The notice states that § 7874(c)(6) grants the Secretary authority to prescribe regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations to treat stock as not stock. In addition, the notice states that § 7874(g) grants the Secretary authority to provide regulations necessary to carry out § 7874, including regulations adjusting the application of § 7874 as necessary to prevent the avoidance of the purposes of § 7874.

4. Change to Substantial Business Activities Test Based on Foreign Acquiring Corporation's Tax Residence.

(a) Under § 7874(a)(2)(B)(iii), an acquisition will only be considered an inversion subject to the rules of § 7874(a) or (b) if, after the acquisition, the EAG which includes the new foreign parent does not have substantial business activities in the foreign country in which, or under the law of which, it is created or organized, when compared to the EAG's total business activities.

(b) In this regard, the notice states that Treasury and the IRS have determined that the policy underlying the substantial business activities test is premised on the foreign acquiring corporation being subject to tax as a resident of the relevant foreign country. Allowing the exception to apply when the foreign acquiring corporation is not subject to tax as a resident of the relevant foreign country effectively permits an EAG to replace its U.S. tax residence with tax residence in any other country (or, in certain cases, in no other country), without regard to the location of any substantial business activities conducted by the EAG. The Treasury Department and the IRS believe that this result is contrary to the policy underlying the substantial business activities test.

(c) Accordingly, the Treasury Department and the IRS intend to issue regulations under § 7874 to provide that an EAG cannot have substantial business activities in the relevant foreign country when compared to the EAG's total business activities unless the foreign acquiring corporation is subject to tax as a resident of the relevant foreign country.

(d) These regulations will apply to acquisitions completed on or after November 19, 2015.

5. Third Country Transactions.

(a) The notice also addresses so-called "third country" transactions, in which a domestic entity combines with an existing foreign corporation by establishing a new foreign parent with a tax residence that is different from that of the existing foreign corporation.

(b) Treasury and the IRS have considered whether certain stock issued in an acquisition structured with a third-country parent should be disregarded pursuant to the authority under §§ 7874(c)(6) and (g). In particular, Treasury and the IRS are concerned that a decision to locate the tax residence of a new foreign parent corporation outside of both the United States and the jurisdiction in which the existing foreign corporation is tax resident generally is driven by tax planning, including the facilitation of U.S. tax avoidance following the acquisition.

(c) The Senate Report and the JCT Explanation indicate that the 80% threshold under § 7874(b) for treating a foreign acquiring corporation as a domestic corporation reflects an assumption that, when the existing foreign corporation's shareholders will own more than 20% of the interests in the combined group, there is a sufficient likelihood of a non-tax business purpose for replacing the U.S. parent with a foreign parent to warrant respecting the new foreign parent. However, Treasury and the IRS have concluded that, when a domestic entity combines with an existing foreign corporation by establishing a new parent for the combined group that is tax resident in a third country, the likelihood that there is a sufficient non-tax business purpose for replacing the U.S. parent with a foreign parent is significantly lower than Congress assumed in establishing the 80% threshold.

(d) Treasury and the IRS therefore intend to issue regulations under §§ 7874(c)(6) and (g) to address these transactions by disregarding certain stock of a foreign acquiring corporation that is issued to the shareholders of the existing foreign corporation for purposes of

determining whether the 80% threshold is met. The regulations will apply to an acquisition that satisfies four requirements.

i. First, in a transaction related to the acquisition ("foreign target acquisition"), the foreign acquiring corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by another foreign corporation ("foreign target corporation").

ii. Second, the gross value of all property directly or indirectly acquired by the foreign acquiring corporation in the foreign target acquisition exceeds 60% of the gross value of all foreign group property. These terms are defined in § 2.01 of Notice 2014-52, with the adjustments described in Section 9 below.

iii. Third, the tax residence of the foreign acquiring corporation is not the same as that of the foreign target corporation, as determined before the foreign target acquisition and any transaction related to the foreign target acquisition. A change in the location of the management and control of a foreign target corporation is treated as a transaction for this purpose.

iv. Fourth, without taking into account the "third country" rule, the ownership percentage is at least 60 but less than 80.

(e) When these four requirements are satisfied, the regulations will provide that stock of the foreign acquiring corporation that otherwise would be included in the denominator of the ownership fraction will be excluded from the denominator to the extent the stock is held by former owners of the foreign target corporation by reason of holding stock in the foreign target corporation (based on the principles of § 7874(a)(2)(B)(ii)).

(f) These regulations will apply to acquisitions completed on or after November 19, 2015.

6. <u>Clarification of "Nonqualified Property" Under Section 1.7874-4T</u>.

(a) Temp. Treas. Reg. § 1.7874-4T (Jan. 2014) provides rules for determining whether certain stock of the foreign acquiring corporation is "disqualified stock" and therefore not counted in the denominator of the ownership fraction. Generally, disqualified stock includes stock of the foreign acquiring corporation that is transferred in exchange for "nonqualified property" in an exchange related to the acquisition.

(b) Temp. Treas. Reg. § 1.7874-4T(i)(7) defines the term "nonqualified property" to mean (i) cash or cash equivalents, (ii) marketable securities, (iii) obligations of EAG members or certain other persons, and (iv) any other property acquired in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the purposes of § 7874. The notice refers at times to the property described in clauses (i), (ii), and (iii) collectively as "specified nonqualified property" and to the property described in clause (iv) as "avoidance property."

(c) Temp. Treas. Reg. § 1.7874-4T(j), Example 2, illustrates a transfer of stock of the foreign acquiring corporation in exchange for avoidance property. PRS, a partnership with individual partners, transfers marketable securities to FT, a newly formed foreign corporation, in exchange solely for all of the FT stock. PRS then transfers the FT stock to FA, a newly formed foreign corporation, in exchange solely for 25 shares of FA stock. Individual A, who is unrelated to PRS, transfers all of the stock of DT, a domestic corporation of which Individual A is the sole shareholder, to FA in exchange solely for 75 shares of FA stock. The facts of the example state that FA acquires the FT stock with a principal purpose of avoiding the purposes of § 7874. The example concludes that the FT stock is nonqualified property.

(d) The notice states that Treasury and the IRS are concerned that some taxpayers may be narrowly interpreting the definition of avoidance property. In particular, taxpayers may be asserting that avoidance property is limited to property, such as stock, that is used to indirectly transfer specified nonqualified property to the foreign acquiring corporation, as in Example 2. This interpretation, states the notice, is inconsistent with both the plain language and purpose of the regulation. In addition, the notice states, § 7874(c)(4) separately provides that a transfer of properties or liabilities is disregarded if the transfer is part of a plan a principal purpose of which is to avoid the purposes of § 7874.

(e) Accordingly, Treasury and the IRS intend to issue regulations that will clarify § 1.7874-4T to provide that avoidance property means any property (other than specified nonqualified property) acquired with a principal purpose of avoiding the purposes of § 7874, regardless of whether the transaction involves an indirect transfer of specified nonqualified property. The regulations will also remove certain redundant phrases from the definitions and make certain clarifying and conforming changes.

(f) These regulations will apply to acquisitions completed on or after November 19, 2015.

7. Broadened Definition of "Inversion Gain".

(a) If an acquisition is an inversion transaction, § 7874(a)(1) requires that the taxable income of a domestic "expatriated entity" for any taxable year during a 10-year "applicable period" be no less than the "inversion gain" of the entity for the taxable year. Section 7874(d)(2) provides that the term "inversion gain" means income or gain recognized by reason of the transfer during the applicable period of stock or other properties by an expatriated entity or, in certain cases, a license of such property.

(b) Section 7874(a)(1), together with § 7874(e)(1) (which prevents the use of certain credits to offset U.S. tax on inversion gain), ensure that an expatriated entity generally pays current U.S. tax with respect to inversion gain. These rules are intended to ensure that an appropriate "toll charge" is paid on transactions that accompany or follow an inversion transaction and are designed to "remove income from foreign operations from the U.S. taxing jurisdiction." See H.R. Conf. Rep. No. 108-755, at 574 (2004); JCT Explanation at 345.

(c) Treasury and the IRS are concerned that certain indirect transfers of stock or other property by an expatriated entity (rather than direct transfers by the expatriated entity itself) may have the effect of removing foreign operations from U.S. taxing jurisdiction while avoiding current U.S. tax, contrary to the policy underlying §§ 7874(a)(1) and (e)(1). For example, following an inversion transaction, an expatriated entity that wholly owns a CFC could cause the CFC to transfer property (including stock of a lower-tier CFC) to a related foreign person in a fully taxable transaction. Gain from the transfer may be subpart F income and, as a result, the expatriated entity may have an income inclusion under § 951(a)(1)(A). However, the inclusion is not inversion gain under current law, and therefore the income can be offset by tax attributes (such as net operating losses).

(d) Treasury and the IRS intend to issue regulations under § 7874(g) that will provide that inversion gain includes certain income or gain recognized by an expatriated entity from an indirect transfer or license of property, such as § 951(a)(1)(A) gross income inclusions taken into account during the applicable period that are attributable to a transfer of stock or other properties or a license of property. As under § 7874(d)(2), the regulations will include an exception for certain transfers of inventory property by a CFC.

(e) In addition, Treasury and the IRS intend to issue regulations that will provide that, if a partnership that is a foreign related person

transfers or licenses property, a partner of the partnership will be treated as having transferred or licensed its proportionate share of that property for purposes of determining inversion gain.

(f) These regulations will apply to transfers or licenses of property occurring on or after November 19, 2015, but only if the inversion transaction is completed on or after September 22, 2014.

8. Section 367(b) Regulations Addressing Certain "Out from Under" Transactions.

(a) Notice 2014-52 announced that the regulations under § 1.367(b)-4(b) would be amended to require an income inclusion in certain nonrecognition transactions that occur after an inversion transaction and that dilute the interest of a U.S. shareholder in a CFC, because such transactions could allow the U.S. shareholder to avoid tax on the CFC's E&P. Specifically, subject to a de minimis rule, § 3.02(e) of Notice 2014-52 provides that an exchanging shareholder in a specified exchange will be required to include in income as a deemed dividend the § 1248 amount with respect to stock of an expatriated foreign subsidiary in certain cases, without regard to whether any condition of § 1.367(b)-4(b)(1)(i)(B) is satisfied. The terms "specified exchange" and "expatriated foreign subsidiary" are defined in Notice 2014-52.

(b) Treasury and the IRS are concerned, however, that certain nonrecognition transactions that dilute a U.S. shareholder's ownership of an expatriated foreign subsidiary may allow the U.S. shareholder to avoid U.S. tax on unrealized appreciation in property held by the expatriated foreign subsidiary at the time of the exchange. This could occur when the amount of realized gain in the stock of the expatriated foreign subsidiary that is exchanged in the specified exchange exceeds the E&P attributable to the stock. For example, the expatriated foreign subsidiary could hold valuable self-developed intangible property that has not yet been brought to market and therefore has not generated any significant E&P.

(c) Accordingly, Treasury and the IRS intend to amend the regulations under § 367(b) to provide that, if an exchanging shareholder would be required under the rules announced in § 3.02(e)(ii) of Notice 2014-52 to include in income as a deemed dividend the § 1248 amount (if any) with respect to stock of an expatriated foreign subsidiary, the exchanging shareholder also must recognize all realized gain with respect to such stock, after taking into account any increase in basis resulting from a deemed dividend as provided in § 1.367(b)-2(e)(3)(ii).

(d) Consistent with this modification, when the regulations described in Notice 2014-52 are issued, the first exception described in § 3.02(e)(i)(C) will be modified to be applicable only if, as a result of the transfer of the "specified stock," all the gain in the specified stock is recognized.

(e) These regulations will apply to specified exchanges occurring on or after November 19, 2015, but only if the inversion transaction is completed on or after September 22, 2014.

9. Changes to Certain Rules Under Notice 2014-52.

(a) Section 2.01(b) of Notice 2014-52 defined the term "foreign group nonqualified property" generally to mean property that is described in §1.7874-4T(i)(7), other than property that gives rise to income described in section 1297(b)(2)(A) (PFIC banking exception) or section 954(h) or (i) (subpart F exceptions for qualified banking or financing income and for qualified insurance income). Notice 2014-52 did not exclude property that gives rise to income described in section 1297(b)(2)(B) (PFIC insurance exception) from the general definition of foreign group nonqualified property. Commenters have noted that certain insurance companies may not be able to satisfy the requirements of the subpart F exception for qualified insurance income under section 954(i), which is a narrower provision than section 1297(b)(2)(B).

(b) The notice announces that the regulations described in § 2.01 of Notice 2014-52 will provide that property that gives rise to income described in the PFIC insurance exception, § 1297(b)(2)(B), will be excluded from the general definition of foreign group nonqualified property.

(c) Those regulations also will provide that the general definition of foreign group nonqualified property does not include property held by a domestic corporation that is subject to tax as an insurance company under subchapter L, provided that the property is required to support, or is substantially related to, the active conduct of an insurance business. Those regulations also will provide that the general definition of foreign group nonqualified property does not include property held by a domestic corporation if that property gives rise to income described in section 954(h), with certain modifications to reflect the fact that the corporation is domestic and its business may be in the United States.

(d) Finally, Treasury and the IRS intend to include in the regulations described in § 2.02 of Notice 2014-52 (disregarding certain non-ordinary course distributions) a de minimis exception similar to the

exception in § 1.7874-4T. The exception will apply to an acquisition if (i) the ownership percentage, determined without regard to § 1.7874-4T or the rules in §§ 2.01 and 2.02 of Notice 2014-52 is less than 5% by vote and value, and (ii) after the acquisition and all transactions related to the acquisition are completed, former shareholders of the domestic entity must own less than 5% by vote and value of any EAG member. If these two requirements are satisfied, the rules announced in § 2.02 of Notice 2014-52 will not apply to the acquisition and, as a result, no distributions will be treated as non-ordinary course distributions that are disregarded under those rules.

(e) These regulations will apply to acquisitions completed on or after November 19, 2015. However, taxpayers may elect to apply these rules to acquisitions completed before November 19, 2015.

10. Clarifying Change to Small Dilution Exception Under Notice 2014-52.

(a) Section 3.02(e)(i)(C) of Notice 2014-52 provides an exception (small dilution exception) to the general recharacterization rule that applies to a "specified transaction" (as defined in Notice 2014-52). The small dilution exception applies if (i) the expatriated foreign subsidiary is a CFC immediately after the specified transaction and all related transactions, and (ii) the amount of stock (by value) in the expatriated foreign subsidiary owned by the § 958(a) U.S. shareholders (as defined in Notice 2014-52) of the expatriated foreign subsidiary immediately before the transactions does not decrease by more than 10%.

(b) Treasury and the IRS are concerned that some taxpayers may be inappropriately interpreting the small dilution exception by comparing the value of the expatriated foreign subsidiary's stock owned by the U.S. shareholders before and after the transactions, rather than comparing the percentage of stock owned. Regulations issued under Notice 2015-79 will clarify the application of the small dilution exception by substituting the phrase "the percentage of stock (by value)" for the phrase "the amount of stock (by value)." A similar clarification will be made to the exception described in § 3.02(e)(ii) of Notice 2014-52.

(c) These regulations will apply to specified transactions and specified exchanges completed on or after November 19, 2015, but only if the inversion transaction is completed on or after September 22, 2014.

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11. No inference is intended regarding the treatment under current law of the transactions described in the notice. The IRS may challenge such transactions under applicable Code provisions or judicial doctrines.

12. The notice states that Treasury and the IRS expect to issue additional guidance to further limit (i) inversion transactions that are contrary to the purposes of § 7874 and (ii) the benefits of post-inversion tax avoidance transactions. In particular, as described in § 5 of Notice 2014-52, Treasury and the IRS continue to consider guidance to address strategies that avoid U.S. tax on U.S. operations by shifting or "stripping" U.S.-source earnings to lower-tax jurisdictions, including through intercompany debt. Accordingly, the Treasury Department and the IRS reiterate the requests for comments made in Notice 2014-52.

D. New Regulations.

1. The IRS issued final and temporary regulations that adopt the rules of Notices 2014-52 and 2015-27 as regulations. We discussed those notices above.

2. The new regulations also attack serial inversion acquisitions, something that was not covered in the previous notices. The new temporary regulations provide an example that explains the new rules. Individual A owns 70 shares of the stock of DC1, a domestic corporation. Individual B owns 30 shares of stock of F1, a foreign corporation that is subject to tax as a resident of Country X. Pursuant to a reorganization, DC1 transfers all of its properties to F1 solely in exchange for 70 newly issued voting shares of F1 stock (the "DC1 acquisition") and distributes the F1 stock to Individual A in liquidation pursuant to § 361(c).

3. Pursuant to a plan that includes the DC1 acquisition, F2, a newly formed foreign corporation that is also subject to tax as a resident of Country X, acquires 100% of the stock of F1 solely in exchange for 100 newly issued shares of F2 stock (the "F1 acquisition"). After the F1 acquisition, Individual A owns 70 shares of F2 stock, Individual B owns 30 shares of F2 stock, F2 owns 100 shares of F1 stock, and F1 owns all the properties held by DC1 immediately before the DC1 acquisition.

4. The DC1 Acquisition is a domestic-entity acquisition, and F1 is a foreign-acquiring corporation because F1 directly acquires 100% of the properties of DC1. In addition, the 70 shares of F1 stock received by A pursuant to the DC1 acquisition in exchange for Individual A's DC1 stock are stock of a foreign corporation that is held by reason of holding stock in DC1. As a result, those 70 shares are included in both the numerator and the denominator of the ownership fraction when applying § 7874 to the DC1 acquisition.

5. The DC1 acquisition is also an initial acquisition because it is a domestic entity acquisition that, pursuant to a plan that includes the F1 acquisition, occurs before the F1 acquisition. Thus, F1 is the initial acquiring corporation.

6. The F1 acquisition is a subsequent acquisition because it occurs, pursuant to a plan that includes the DC1 acquisition, after the DC1 acquisition and, pursuant to the F1 acquisition, F2 acquires 100% of the stock of F1 and therefore is treated as indirectly acquiring all the properties held directly or indirectly by F1. Thus, F2 is a subsequent acquiring corporation.

7. The F1 acquisition is treated as a domestic-entity acquisition, and F2 is treated as a foreign-acquiring corporation. In addition, the 70 shares of F2 stock received by Individual A pursuant to the F1 acquisition in exchange for Individual A's F1 stock are stock of a foreign corporation that is held by reason of holding stock of DC1. As a result, those 70 shares are included in both the numerator and the denominator of the ownership fraction when applying § 7874 to the F1 acquisition.

8. In addressing the 2014 notice's non-ordinary course distributions ("NOCD") rules, the temporary regulations provide, consistent with the approach recommended in comments received, that the amount of a distribution (including with respect to property distributed in a redemption of stock) is determined based on the value of the property distributed at the time of the distribution. This is a helpful change. In a given case it could be important.

9. Under the same NOCD rules, the regulations address a comment that stated that in cases in which a foreign corporation will acquire only a portion of a domestic corporation's properties, different results may arise under the NOCD rule depending on how the parties structure the acquisition and related transactions. The comment explained that in certain cases the direction of a spin-off, if respected for purposes of the NOCD rules (which business is distributed in the spin-off), then transactions that are substantively the same could give rise to vastly different results.

10. Treasury and the IRS agreed with these concerns. As a result, the temporary regulations include a special provision that, for purposes of the NOCD rules, creates parity between certain transactions regardless of the direction of the spin-off.

11. The special rule applies when a domestic corporation (domestic distributing corporation) distributes stock of another domestic corporation (controlled corporation) in a § 355 spin-off, and immediately before the distribution, the value of the distributed stock represents more than 50% of the value of the domestic distributing corporation.

12. When the special rule applies, the controlled corporation is deemed for purposes of the NOCD rule to have distributed the stock of the distributing corporation. The value of the deemed distribution is equal to the fair market value of the distributing corporation (but not taking into account the fair market value of the stock of the controlled corporation) on the date of the distribution.

13. Curiously, the temporary regulations also contain the rules described in Notice 88-108 and related notices concerning the short-term obligation exception from United States property for purposes of § 956. These notices and the related new temporary regulations would seem to have nothing at all to do with inversions.

14. The new regulation states that for purposes of § 956 the term "obligation" does not include any obligation of the United States person that is collected within 30 days from the time it is incurred (a 30-day obligation), unless the controlled foreign corporation that holds the 30-day obligation holds for 60 or more calendar days during the taxable year in which it holds the 30-day obligation any obligation which, without regard to the exclusion, would constitute United States property within the meaning of § 956 and § 1.956-2(a).

E. Business Groups Challenge Inversion Regulation.

1. The U.S. Chamber of Commerce and the Texas Association of Business commenced an action in U.S. Federal District Court challenging a § 7874 anti-inversion regulation asserting that adoption of the rule violates the Administrative Procedure Act. The Chamber is the world's largest federation of businesses and associations, directly representing 300,000 members and indirectly representing the interests of more than three million U.S. businesses and professional organizations. The Texas Association of Business is the state chamber of commerce for Texas, representing more than 4,000 businesses and their more than 600,000 employees.

2. Treasury and the IRS have issued a number of § 7874 anti-inversion notices and regulations that many practitioners believe exceed the government's authority under § 7874. They represent a concerted government effort to limit inversions. The particular focal point of the business associations' lawsuit is the so-called "multiple domestic entity acquisition rule" set forth in regulations issued on April 4, 2006. In my view, this regulation does clearly exceed the government's authority under the statute. It was widely believed that the regulation caused the Pfizer/Allergan transaction to be terminated.

3. In the Pfizer/Allergan transaction, Allergan shareholders would have owned 44% of the new corporation following the merger. However,

Treasury's and the IRS's new multiple acquisition rule would have treated those shareholders treated as owning under 20%. This would leave Pfizer shareholders treated as owning over 80% of the new corporation. Thus, it would have been treated as a domestic corporation under § 7874.

4. To ensure that Allergan and Pfizer could not abandon the merger and then enter into a new transaction once the multiple acquisition rules' three-year window no longer applied to Allergan's prior domestic acquisitions, the new regulations specify that the three-year window would look back from any "substantially similar acquisition" that had previously been terminated "with a principal purpose of avoiding § 7874."

5. The complaint filed in court quoted Representative Sander Levin, a supporter of Treasury's action, acknowledging that the multiple acquisition rule, "in many ways was targeting Pfizer/Allergan," and that "what the Treasury did was take the history of the inversions by Allergan" and then gerrymander a regulation to support rejection of the Pfizer transaction.

6. The complaint asserts that the Administrative Procedure Act forbids agency action "in excess of statutory jurisdiction, authority or limitations." It also forbids action that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law." Finally, it forbids agency action that is "without observance of procedure required by law," specifically notice and an opportunity for comment by those affected by the action.

7. The case could be an extremely important one. In a report by Andrew Velarde at 2016 TNT 151-1, he quotes practitioners discussing Treasury's and the IRS's "increasing use of *in terrorem* rulemaking." One practitioner is quoted saying that the suit could be a harbinger of future pre-enforcement challenges, particularly to the sweeping § 385 regulations once they are finalized.

8. Interestingly, in the preamble to the regulation under challenge, Treasury and the IRS decreed, with no explanation, that it has "been determined that § 553(b) of the Administrative Procedure Act" -- which requires agencies to notify regulated parties of a proposed substantive rule so that they have a chance to comment before it goes into effect -- "does not apply to th[is] regulation []." As the complaint notes, they did so even though their prior claims to immunity from the APA had been repeatedly rebuked by the judiciary.

XI. ADMINISTRATION'S FY 2017 BUDGET.

A. The Obama Administration's Fiscal Year 2017 Budget Green Book discusses the same proposals that were made last year. They include proposals such as

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imposing a 19% minimum tax on foreign income and imposing a 14% one-time tax on previously untaxed foreign income. Deductions for excessive interest of members of financial reporting groups would be restricted. There would be a limitation on the potential shifting of income through intangible property transfers by changing the definition of intangible property income to include workforce-in-place, goodwill and going concern value and any other item owned or controlled by a taxpayer that is not a tangible or financial asset and that has substantial value independent of the services of any individual. The so-called "loop-holes" under Subpart F would be closed and there would be a restriction on the use of certain hybrid arrangements that create stateless income.

B. Since these proposals were widely discussed in past years, I will not discuss them again. They are not new news. Given the political environment, they also are not likely to be enacted in the foreseeable future.

XII. BEPS: FINAL REPORTS.

A. The OECD released final BEPS reports on October 5, 2015.

B. The OECD's Introduction states that the BEPS package lays the foundations of a "modern international tax framework under which profits will be taxed where economic activity and value creation occurs." It says that "it is now time to focus on the upcoming challenges, which include supporting the implementation of the recommended changes in a consistent and coherent manner, monitoring the impact on double non-taxation and on double taxation, and designing a more inclusive framework to support implementation and carry out monitoring."

C. The Introduction says that some of the revisions may be immediately applicable, such as the revisions to the Transfer Pricing Guidelines, while others will require changes that can be implemented by tax treaties, including through the BEPS' multilateral instrument. Some will require domestic law changes, such as the provisions on hybrid mismatches, CFCs, interest deductibility, country-by-country reporting, and the mandatory disclosure rules. Preferential IP regimes will need to be aligned with the harmful tax practices criteria.

D. The Introduction further states that challenges arose during the development process: some countries enacted unilateral measures, some tax administrations have been more aggressive, and the increasing uncertainty has been denounced by some practitioners. The BEPS writers say that governments recognize these challenges and that consistent implementation and application will be the key to success. Accordingly, the OECD and the G20 countries have agreed to continue to work together to support an efficient and consistent implementation of the BEPS project framework.

E. Action #1 – Digital Economy.

1. The Action #1 Executive Summary says that the digital economy is increasingly becoming the economy itself. Thus, it would be difficult, if

not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. The digital economy and its business models nevertheless present some key features that are relevant from a tax perspective. The work on the relevant BEPS provisions took these issues into account to ensure that the proposed solutions fully address the digital economy.

2. Accordingly, it was agreed to modify the list of exceptions to the definition of permanent establishment ("PE") to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary" character, and to introduce a new anti-fragmentation rule to prevent the use of these exceptions through the fragmentation of business activities among closely-related enterprises.

3. For example, the maintenance of a very large warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers of a foreign online seller of physical products (whose business model relies on proximity to customers and quick delivery to clients) would constitute a PE of the seller under the new standard.

4. The definition of PE also was modified to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they have been made by that company.

5. Thus, if the sales force of a local subsidiary of a foreign online seller of tangible products or an online provider of advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and these contracts are routinely concluded without material modification by the parent company, this activity would result in a PE for the parent company.

6. Further, under the revised transfer pricing guidance, legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. Instead, the group companies performing the important functions, contributing the important assets and controlling economically significant risks, as determined through an analysis of the actual transaction, will be entitled to an appropriate return. The report also emphasizes the need for greater reliance on value chain analyses and transactional profit split methods.

7. The controlled foreign corporation ("CFC") proposals also would treat income that is typically earned in the digital economy as subject to taxation in the jurisdiction of the ultimate parent company (*i.e.*, like Subpart F income), with the aim of eliminating so-called stateless income.

8. The report discusses broader tax policy challenges raised by the digital economy, specifically relating to (i) nexus issues and the reduced need in many cases for an extensive physical presence in order to carry on business in a jurisdiction, (ii) the increasing reliance on data collection and analysis and how to attribute value created from the generation of data through digital products and services, and (iii) income characterization questions resulting from the development of new digital products and means of delivering services.

9. The BEPS task force considered several options to address these broader tax challenges raised by the digital economy, but ultimately did not recommend any of the three options that it previously had considered for taxing income from the sales of digital goods and services by foreign suppliers lacking a permanent establishment in the customers' country under current treaty rules. The proposals were a withholding tax on income from certain kinds of digital transactions, a new nexus rule in the form of a significant economic presence, and an equalization levy to tax the non-resident enterprise's significant economic presence in the given country.

10. However, the report suggests that countries could implement any of the three options to further protect against base erosion and profit shifting, as long as they respect existing treaty obligations and adapt the rules to ensure consistency with existing international commitments.

11. A U.S. spokesperson (Bob Stack) said the language regarding the three options represents a compromise on a sticky issue, but expressed the view that, as written, there is not a lot of freedom for countries to adopt any of the options.

12. The report also recommended that countries apply the OECD's International VAT/GST Guidelines for the collection of VAT on cross-border transactions and consider implementing the collection mechanisms described in those guidelines.

13. The report states that its conclusions may evolve as the digital economy continues to develop. Thus, it is important to continue working on these issues and to monitor developments over time. Thus, the work will continue following completion of the other follow-up work on BEPS projects. This future work will be done in consultation with a broad range of stakeholders, and on the basis of a detailed mandate to be developed during 2016 in the context of designing an inclusive post-BEPS monitoring process. A supplementary report reflecting the outcome of continued work in relation to the digital economy is planned by 2020.

14. The Digital Economy Final Report is the second-longest of the BEPS reports at 285 pages.

F. Action #2 – Hybrids.

1. Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. The Action #2 Executive Summary says these types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned.

2. Part 1 of the Final Report provides recommendations for rules to address mismatches in tax outcomes when they arise regarding payments made under a hybrid financial instrument or those made to or by a hybrid entity. It also recommends rules to address indirect mismatches that arise when the effects of a hybrid mismatch arrangement are imported into a third jurisdiction. The recommendations take the form of linking rules that align the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction but otherwise do not disturb the commercial outcomes.

3. The rules apply automatically, and there is a primary rule and a secondary, or defensive, rule. This prevents more than one country from applying the rule for the same arrangement and avoids double taxation.

4. The recommended primary rule is that countries deny the taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction or it is also deductible in the counterparty jurisdiction. If the primary rule does not apply, then the counterparty jurisdiction can generally apply a defensive rule, requiring the deductible payment to be included in income or denying the duplicate deduction, depending on the nature of the mismatch.

5. Part 2 addresses rules designed to ensure that hybrid instruments and entities, as well as dual resident entities, are not used to improperly obtain the benefits of tax treaties and that tax treaties do not prevent the application of the changes to domestic law recommended in Part 1.

6. It states that Action 6 (treaties) will address some of the BEPS concerns related to dual resident entities. Cases involving dual residence under a tax treaty will be resolved on a case-by-case basis, rather than on the basis of the current rule and the place of effective management. This change, however, will not address all BEPS concerns related to dual resident entities. Domestic law changes will be necessary to address other avoidance strategies involving dual residence.

7. Part 2 proposes to include in the OECD model tax convention a new provision and detailed commentary that will ensure that benefits of tax treaties are granted in appropriate cases to the income of hybrid entities

but also that these benefits are not granted where neither state treats, under its domestic law, the income of such an entity as the income of one of its residents.

8. Finally, Part 2 addresses potential treaty issues that could arise from the recommendations in Part 1. The report describes possible treaty changes that would address these issues.

9. The Final Report also contains some additions to the hybrid rules that would make them even more complex, most notably those addressing hybrid transfers, which includes repos and securities lending transactions. In addition, a special new rule would deal with disregarded payments made by hybrid entities. A disregarded payment would be one that the payee jurisdiction does not see. The payer jurisdiction would be expected to deny a deduction, and failing that, the payee jurisdiction would be expected to require inclusion.

G. Action #3 - CFC Rules.

1. This report sets out CFC recommendations, which are described as "building blocks." The six building blocks for the design of effective CFC rules are:

   (a) Definition of a CFC

   (b) CFC exemptions and threshold requirements

   (c) Definition of income

   (d) Computation of income

   (e) Attribution of income

   (f) Prevention and elimination of double taxation

2. The recommendations are not minimum standards, but are designed to ensure that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from shifting income to foreign subsidiaries. The report retains much of what was in the discussion draft, released April 3, as well as the sense that the various options reflect a deep lack of consensus among the stakeholders. A U.S. spokesperson indeed expressed disappointment that a consensus could not be reached on CFC rules.

H. Action #4 – Interest Deductions.

1. The BEPS Action #4 Final Report does not differ significantly from the earlier discussion draft, which presented a number of choices and left restrictions up to individual countries.

2. The Final Report, however, seemingly provides more direction. It analyzes several "best practices" and then provides a suggested approach. The recommended approach is based on a fixed ratio rule that limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA). At a minimum, states the Action #4 Executive Summary, this should apply to entities in multinational groups.

3. The recommended approach includes a range of possible ratios of between 10% and 30% to ensure that countries apply a fixed ratio that is sufficiently low to deal with base erosion issues while at the same time recognizing that all countries are not in the same position. The report also includes factors that countries should take into account in setting their fixed ratio within this range.

4. The fixed-ratio approach can be supplemented with a worldwide-group ratio rule that allows an entity to exceed the fixed-ratio limit in certain circumstances. Using a worldwide-group ratio along with a fixed ratio would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group.

5. Countries may also apply an uplift of up to 10% to the group's net third-party interest expense to prevent double taxation. The earnings-based worldwide-group ratio rule also could be replaced by different group-ratio rules, such as the "equity escape" rule (which compares an entity's level of equity and assets to those of its group) currently in place in some countries. A country may also choose not to introduce any group-ratio rule. If a country does not introduce a group-ratio rule, it should apply the fixed ratio to entities in multinational and domestic groups without improper discrimination.

6. The recommended approach allows countries to supplement the fixed-ratio and group-ratio rules with other provisions that reduce the impact of the rules on entities or in situations which pose less BEPS risk. The report also recognizes that the banking and insurance sectors have specific features that must be taken into account and that there is a need to develop suitable rules that address BEPS risks in these sectors.

I. Action #5 – Harmful Tax Practices.

1. The participating countries agreed that the substantial activity requirement used to assess preferential regimes should be strengthened in order to re-align taxation of profits with the substantial activities that generate them. Several approaches were considered and consensus was reached on a "nexus approach."

2. This approach was developed in the context of IP regimes, and allows a taxpayer to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying research and development ("R&D") expenditures that gave rise to the IP income. The nexus approach uses expenditures as a proxy for activity and builds on the principle that, because IP regimes are designed to encourage R&D activities and to foster growth and employment, a substantial activity requirement should ensure that taxpayers benefiting from these regimes did in fact engage in the activities and did incur the actual expenditures regarding these activities. Saint-Amans said in his webcast that the nexus approach will ultimately limit the toxicity of patent boxes.

3. In the area of transparency, there was an agreement regarding the exchange of rulings that could give rise to BEPS concerns. There will be a compulsory spontaneous exchange of rulings related to: (1) preferential regimes; (2) cross-border unilateral advance pricing agreements or other unilateral transfer pricing rulings; (3) a downward adjustment to profits; (4) permanent establishments; and (5) conduits. Other categories of rulings can be added to the list if the OECD's Forum on Harmful Tax Practices agrees that the absence of an exchange would give rise to BEPS concerns.

4. The Final Report states that an inclusion on the list does not mean that these rulings are *per se* preferential or that they will in themselves give rise to BEPS issues, but it does acknowledge that a lack of transparency in the operation of a regime or administrative process can give rise to mismatches in tax treatment and instances of double non-taxation. For countries that have the necessary legal basis in place, an exchange of information will take place starting April 1, 2016 for future rulings. The exchange of certain past rulings will need to be completed by December 31, 2016. The report also provides best practices for cross-border rulings.

5. The Report includes a review of 43 preferential regimes, 16 of which are IP regimes. In respect of substantial activity, the IP regimes reviewed were all considered inconsistent, either in whole or in part, with the nexus approach described in the report. Countries with these regimes will now need to review them for possible changes to conform. The BEPS review process will be ongoing.

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J. Action #6 – Treaty Abuse.

1. The Action #6 Executive Summary says that taxpayers engaged in treaty shopping and other treaty abuse strategies undermine tax sovereignty by claiming treaty benefits in situations in which these benefits were not intended to be granted, thereby depriving countries of tax revenues. The BEPS participant countries have therefore agreed to include anti-abuse provisions in their tax treaties, including a minimum standard to counter treaty shopping.

2. Section A of the Final Report includes new treaty anti-abuse rules that provide safeguards against the abuse of treaty provisions and offer a certain degree of flexibility regarding how to do so. These new treaty anti-abuse rules first address treaty shopping, which involves strategies through which a person that is not a resident of a state attempts to obtain benefits that a tax treaty concluded by that state grants to residents of the state, for example, by establishing a letterbox company in that state.

3. The following approach is recommended to deal with these strategies: (1) provide a clear statement that the states that enter into a tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including treaty shopping arrangements; (2) include a specific anti-abuse rule, the limitation-on-benefits (LOB) rule, that limits the availability of treaty benefits to entities that meet certain conditions in the OECD model tax convention; and (3) include a more general anti-abuse rule based on the principal purpose of transactions or arrangements (the principal purpose test ("PPT")) in the OECD model tax convention. The latter provision is to address other forms of treaty abuse, including treaty shopping situations that would not be covered by an LOB rule.

4. The report recognizes that each of the LOB and PPT rules has strengths and weaknesses and may not be appropriate for, or accord with treaty policy of, all countries. Also, the domestic law of some countries may include provisions that make it unnecessary to combine these rules to prevent treaty shopping.

5. The participating BEPS countries have committed to ensure a minimum level of protection against treaty shopping (the minimum standard). This commitment will require countries to include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements.

6. The U.S. will not utilize a PPT approach in its treaties. Such an approach was rejected by the Senate several years ago. Nearly all U.S. treaties, of

course, contain an LOB provision. The U.S. also has domestic rules to help prevent treaty shopping (anti-conduit rules under § 881). Thus, the U.S. will be compliant. Nonetheless, U.S. tax advisors will need to understand the new PPT rules. They likely will find themselves dealing with foreign-to-foreign treaties in their practices.

7. Section A also provides new rules to be included in tax treaties in order to address other forms of treaty abuse. These targeted rules address: (1) certain dividend transfer transactions that are intended to artificially lower withholding taxes payable on dividends; (2) transactions that circumvent the application of the treaty that allows source taxation of shares of companies that derive their value primarily from movable property; (3) situations in which an entity is a resident of two contracting states; and (4) situations in which the state of residence exempts the income of permanent establishments situated in third states and where shares, debt claims, rights or property are transferred to permanent establishments set up in countries that do not tax that income or offer preferential treatment to that income.

8. Changes to the commentary to the OECD model tax treaty convention will clarify that treaties do not prevent application of the contracting state's right to tax its own residents or imposition of a so-called "departure" or "exit" tax under which liability to tax some types of income that has accrued for the benefit of a resident is triggered in the event that the resident ceases to be a resident of that state.

9. Section B of the report addresses the part of Action 6 that seeks clarification "that tax treaties are not intended to be used to generate non-taxation." This clarification is provided through a reformulation of the title and preamble of the model tax convention that will state that the joint intention of the parties to a treaty is to eliminate double taxation without creating opportunities for tax evasion and avoidance, in particular through treaty shopping arrangements.

10. Section C of the report addresses the third part of the work mandated by Action 6, which is "to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another county."

11. Additional work will be required to fully consider proposals recently released by the U.S. concerning the LOB rule and other provisions included in the report. The new U.S. model treaty includes a more complicated LOB provision than before, seemingly making it less likely that other countries will want to adopt a similar approach in their non-U.S. treaties.

K. Action #7 – PE Status. Action #7 is entitled "Preventing the Artificial Avoidance of Permanent Establishment Status."

1. The final report for Action #7 introduces a number of changes that would substantially expand the definition of a permanent establishment, relative to the current OECD model treaty.

2. Commissionaires.

(a) Commissionaire arrangements, a specific target of Action #7, may loosely be defined as an arrangement through which a person sells products in a state in its own name, but on behalf of a foreign enterprise that is the owner of the products. Through such an arrangement, the foreign enterprise is able to sell its products in a state without technically having a PE in that state to which the sales may be attributed for tax purposes and without, therefore, being taxable in that state on the profits derived from those sales. Commissionaire arrangements have been a major preoccupation of the tax administrations in many countries, as shown by the number of cases dealing with these arrangements that have been litigated in OECD countries. In most of the cases that went to court, the tax administration's arguments were rejected.

(b) The Executive Summary states that, as a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a taxable presence in the country unless the intermediary is performing these activities in the course of an independent business. Changes to Articles 5(5) and 5(6) of the OECD model tax convention and the related commentary that is included in Section A of the report address commissionaire arrangements and similar strategies by ensuring that the wording of these provisions better reflects this underlying policy.

3. Habitually Concludes Contracts.

(a) Commentators on the discussion draft's broadening of the term "habitually concludes contracts" in Article 5(5) to the term "habitually concludes contracts or negotiates the material elements of contracts" were concerned that the proposed new rule was so broadly worded that it could apply to some of the most basic business practices of modern multinational enterprises and that it would capture much more than simply commissionaire arrangements. They also were concerned that it would apply to many transactions that do not raise BEPS-related concerns.

(b) The Tax Executives Institute ("TEI") stated, for example, that many businesses require goods and services to be delivered in multiple locations around the world. To ensure that the goods and services are always provided under the same terms and conditions and meet the same standards, a global master sales or service agreement is often negotiated by a lead provider (for example, the parent company) to save time in negotiation and administration of contracts. The master agreement's terms are then incorporated by reference into local agreements with local subsidiaries. The local agreement is reviewed, approved and signed by the local subsidiary; however, to keep each local subsidiary from re-negotiating the contract, modifications are generally limited to changes that are necessary because of specific local business needs or to satisfy local legal, tax and other regulatory requirements.

(c) TEI was concerned that under the discussion draft, the parent company likely would have a permanent establishment in each location that a local agreement is executed based on the master services agreement. Given that the local subsidiary is already paying tax for its local activities, the lead service provider that negotiated the global master agreement should not also have a permanent establishment in that jurisdiction merely by virtue of the agreement.

(d) TEI also was concerned that the proposed commentary in the discussion draft also stretched the interpretation of the phrase "concludes contracts" beyond any reasonable definition. Specifically, it indicated that a contract may be considered to be concluded in a state (1) even without any active negotiation of the terms of that contract, or (2) if a person accepts, on behalf of an enterprise, the offer made by a third party to enter into a standard contract with that enterprise even if the contract is signed outside of that state.

(e) To address these concerns, the Final Report uses the language habitually "concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise." The revised commentary says that while the term "concludes contracts"

> "provides a relatively well-known test based on contract law, it was found necessary to supplement that test with a test focusing on substantive activities taking place in one State in order to address cases where the conclusion of contracts is clearly the direct result of these activities although the relevant rules of contract law provide that the conclusion of the contract takes place outside that State. The phrase must be interpreted in the light of the object and

purpose of paragraph 5, which is to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, *i.e.* where that person acts as the sales force of the enterprise. The principal role leading to the conclusion of the contract will therefore typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise. The phrase therefore applies where, for example, a person solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the enterprise routinely approves these transactions. It does not apply, however, where a person merely promotes and markets goods or services of an enterprise in a way that does not directly result in the conclusion of contracts. Where, for example, representatives of a pharmaceutical enterprise actively promote drugs produced by that enterprise by contacting doctors that subsequently prescribe these drugs, that marketing activity does not directly result in the conclusion of contracts between the doctors and the enterprise so that the paragraph does not apply even though the sales of these drugs may significantly increase as a result of that marketing activity.

"The following is another example that illustrates the application of paragraph 5. RCO, a company resident of Sate R, distributes various products and services worldwide through its websites, SCO, a company resident of State S, is a wholly-owned subsidiary of RCO. SCO's employees send emails, make telephone calls to, or visit large organisations in order to convince them to buy RCO's products and services and are therefore responsible for large accounts in State S; SCO's employees, whose remuneration is partially based on the revenues derived by RCO from the holders of these accounts, use their relationship building skills to try to anticipate the needs of these account holders and to convince them to acquire the products and services offered by RCO. When one of these account holders is persuaded by an employee of SCO to purchase a given quantity of goods or services, the employee indicates the price that will be payable for that quantity, indicates that a contract must be concluded online with RCO before the goods or services can be provided by RCO and explains the standard terms of RCO's contracts, including the fixed price structure used by RCO, which the employee is not authorized to modify. The account holder subsequently concludes that contract online for the quantity discussed with SCO's employee and in accordance with the price structure presented by that employee. In this example, SCO's employees play the principal role leading to the conclusion of the contract

between the account holder and RCO and such contracts are routinely concluded without material modification by the enterprise. The fact that SCO's employees cannot vary the terms of the contracts does not mean that the conclusion of the contracts is not the direct result of the activities that they perform on behalf of the enterprise, convincing the account holder to accept these standard terms being the crucial element leading to the conclusion of the contracts between the account holder and RCO."

4. Independent Agent Exception.

   (a) Article 5(6) generally provides an exception to Article 5(5) for independent agents. More specifically, new revised Article 5(6) provides that Article 5(5) will not apply where a person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business.

   (b) The usefulness of the independent agent exception under new revised Article 5(6) will be substantially limited, however, by the exclusion of many related party transactions. New revised Article 5(6) specifically provides that a person who acts exclusively or almost exclusively on behalf of closely related enterprises shall not be considered to be an independent agent within the meaning of this paragraph.

5. Preparatory or Auxiliary.

   (a) When the specific exceptions to the definition of PE in Article 5(4) of the OECD model tax convention were first introduced, the described activities were generally considered to be of a preparatory or auxiliary nature.

   (b) The Executive Summary to the Action #7 Final Report says there have been dramatic changes in the way that business is conducted since the introduction of these exceptions. This was discussed in part in the Final Report on Action 1 ("Digital Economy"). Depending on the circumstances, activities previously considered to be merely preparatory or auxiliary in nature may today correspond to core business activities. In order to ensure that profits derived from core activities performed in a country can be taxed in that country, Article 5(4) will be modified to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary" character.

(c) Commentators on the earlier discussion draft had objected to various options proposed as replacements to the present rules. The BEPS draftspersons decided that the "preparatory or auxiliary" approach would work best, with a clarification of the scope of this term. The U.S. disagreed with this approach on the grounds that the standard "preparatory or auxiliary" is too subjective. Some countries believe the issue should be resolved by the anti-fragmentation rule, discussed below.

(d) Accordingly, the Final Draft, while adding the "preparatory or auxiliary" limiting language to the OECD model treaty, also provides that it is optional, provided countries that do not include it as an overall limitation include an anti-fragmentation provision in their treaties.

(e) The new limiting provision ("preparatory or auxiliary") will be discussed in the OECD model convention commentary as follows:

> "It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity.
>
> "As a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise. This, however, will not always be the case as it is possible to carry on an activity at a given place for a substantial period of time in preparation for activities that take place somewhere else. Where, for example, a construction enterprise trains its employees at one place before these employees are sent to work at remote work sites located in other countries, the training that takes place at the first location constitutes a preparatory activity for that enterprise. An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole. It is unlikely that an activity that requires a significant proportion of the assets or employees

of the enterprise could be considered as having an auxiliary character."

6. Fragmentation.

(a) BEPS concerns related to Article 5(4) also arise from what the report calls the "fragmentation of activities." The Executive Summary states that given the ease with which multinational enterprises may alter their structures to obtain tax advantages, it is important to clarify that PE status cannot be avoided by fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities that benefit from the exceptions of Article 5(4). The U.S. agreed with the need for an anti-fragmentation rule.

(b) However, the vast majority of comments regarding the discussion draft's fragmentation proposals objected to both proposed approaches to changing the rule. All commenters agreed that a fragmentation rule would be difficult to apply in practice, even those few who supported a change. TEI stated that many multinational enterprises are divided functionally on a worldwide basis so that, for example, the purchasing function is separated from the manufacturing function, which is separated from the sales function. Each of these corporate functions has its own management, reporting lines and financial statements. Commercial advantage is the primary driver for utilizing the specialization, expertise, economies of scale, and flexibility that accompanies this manner of conducting worldwide operations.

(c) TEI's specific concern was that an anti-fragmentation rule could cause a multinational enterprise to have multiple PE's in a given country or a PE in situations in which there really should not be a PE, for example, where there are no BEPS concerns, simply by having a rule that fails to recognize how large modern corporate enterprises operate in today's business environment.

(d) The new anti-fragmentation language in Article 5 (4.1) will provide:

> "Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and

a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or

b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation."

(e) The OECD model treaty commentary will provide:

"The purpose of paragraph 4.1 [above] is to prevent an enterprise or a group of closely related enterprises from fragmenting a cohesive business operation into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity. Under paragraph 4.1, the exceptions provided for by paragraph 4 do not apply to a place of business that would otherwise constitute a permanent establishment where the activities carried on at that place and other activities of the same enterprise or of closely related enterprises exercised at that place or at another place in the same State constitute complementary functions that are part of a cohesive business operation. For paragraph 4.1 to apply, however, at least one of the places where these activities are exercised must constitute a permanent establishment or, if that is not the case, the overall activity resulting from the combination of the relevant activities must go beyond what is merely preparatory or auxiliary.

* * *

"The following examples illustrate the application of paragraph 4.1:

Example A: RCO, a bank resident of State R, has a number of branches in State S which constitute permanent establishments. It also has a separate office in State S where a few employees verify information provided by clients that have made loan applications at these different branches. The results of the verifications done by the employees are forwarded to the headquarters of RCO in State R where other employees analyse the information included in the loan applications and

provide reports to the branches where the decisions to grant the loans are made. In that case, the exceptions of paragraph 4 will not apply to the office because another place (*i.e.* any of the other branches where the loan applications are made) constitutes a permanent establishment of RCO in State S and the business activities carried on by RCO at the office and at the relevant branch constitute complementary functions that are part of a cohesive business operation (*i.e.* providing loans to clients in State S).

"Example B: RCO, a company resident of State R, manufactures and sells appliances. SCO, a resident of State S that is a wholly-owned subsidiary of RCO, owns a store where it sells appliances that it acquires from RCO. RCO also owns a small warehouse in State S where it stores a few large items that are identical to some of those displayed in the store owned by SCO. When a customer buys such a large item from SCO, SCO employees go to the warehouse where they take possession of the item before delivering it to the customer; the ownership of the item is only acquired by SCO from RCO when the item leaves the warehouse. In this case, paragraph 4.1 prevents the application of the exceptions of paragraph 4 to the warehouse and it will not be necessary, therefore, to determine whether paragraph 4, and in particular subparagraph 4 a), applies to the warehouse. The conditions for the application of paragraph 4.1 are met because

- SCO and RCO are closely related enterprises;

- SCO's store constitutes a permanent establishment of SCO (the definition of permanent establishment is not limited to situations where a resident of one Contracting State uses or maintains a fixed place of business in the other State; it applies equally where an enterprise of one State uses or maintains a fixed place of business in that same State); and

- The business activities carried on by RCO at its warehouse and by SCO at its store constitute complementary functions that are part of a cohesive business operation (*i.e.* storing goods in one place for the purpose of delivering these goods as part of the obligations resulting from the sale of these goods through another place in the same State)."

7. Splitting-Up Contracts. The Executive Summary says that the exception in Article 5(3), which applies to construction sites, also has given rise to abuses through the practice of splitting up contracts between closely related enterprises. The PPT that will be added to the OECD model tax convention as a result of Action 6 will address the BEPS concerns related to these abuses. In order to make this clear, a new example will be added to the commentary on the PPT rules.

8. Multilateral Instrument. The changes to the definition of PE that are included in the report will be among the changes proposed for inclusion in the multilateral instrument that will implement the results of the BEPS work on treaty issues.

9. PE Profits. In order to provide greater certainty about the determination of profits to be attributed to a PE and to take account of the need for additional guidance on the issue of attribution and profits to PEs, follow-up work on attribution and profits issues related to Action 7 will be carried on with a view to providing the necessary guidance before the end of 2016, which is a deadline for the negotiation of the multilateral instrument.

10. Treasury officials have expressed concerns regarding the new PE standard and the attribution of profits to such PEs.

    (a) Treasury officials have raised concerns regarding the new expanded definition of PEs, stating that the U.S. may decide to opt out of the new PE standard. Although some of these concerns could be addressed via the appropriate attribution of profits to a PE, Treasury is concerned that the OECD's attribution work (scheduled for 2016) will not be enough to counter the U.S.'s concerns about the new standard.

    (b) Treasury officials have stated that the mere fact that new PE standards may result in additional new PEs does not necessarily mean a local jurisdiction can claim more taxable income. Michael McDonald, a Treasury economist and delegate to the OECD, noted that in cases where a PE is triggered due to a subsidiary or affiliate's being classified as an agent or deemed to be carrying out non-auxiliary activity under the new rules, that entity will already be a taxpayer in that local jurisdiction. According to McDonald, it may be possible that a determination could be made that there are significant people functions that might attract assets and risks, but a separate question is to what extent have those functions and risks and assets already been remunerated under Article 9.

L. Actions #8 - #10 – Transfer Pricing.

1. The arm's-length principle is used by countries as the cornerstone of transfer pricing rules. The Executive Summary states that it is embedded in treaties and appears in Article 9(1) of the OECD and UN model tax conventions. A shared interpretation of the arm's-length principle by many of those countries is provided in the OECD's transfer pricing guidelines for multinational enterprises and tax administrations. The BEPS action plan required guidance on the arm's-length principle to be clarified and strengthened and, furthermore, if transfer pricing risks remain after clarifying and strengthening the guidance, the BEPS action plan foresaw the possibility of introducing "special measures" either within or beyond the arm's-length principle.

2. The work on transfer pricing focused on three key areas. Work under Action 8 considered transfer pricing issues relating to intangibles, since misallocation of the profits generated by valuable intangibles has contributed to base erosion and profit-shifting.

3. Work under Action 9 addressed the contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond to the activities actually carried on. The work also addressed the level of returns to funding provided by a capital-rich multinational group member where those returns do not correspond to the level of activity undertaken by the funding company.

4. The Action 10 efforts focused on other high-risk areas, including addressing profit allocations resulting from transactions that are not commercially rational for the individual enterprises concerned (re-characterization), targeting the use of transfer pricing methods in a way that results in diverting profits away from the most economically important activities of the multinational group, and neutralizing the use of certain types of payments between members of the multinational group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation.

5. As noted earlier, the BEPS Final Report's Introduction states that the new Transfer Pricing Guidelines may be immediately applicable with no further action needed on the part of participating countries. This is perhaps optimistic. *See* footnote 6 on p. 140 regarding implementation. A U.S. spokesperson (Bob Stack) stated that the BEPS Final Report on Actions 8-10 clarifies the arm's-length standards that are already in the IRS regulations and that Treasury and the IRS do not anticipate making substantial changes to the § 482 regulations.

6. Commercial Rationality.

(a) The revised transfer pricing guidance requires careful analysis of the actual transaction between associated enterprises by considering the contractual relations between the parties in combination with the conduct of the parties. Their conduct will supplement or replace the contractual arrangements if the contracts are incomplete or not supported by the parties' conduct. The Executive Summary states that in combination with the proper application of pricing methods in a way that prevents the allocation of profits to locations where no contributions are made to these profits, this will lead to the allocation of profits to the enterprises that conduct the corresponding business activities. In circumstances where the transaction between associated enterprises lacks commercial rationality, the guidance authorizes disregarding the arrangement for transfer pricing purposes.

(b) Use of the term "commercial rationality" represents a change in the Final Report for transactions to be recognized from the earlier approach that transactions must have had fundamental attributes of transactions between unrelated parties to be recognized. The concern, as stated by a U.S. spokesperson (Treasury's Michael McDonald, who served as co-chair of the relevant OECD Working Party), was that the discussion draft's standard could have been interpreted too broadly whereas the intent is to provide nonrecognition of transactions only in exceptional circumstances.

7. Risk and Intangibles.

(a) The revised guidance includes two important clarifications relating to risks and intangibles.

(b) Risks are defined as the effect of uncertainty on the objectives of the business. Uncertainty exists and risk is assumed in a company's operations every time steps are taken to exploit opportunities and every time a company spends money to generate income. No profit-seeking business takes on risk associated with commercial opportunities without expecting a positive return.

(c) The Executive Summary states that this economic notion that higher risks warrant anticipated returns made multinational groups pursue tax-planning strategies based on contractual re-allocations of risks, sometimes without any change in business operations.

(d) In order to address this, the report provides that risks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over the risks, or does not have the

financial capacity to assume the risks, will be allocated to the party that does exercise that control and does have the financial capacity to assume the risks.

(e) A U.S. spokesperson stated that the report more clearly gives equal weight to functions, assets and risks. One interpretation of the 2014 discussion draft was that risk could be allocated to functions, which was not the intended meaning.

(f) For intangibles, the guidance clarifies that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. The group companies performing important functions, controlling economically significant risks and contributing assets, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return reflecting the value of their contributions. Specific guidance will ensure that the analysis is not weakened by information asymmetries between the tax administration and the taxpayer in relation to hard-to-value intangibles (*see* the discussion in the next section regarding the OECD Transfer Pricing Guidelines), or by using special contractual relationships, such as a cross-contribution agreement.

(g) The final guidance also addresses the situation when a capital-rich member of the group provides funding but performs few activities. If this associated enterprise does not in fact control the financial risks associated with this funding (for example, because it just provides the money when it is asked to do so, without any assessment of whether the party receiving the money is credit-worthy), then it will not be allocated profits associated with the financial risks and will be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational and therefore the guidance on non-recognition applies.

(h) Finally, the guidance ensures that transfer pricing principles will allocate profits to the most important economic activities. It also will not be possible to allocate the synergistic benefits of operating as a group to members other than the ones contributing to the synergistic benefits. For example, discounts that are generated because of the value of goods ordered by a combination of group companies will need to be allocated to those group companies.

8. Profit Split. Follow-up work will be done regarding the transactional profit-split method during 2016 that will be finalized in the first half of 2017. This work should lead to detailed guidance on the ways in which this method can usefully and appropriately be applied to align transfer pricing outcomes and value creation, including in the circumstances of

integrated global value chains. A U.S. spokesperson, in any event, said the U.S. is reluctant to push taxpayers towards using profit split methods when traditional pricing models using valuation methods and comparables will suffice.

9. Related Guidance.

(a) The Final Report's guidance is linked with other BEPS actions. This guidance will ensure that capital-rich entities without any other relevant economic activities ("cash boxes") will not be entitled to any excess profits. The profits the cash box is entitled to retain will be equivalent to no more than a risk-free return. Moreover, if this return qualifies as interest or an economically equivalent payment, then those already marginal profits will also be targeted by the interest deductibility rules of Action 4.

(b) In addition, it will become extremely difficult to structure the payments to the country where the cash box is tax-resident in a way that avoids withholding taxes, due to the guidance on preventing treaty abuse (Action 6). Finally, a cash box with limited or no economic activities is likely to be the target of CFC rules (Action 3). The role of cash boxes in base erosion and profit shifting strategies will be seriously discouraged.

(c) A transfer pricing analysis requires access to the relevant information. Access to the transfer pricing documentation provided by Action 13 will enable the guidance provided in the Final Report to be applied in practice, based on relevant information on global and local operations in the master file and local file. In addition, the country-by-country ("CbC") reports will enable better risk assessment practices by providing information about the global allocation of the multinational group's revenues, profits, taxes and economic activity.

(d) A U.S. spokesperson said, however, the U.S. is able and willing to suspend information exchange with countries that misuse data taken from CbC reports, such as using things like headcount and making assumptions about allocable profits.

10. Commodities and Developing Countries. The report also contains guidance on transactions involving commodities, as well as on low-value-adding intra-group services. As BEPS creates additional transfer pricing challenges for developing countries, and these two areas were identified by them as being of critical importance, this guidance will be supplemented with further work mandated by the G20 developing-country working group, which will provide knowledge, best practices, and tools for developing countries to use to price commodity transactions for

transfer pricing purposes and to prevent erosion of their tax bases through common types of base-eroding payments.

11. Mutual Agreement Procedures. Transfer pricing depends on a facts-and-circumstances analysis and can involve subjective interpretations of these facts and circumstances. In order to address the risk of double taxation, the work under Action 14 to improve the effectiveness of dispute resolution mechanisms includes a new minimum standard providing for access to the mutual agreement procedures of Article 25 of the model tax convention for all transfer pricing cases. In addition, the 20 countries that have made a commitment to mandatory binding arbitration under Article 14 have specified that they will allow arbitration for transfer pricing cases so that double taxation will be eliminated.

12. Special Measures. The Executive Summary states that the work under Actions 8-10 of the BEPS Action Plan will ensure that transfer pricing outcomes better align with value creation of the multinational group. This will ensure that the role of capital-rich low-functioning entities in base erosion and profit shift planning will become less relevant. As a consequence, the goals set by the BEPS Action Plan in relation to the development of transfer pricing rules have been achieved without the need to develop so-called "special measures" outside the arm's-length principle.

13. Risk and Re-characterization, Intangibles, etc. The Final Report contains significant revisions regarding risk and re-characterization, intangibles, cost-contribution arrangements and low-value-adding services. The OECD Transfer Pricing Guidelines are materially changed regarding these areas and they are discussed at length in the next section of this outline.

M. Action #11 – Measuring and Monitoring BEPS.

1. The April 16 discussion draft on Action #11 indicated that measuring the scale and effect of base erosion and profit shifting is challenging because of the complexity and the serious data limitations. The Final Report does not improve upon that assessment. However, it nonetheless states in an *ipse dixit* manner that, although measuring the scale of base erosion and profit shifting is challenging, "We know that the fiscal effects of [base erosion and profit shifting] are significant."

2. The report states that six indicators of this base erosion activity highlight taxpayer base-eroding behaviors using different sources of data, employing different metrics, and examining base erosion channels. The report adds that new empirical analysis of the fiscal and economic effects of base erosion and profit shifting and "hundreds" of existing empirical studies that find the existence of profit shifting through transfer mispricing, strategic location of intangibles and debt, as well as treaty

abuse confirm that profit-shifting is occurring, is significant in scale and likely to be increasing, and creates adverse economic distortions.

3. The report then states, however, that these indicators and all analyses of base erosion and profit shifting are severely constrained by the limitations of the currently available data. The available data is not comprehensive across countries or companies, and often does not include actual taxes paid. In addition, the analyses of profit-shifting to date have found it difficult to separate the effects of profit-shifting from real economic factors and the effects of deliberate government tax policy choices. Improving the tools and data available to measure base erosion and profit shifting will be critical for measuring and monitoring it in the future.

4. The report makes a number of recommendations intended to improve the analysis of the available data while recognizing the need to maintain appropriate safeguards to protect the confidentiality of taxpayer information. The report is the third-longest of the BEPS reports at 268 pages.

N. Action #12 – Mandatory Disclosure Rules.

1. Action 12 addresses mandatory disclosure regimes to fight abusive tax schemes. The Executive Summary states that mandatory disclosure regimes should be clear and easy to understand, should balance additional compliance costs to taxpayers with the benefits obtained by the tax administration, should be effective in achieving their objectives, and should accurately identify the schemes to be disclosed. One objective of mandatory disclosure regimes is deterrence: taxpayers may think twice about entering into a scheme if it has to be disclosed. Pressure is also placed on the tax avoidance market as promoters and users have only a limited opportunity to implement schemes before they are closed down.

2. The Final Report does not set forth a minimum standard and countries are free to choose whether or not to introduce mandatory disclosure regimes. In order to successfully design an effective mandatory disclosure regime, the following features need to be considered: who reports, what information needs to be reported, when the information has to be reported, and the consequences of non-reporting. The report recommends that countries introducing mandatory disclosure regimes consider a list of five specified items, such as, should the disclosure requirement be imposed on both the promoter and the taxpayer or should the primary obligation to disclose be imposed on either the promoter or the taxpayer? Also, penalties should be introduced to ensure compliance with mandatory disclosure regimes that are consistent with general domestic law.

O. Action #13 – Transfer Pricing Documentation and CbC Reporting.

1. The Action #13 Executive Summary states that guidance on transfer pricing documentation requires multinational enterprises to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies in a "master file" that is to be available to all relevant tax administrations. The master file provides a blueprint of the multinational group and contains relevant information in five categories: (1) organizational structure, (2) description of the business, (3) intangibles, (4) intercompany financial activities, and (5) financial and tax positions.

2. Second, the guidance requires that detailed transactional transfer pricing documentation be provided in a "local file" specific to each country, identifying material-related party transactions, the amounts involved in those transactions, and the company's analysis of its transfer pricing determinations regarding those transactions.

3. Third, large multinational enterprises are required to file a CbC report that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued. It also requires multinational enterprises to report the number of their employees, stated capital, retained earnings, and tangible assets in each tax jurisdiction. Finally, it requires multinational enterprises to identify each entity in the group that does business in a particular tax jurisdiction and to provide an indication of the business activities in which each entity engages.

4. The Executive Summary says that consistent and effective implementation of the transfer pricing documentation standards and in particular of the CbC report is essential. Therefore, countries participating in the BEPS project agreed on the core elements of implementing transfer pricing documentation and CbC reporting. This agreement calls for the master file and the local file to be delivered by multinational enterprises directly to local tax administrations. CbC reports should be filed in the jurisdiction of tax residence of the ultimate parent entity and shared between jurisdictions through automatic exchange of information pursuant to government-to-government mechanisms.

5. The new CbC reporting requirements are to be implemented for fiscal years beginning on or after January 1, 2016 and applied, subject to a review in 2020, to multinational enterprises with annual consolidated group revenue equal to or exceeding €750 million.

6. As of February 2016, 32 countries have signed the Multilateral Competent Authority Agreement (MCAA), providing for the automatic exchange of CbC reports across tax jurisdictions in which a multinational enterprise

operates. The expectation is that the first exchanges will start in 2017 and 2018 with respect to 2016 information.

7. The OECD has also released its standardized electronic format for the exchange of CbC reports between jurisdictions (CbC XML Schema) and user guide. The OECD noted that although the CbC XML Schema has been primarily designed to be used for the automatic exchange of CbC reports between competent authorities, the CbC XML Schema can also be relied upon by reporting entities for transmitting the CbC report to their tax authorities, provided the use of the CbC XML Schema is mandated domestically.

8. Treasury and the IRS recently issued proposed intended to implement CbC reporting for U.S. taxpayers (*see Section XII below*). The year 2016 apparently will be a gap period for most U.S.-parented groups with no U.S. filing, but foreign reports required. This is not good.

P. Action #14 – Dispute Resolution Mechanisms.

1. Article 25 of the OECD model tax convention provides a mechanism, independent of ordinary legal remedies available under domestic law, through which the competent authorities of the contracting states may resolve differences or difficulties regarding the interpretation or application of the convention on a mutually-agreed basis. This mechanism—the mutual agreement procedure— is of fundamental importance to the proper application and interpretation of tax treaties, notably to ensure that taxpayers entitled to the benefits of the treaty are not subject to taxation by either of the contracting states which is not in accordance with the terms of the treaty.

2. The BEPS countries have agreed to important changes in their approach to dispute resolution, in particular by having developed a minimum standard with respect to the resolution of treaty-related disputes, committed to its rapid implementation and agreed to ensure its effective implementation through the establishment of a robust peer-based monitoring mechanism that will report regularly through the committee on fiscal affairs to the G20.

3. The minimum standard will: (1) ensure that treaty obligations related to the mutual agreement procedure are fully implemented in good faith and that mutual agreement cases are resolved in a timely manner; (2) ensure the implementation of administrative processes that promote the timely resolution of treaty-related disputes; and (3) ensure that taxpayers can access the mutual agreement procedures when eligible. The BEPS countries' implementation of the minimum standard will monitored using a detailed terms of reference and assessment methodology to be developed in 2016.

4. A set of 11 best practices also is described in the report. Countries are free to adopt them, and they are not a part of the minimum standard. A U.S. spokesperson (David Varley, acting director of the IRS's transfer pricing operations) expressed disappointment that they were not included as a part of the minimum standard.

5. In addition to the commitment to implement the minimum standard by all countries, 20 countries have declared their commitment to provide for mandatory binding mutual agreement procedure arbitration in their bilateral tax treaties as a mechanism to guarantee that their treaty-related disputes will be resolved within a specified time frame. The Final Report states that this represents a major step forward. These countries collectively were involved in more than 90% of the outstanding mutual agreement procedure cases at the end of 2013, as reported to the OECD.

6. A U.S. spokesperson expressed optimism that more countries would join the 20 countries that have already agreed to mandatory binding arbitration, although he added that political support will be key to that effort.

7. While binding arbitration is important, some developing countries expressed objections relating to costs, fairness, accessibility, sovereignty, information security and coordination with domestic law. This could present serious problems moving forward as some important developing countries are not included in the list of 20 countries that have agreed to binding mandatory arbitration.

Q. <u>Action #15 – Multilateral Instrument</u>.

1. Action 15 provides for an analysis of the tax and public international law issues related to the development of a multilateral instrument to enable countries that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. Interested countries will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution.

2. A group authorized by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors began working on drafting the multilateral instrument in May 2015, with the goal to complete its work and present for signature by the end of 2016. Participation in the development of the multilateral instrument is voluntary and does not require any commitment by a participating country to sign it.

3. The task of drafting a multilateral instrument to implement the treaty-related changes will be challenging, with the need to achieve consensus among the 95+ countries and the OECD who are working on the

multilateral instrument. Due to the seemingly unavoidable trade-off between flexibility and complexity, it is expected that the multilateral instrument will not be a one size fits all document, but rather will permit countries to pick and choose which aspects of the multilateral instrument they will agree to.

XIII. COUNTRY-BY-COUNTRY REPORTING.

A. New IRS CbC Reporting Regulations.

1. Treasury and the IRS issued proposed regulations on December 23, 2015, regarding country-by-country ("CbC") reporting under BEPS Action 13. Prop. Treas. Reg. § 1.6038-4 generally incorporates the CbC report template proposed in BEPS Action 13. As such, the new reporting requirement would include reporting by a multinational group on income earned, headcount, taxes paid, and certain other economic indicators along with the location of the relevant economic activity. CbC reports would be required of U.S. parented multinational groups with $850 million or more in annual revenue.

2. The regulations would take effect in the first tax year beginning on or after the date they become finalized, with Treasury officials indicating a June 30 target date for finalizing the regulations. Thus, the rules likely won't take effect for most companies before Jan. 1, 2017. Note the one-year lag vis-á-vis the BEPS Final Report. This could give rise to issues if, for example, other countries request CbC documents from U.S.-based multinationals for the year before the U.S. rules take effect (2016) (discussed below).

3. The preamble states that Treasury and the IRS have determined that the information required under the proposed regulations will assist in better enforcement of the federal income tax laws by providing the IRS with greater transparency regarding operations and tax positions taken by U.S. multinational groups. In addition to this direct benefit expected from collecting U.S. CbC reports, pursuant to income tax conventions and other conventions and bilateral agreements relating to the exchange of tax information, a U.S. CbC report filed with the IRS may be exchanged by the U.S. with other tax jurisdictions in which the U.S. multinational group operates that have agreed to provide the IRS with foreign CbC reports filed in their jurisdiction by foreign multinational corporate groups that have operations in the U.S.

4. In particular, states the preamble, it is expected that CbC reports filed by both U.S. multinational groups and foreign multinational groups will help the IRS perform high-level transfer pricing risk identification and assessment. The information in a CbC report will not itself constitute

conclusive evidence that transfer pricing practices are or are not consistent with the arm's length standard.

5. Accordingly, the information in a CbC report will not be used as a substitute for an appropriate transfer pricing determination based on a best method analysis (including a full comparability analysis of factors such as functions performed, resources employed and risks assumed) as required by the arm's length standard set forth in the § 482 regulations. Thus, transfer pricing adjustments will not be based solely on a CbC report.

6. However, a CbC report may be used as a basis for making further inquiries into transfer pricing practices or other tax matters in the course of an examination of a member of a multinational group, and adjustments may be based on additional information developed through those inquires in accordance with applicable law.

7. Information reported pursuant to the proposed regulations is tax return information under § 6103. That section imposes strict confidentiality rules with respect to all return information. Section 6103(k)(4) allows the IRS to exchange return information with a competent authority of a tax jurisdiction only to the extent provided in, and subject to the terms and conditions of, an information exchange agreement. The preamble states that it is expected the U.S. competent authority will enter into competent authority arrangements for the automatic exchange of CbC reports under the authority of information exchange agreements to which the U.S. is a party.

8. Consistent with established international standards, all the information exchange agreements to which the U.S. is a party require the information exchanged to be treated as confidential by both parties, and disclosure and use of the information must be in accordance with the terms of the relevant information exchange agreement.

9. Accordingly, under the terms of information exchange agreements, neither tax jurisdiction is permitted to disclose the information received under the information exchange agreement or use such information for any non-tax purpose. Under the competent authority agreements for the exchange of CbC reports, the competent authorities of the U.S. and other tax jurisdictions intend to further limit the permissible uses of exchanged CbC reports to assessing high-level transfer pricing and other tax risks, and where appropriate, for economic and statistical analysis.

10. In order to conclude an information exchange agreement with another tax jurisdiction, Treasury and the IRS must be satisfied that the tax jurisdiction has the necessary legal safeguards in place to protect exchanged information, the protections are enforced, and adequate penalties apply to any breach of that confidentiality.

11. If the U.S. determines that a tax jurisdiction is not in compliance with the confidentiality requirements, data safeguards, and the appropriate use standards provided for under the information exchange agreement or the competent authority arrangement, the U.S. will pause automatic exchange of CbC reports with that tax jurisdiction until the U.S. is satisfied that the jurisdiction is meeting its obligations under the applicable information exchange or competent authority agreement or arrangement.

12. While Treasury and the IRS have sought to minimize deviations from the model template developed in the BEPS process, they understand that there may be areas where further clarification or refinement is warranted to take into account the purpose of the proposed regulations to collect relevant information for high-risk assessment while minimizing the burdens imposed. Thus, Treasury and the IRS solicit comments on the manner in which the proposed regulations request information. They also request comments on whether any of the other items should be further refined or whether additional guidance is needed regarding how to determine any of the items in the proposed regulations. The IRS has set a hearing for May 13 to discuss the proposed country-by-country reporting regulations.

13. TEI submitted comments (March 21, 2016) to the proposed CbC reporting regulations, including recommending that the regulations apply to filings in 2017 for 2016 tax years (including those beginning on or after January 1, 2016). Alternatively, TEI urged the IRS and Treasury to consult with foreign tax authorities in those countries requiring 2016 reporting and request U.S. multinational enterprises to be permitted to file the U.S. version of the CbC report, as required by the final CbC regulations. TEI also recommended the final CbC regulations be consistent with the OECD standard for determining the location of an employee based on the tax residence of the employer.

14. The U.S. has opted to not participate in the aforementioned OECD's Multilateral Competent Authority Agreement for the automatic exchange of CbC reports, opting instead to sign bilateral agreements with other countries.

15. Treasury has stated that it is exploring discussions with foreign governments to ease administrative hassles and privacy concerns due to the one-year gap in the implementation of U.S. CbC reporting.

    (a) Ryan Finley reported that tax officials from the United States, Canada and the U.K. are optimistic that their countries will be able to effectively coordinate implementation of CbC reporting. 2016 TNT 30-5. The issue involves the potential treatment of 2016 as a "gap year" in which U.S. multinationals would not be subject to reporting under Treasury regulations, but rather could be subject to the "surrogate parent entity" rules in countries that have already

implemented CbC reporting. These rules require a multinational to appoint a group entity other than the ultimate parent to file a CbC report in specified situations, including when a multinational isn't subject to CbC reporting in its home country. The UK has stated that it will accept surrogate filings of CbC reports by UK subsidiaries of U.S. multinational groups for 2016 as a way of addressing the one-year gap issue.

(b) French subsidiaries of U.S. parent companies could get caught between France's 2016 implementation and the expected U.S. 2017 implementation. France's implementation of the CbC reporting requirement is effective for tax years beginning on or after January 1, 2016, and includes a penalty of up to 100,000 euros for companies that don't comply (including, possibly, in the case of a French subsidiary of a U.S. parent, which is not subject to CbC reporting requirement in the U.S.).

(c) Contrast with Denmark's new CbC reporting requirements, which although apply for income years beginning in 2016, provide that Danish subsidiaries of foreign groups will not have a reporting obligation for 2016 if the country of the foreign parent company has not yet implemented the reporting requirement.

(d) An IRS spokesperson (Jeff Mitchell) initially said the IRS will not accept voluntary early filings to remedy the gap period issue. More recently, Bob Stack, of U.S. Treasury, said the U.S. might use a voluntary filing program for 2016, but expressed some concern that foreign countries might not accept this "fix" to the gap problem, because the CbC reports filed would not be mandatory According to Stack, companies need to be prepared for either local filings or surrogate filings with respect to their 2016 year.

16. Stack has stated that the U.S. would halt the exchange of CbC information to a jurisdiction that makes the CbC reports public. According to Stack, "There is no circumstance in which the U.S. CBC information that's given by the IRS can be made public as a general matter, or as a matter of compliance for some other legislative rule. If they take IRS information and make it public, we will stop sending it, because it violates our treaties."

17. Treasury and the IRS thus state they expect to issue the final CbC regulations in time for them to apply to tax years beginning in the second half of 2016, instead of in 2017. While this will serve to shorten or eliminate the gap period for some taxpayers, most U.S.-based multinational corporations still have a concern that they will become

subject to local (foreign-country) reporting without the "protection" of filing first with the IRS.

B. Country-By-Country Reporting.

1. The IRS issued final regulations that require annual country-by-country ("CbC") reporting by certain U.S. persons that are the ultimate parent entity of a multinational enterprise group. The final regulations affect U.S. persons that are the ultimate parent of a group that has annual revenue for the proceeding annual accounting period of $850 million or more. Reporting is for taxable years beginning after June 30, 2016, as expected.

2. The preamble to the final regulations discusses many of the comments that Treasury and the IRS received. They responded to a number of these comments in a very helpful manner. I will not discuss the comments or Treasury's and the IRS's responsive changes made in the regulations, as they are numerous.

3. The most important modification is that Treasury and the IRS adopted a procedure for the voluntary filing of CbC reports with the IRS for annual accounting periods beginning on or after January 1, 2016. Some foreign countries have adopted rules that require reporting for periods beginning on or after that date.

4. The preamble to the final regulation states that Treasury is working to ensure that foreign jurisdictions implementing CbC reporting requirements will not require constituent entities of U.S. multinational groups to file a CbC report with the foreign jurisdiction if the U.S. multinational group files a CbC report with the IRS pursuant to this voluntary procedure and the CbC report is exchanged with that foreign jurisdiction pursuant to a competent authority arrangement.

5. On the same day that Treasury and the IRS released final CbC reporting regulations, the OECD issued guidelines recommending that other countries accept for years beginning on January 1, 2016 reports filed voluntarily in the U.S. and other countries that do not yet require reports. Under the BEPS Action 13 report, countries can require reporting for multinationals with a foreign parent entity if that parent's country of residence does not require CbC reporting or fails to exchange reports. The OECD's report recommends accepting voluntarily filed CbC reports, subject to a list of conditions. It identifies the United States, Japan and Switzerland as countries that will likely satisfy those requirements.

XIV. BEPS: REVISIONS TO THE OECD'S TRANSFER PRICING GUIDELINES

A. Guidance for Applying the Arm's Length Principle.

1. As a part of the BEPS project, and as a part of the BEPS Final Report on Actions 8-10, Chapter I, Section D of the OECD's Transfer Pricing Guidelines will be deleted in its entirety and replaced with a lengthy new discussion developed in the context of the BEPS work.[6] The new guidance ensures that (1) actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality; (2) contractual allocations of risk are respected only when they are supported by actual decision-making; (3) capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocate to cash boxes without relevant substance; and (4) tax administrations may disregard transactions when the exceptional circumstances of commercial irrationality apply. In combination, the changes are intended to help align transfer pricing outcomes with the value creating activities performed by members of a multinational group.

2. Comparability Analysis.

    (a) A "comparability analysis" is at the heart of the application of the arm's length principle. Application of the arm's length principle is based on a comparison of the conditions in a controlled transaction with the conditions that would have existed had the parties been independent and undertaken a comparable transaction under comparable circumstances. There are two key aspects in such an analysis:

    > (1) identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated; and (2) compare the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of the comparable transactions between independent enterprises.

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[6] In a June 15 statement, the OECD announced that OECD Council had on May 23 approved amendments to the transfer pricing guidelines based on the BEPS reports (Actions 8, 9 and 10 and Action 13), including additions to and replacements of existing language. This was discussed in a report by Ryan Finley at 2016 WTD 116-1. This includes adding the new guidance on risk to Chapter 1 and removing the existing chapters on transfer pricing documentation, intangibles, services, and cost contribution arrangements and replacing them with the corresponding provisions in the BEPS reports.

(b) The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between the associated enterprises in order to accurately delineate the actual transaction can be broadly categorizes as follows: (1) the contractual terms of the transaction; (2) the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the multinational group to which the parties belong, the circumstances surrounding the transaction and industry practices; (3) the characteristics of the property transferred or services provided; (4) the economic circumstances of the parties and of the market in which the parties operate; and (5) the business strategies pursued by the parties.

(c) Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives. Independent enterprises will generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk) when evaluating those options.

3. The Parties' Agreement.

(a) In situations where a transaction has been formalized by the associated enterprises through written contractual agreements, those agreements provide a starting point for delineating the transaction between them and how the responsibilities, risks, and anticipated outcomes arising from their interaction were intended to be divided at the time of entering into the contract. However, the parties' written contracts alone are unlikely to provide all the information necessary to perform a transfer pricing analysis, or to provide information regarding the relevant contractual terms in sufficient detail. Consideration must be given to the economically relevant characteristics in the other four categories above, taking into account the functions performed, the assets used and risks assumed, together with the characteristics of property transferred or services provided, the economic circumstances of the parties and of the market in which the parties operate, and the business strategies pursued by the parties.

> In an example, Company P, the parent company, owns Company S, a wholly owned subsidiary that acts as an agent for Company P's branded products in the Country

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> S market. The agency contract between the two is silent about any marketing and advertising activities in Country S. An analysis determines that Company S launched an intensive media campaign in Country S in order to develop brand awareness. The campaign represents a significant investment for Company S. Based on the evidence provided by the conduct of the parties, it could be concluded that the written contract may not reflect the full extent of the commercial or financial relations between the parties.

(b) If the characteristics of the transaction that are economically relevant are inconsistent with the written contract, the actual transaction should generally be delineated for purposes of the transfer pricing analysis in accordance with the characteristics of the transaction reflected in the conduct of the parties. Where there is doubt as to what transaction was agreed to between the associated enterprises, it is necessary to take into account all the relevant evidence from the economically relevant characteristics of the transaction.

(c) In an example to illustrate the concept of differences between written contractual terms and the conduct of the parties,

> Company S is a wholly owned subsidiary of Company P. The parties have entered into a written contract pursuant to which Company P licenses intellectual property to Company S for use in Company S's business. Company S agrees to pay a royalty to Company P. Evidence provided by other economically relevant characteristics, and in particular the functions performed, establishes that Company P performs negotiations with third-party customers to achieve sales for Company S, provides regular technical services to support Company S so that Company S can deliver the contracted sales to its customers, and regularly provide staff to enable Company S to fulfill customer orders. A majority of customers insist on including Company P as joint contracting party along with Company S, although fee income under the contract is payable to Company S. The analysis of the commercial or financial relations indicates that Company S is not capable of providing the contracted services to customers without significant support from Company P, and is not developing its own capacity. Under the contract, Company P has given a license to Company S, but in fact controls the business risk and output of Company S such that it has not transferred risk and functions consistent with a licensing agreement, and acts not as the licensor but as the principal. The identification of the actual transaction between Company P and Company S should not be defined solely by the terms of the written contract.

> Instead, the actual transaction should be determined from the conduct of the parties, leading to the conclusion that the actual functions performed, assets used, and risks assumed by the parties are not consistent with the written license agreement.

(d) TEI singled out this example in its comments on an earlier discussion draft. TEI said the P-S license should not be ignored, or treated as though it does not recognize the parties "actual transaction." P's assistance to S obviously is in the interest of P since P receives a royalty from S, presumably based on S's gross revenue. Thus, there are countervailing considerations that might lead P to act in the manner described in the example that should be taken into account. Analyzing the conduct of the parties can be difficult, stated TEI, and thus can be subject to different interpretations and views, much more so than the written agreements that underlie the contractual arrangements. TEI stated that the economic analysis should not downplay the importance of contracts. Nonetheless, the example was included in the final revisions to the Transfer Pricing Guidelines.

(e) The new the Transfer Pricing Guidelines continue by stating that compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). However, the actual contributions, capabilities, and other features of the parties also can influence the options realistically available to them.

4. <u>Risk</u>.

(a) A functional analysis is incomplete unless the material risks assumed by each party have been identified and considered since the actual assumption of risks would influence the prices and other conditions of transactions between associated enterprises. The assumption of risks associated with a commercial opportunity affects the profit potential of that opportunity in the open market, and the allocation of risks assumed between parties to the arrangement reflects how profits and losses resulting from transactions are allocated at arm's length through a transfer pricing analysis.

(b) The new guidelines state that the steps in the process for analyzing risk in a controlled transaction can be summarized as follows: (1) identify economically significant risks with specificity; (2) determine how specific, economically significant risks are contractually assumed by the associated enterprises under the terms of the transaction; (3) determine through a functional analysis how the associated enterprises that are parties to the

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transaction operate in relation to the assumption and management of the specific, economically significant risks, and in particular which enterprise or enterprises perform controlled functions and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk; and (4) interpret the information and determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case by analyzing (a) whether the associated enterprises follow the contractual terms under the principles of the new guidelines and (b) whether the party assuming risk exercises control over the risk and has the financial capacity to assume the risk.

(c) Risk management is not the same as assuming a risk. Risk assumption means taking on the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materializes.

(d) Financial capacity to assume risk can be defined as access to funding to take on the risk or layoff the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materializes.

(e) Control over risk involves the first of two elements of risk management, that is (1) the capability to make decisions to take on, layoff, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (2) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function. Day-to-day mitigation is not necessary to have control of the risks. However, where these day-to-day mitigation activities are outsourced, control of the risk would require capability to determine the objectives of the outsourced activities, to decide to hire the provider of the risk mitigation functions and related matters.

(f) Risks can be categorized in various ways, but a relevant framework in a transfer pricing analysis is to consider the source of uncertainty that gives rise to risk. Risk can involve strategic risks or marketplace risks, infrastructure or operational risks, financial risks, transactional risks and hazard risks.

(g) Two examples illustrate risk:

In the first situation, the multinational group distributes heating oil to consumers. Analysis of the economically relevant characteristics establishes that the product is undifferentiated, the market is competitive, the market size is predictable, and players are price-takers. In these circumstances, the ability to influence margins may be limited. The credit terms achieved from managing the relationship with the oil suppliers fund working capital and are crucial to the distributor's margin. The impact of the risk on cost of capital is, therefore, significant in the context of how value is created for the distribution function.

In the second situation, a multinational toy retailer buys a wide range of products from a number of third-party manufacturers. Most of its sales are concentrated in the last two months of the calendar year, and a significant risk relates to the strategic direction of the buying function, and in making the right bets on trends and determining the products that will sell and in what volumes. Trends and the demand for products can vary across markets, and so expertise is needed to evaluate the right bets in the local markets. The effect of the buying risk can be magnified if the retailer negotiates a period of exclusivity for a particular product with the third-party manufacturer.

(h) Other examples include development risk, capacity utilization and supply chain risk, and utilization of an intangible asset which presents the risk that there will be insufficient demand for the asset to cover the costs involved.

(i) The guidelines state that when two or more parties to a transaction assume a specific risk, and in addition, they together control the specific risk and each has the financial capacity to assume their share of the risk, that assumption of risk should be respected. Examples may include the contractual assumption of development risk in a transaction in which the enterprises agree jointly to bear the risks of creating a new product.

5. Economic Circumstances. Economic circumstances that may be relevant to determining market comparability include the geographic region, the size of markets, the extent of competition in the markets and the relative competitive positions of the buyers and the sellers, the availability (risk thereof) of substitute goods and services, the levels of supply and demand in the market as a whole, consumer purchasing power, the nature and extent of government regulation of the market, cost of production, the cost of land, transportation costs, the level of the market, and so forth. The existence of a cycle, such as an economic, business or product cycle, is one of the economic circumstances that should be identified.

6. Business Strategies. Business strategies could include market penetration plans. A taxpayer seeking to penetrate a market or to increase its market share might temporarily charge a price for its product that is lower than the price charged for otherwise comparable products in the same market. Business strategies such as those involving market penetration or expansion of market share involve reductions in the taxpayer's current profits in anticipation of increased future profits.

7. Accurately Delineating the Transaction.

   (a) The transfer pricing analysis at this point will have identified the substance of the commercial or financial relation between the parties and will have accurately delineated the actual transaction by analyzing the economically relevant characteristics. The next analysis involves determining the circumstances in which the transaction between the parties has accurately delineated can be disregarded for transfer pricing purposes. Disregarding the transaction between the parties can be contentious and thus a source of double taxation. Thus, every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition of the transaction as structured is not used simply because determining an arm's length price is difficult.

   (b) The key question in the analysis is whether the actual transaction possesses the *commercial rationality* of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the transaction can be observed between independent parties. The non-recognition of a transaction that possesses commercial rationality of an arm's length arrangement is not an appropriate application of the arm's length principle.

   (c) The guidelines set forth two examples:

> In the first example, Company S1 carries on a manufacturing business that involves holding substantial inventory and a significant investment in plant and machinery. It owns commercial property situated in an area prone to increasingly frequent flooding in recent years. Third-party insurers experience significant uncertainty over the exposure to large claims, with the result that there is no active market for insurance of properties in the area. Company S2, an associated enterprise, provides insurance to Company S1, and an annual premium representing 80% of the value of the inventory, property and content is paid by Company S1. In this example, S1 has entered into a commercially irrational transaction since there is no market

for insurance given the likelihood of significant claims. The transaction should not be recognized.

In the second example, Company S1 conducts research activities to develop intangibles that it uses to create new products that it can produce and sell. It agrees to transfer to an associated company, Company S2, unlimited rights to all future intangibles which may arise from its future work over a period of 20 years for a lump-sum payment. The arrangement is commercially irrational for both companies since neither Company S1 nor Company S2 has any reliable means to determine whether the payment reflects an appropriate valuation, both because it is uncertain what range of development activities Company S1 might conduct over the period and also because valuing the potential outcomes would be entirely speculative. The arrangement adopted by the taxpayer, including the form of the payment should be modified for purposes of the transfer pricing analysis.

8. Location Savings and Other Local Market Features.

(a) Location savings and other market features can be important in the analysis. Determining how location savings are to be shared between two or more associated enterprises requires considering (1) whether location savings exists, (2) the amount of any location savings, (3) the extent to which location savings are either retained by a member or members of the multinational group or are passed on to independent customers or suppliers, and (4) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprise is operating under similar circumstances would allocate any retained location savings.

(b) Features of the local market in which the business operates may affect the arm's length price with respect to transactions between associated enterprises. For example, the comparability and functional analysis conducted with a particular matter may suggest that the relevant characteristics of the geographic market in which the products are manufactured or sold, the purchasing power and product preferences of households in that market, whether the market is expanding or contracting, the degree of competition in the market and other similar factors affect prices and margins that can be realized in the market. It is important to distinguish between features of the local market, which are not intangibles, and any contract rights, government licenses, or know-how necessary to exploit that market, which may be intangibles.

9. Assembled Workforce.

(a) Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm's length price for services provided by the employee group or the efficiency with which the services are provided or goods produced by the enterprise. In some business restructurings and similar transactions, an assembled workforce might be transferred from one associated enterprise to another as a part of the transaction. It may be appropriate to reflect the time and expense savings in the form of comparability adjustments to the arm's length price otherwise charged for the transferred assets.

(b) This is not to suggest that transfers or secondments of individual employees between members of a multinational group should be separately compensated as a general matter. In some situations, however, the transfer or secondment of one or more employees may, depending on the facts and circumstances, result in the transfer of valuable know-how or other intangibles from one associated enterprise to another.

10. Group Synergies.

(a) Comparability issues, and a need for comparability adjustments, can also arise because of the existence of group synergies. Group synergies are often favorable to the group as a whole and therefore may heighten the aggregate profits earned by group members, depending on whether expected cost savings are, in fact, realized, and on competitive conditions. An associated enterprise should not be considered to receive an intra-group service or be required to make any payment when it obtains incidental benefits attributable solely to being part of a larger group. The term incidental refers to benefits arising solely by virtue of group affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit.

(b) In some circumstances, however, synergistic benefits and burdens of group membership may rise because of deliberate concerted group actions and may give a multinational group a material, clearly identifiable structural advantage or disadvantage in the marketplace over market participants that are not part of a multinational group.

(c) Two of the examples follow:

In the first example, Company A is assigned to the role of central purchasing manager on behalf of the entire

multinational group. It purchases from independent suppliers and resells to associated enterprises. Company A, based solely on the negotiating leverage provided by the purchasing power of the entire group is able to negotiate with a supplier to reduce the price of widgets from $200 to $110. Under these circumstances, the arm's length price for the resale of widgets by Company A to other members of the group would not be at all near $200. Instead, the arm's length price would remunerate Company A for its services of coordinating the purchasing activity. If the comparability and functional analysis suggests in this case that in comparable uncontrolled transactions involving a comparable volume of purchases, comparable coordination services resulted in a service fee based on Company A's costs incurred plus a mark-up equating to a total service fee of $6 per widget, then the intercompany price for the resales of the widgets would be approximately $116.

In a second example, Company A negotiates the discount on behalf of the group and group members subsequently purchase the widgets directly from the independent supplier. Under these circumstances, assume that the comparability analysis suggests that Company A would be entitled to a service fee of $5 per widget for coordinating services that are performed on behalf of the other group members. The lower assumed service fee may reflect a lower level of risk in the service provider following from the fact that it does not take title to the widgets or hold inventory. Group members purchasing widgets would retain the benefit of the group purchasing discount attributable to their individual purchases after payment of the service fee to Company A.

B. Intangibles.

1. Chapter VI of the Transfer Pricing Guidelines also would be replaced with a new descriptive analysis. Chapter VI is the important chapter on intangibles.

2. Difficulties can arise in a transfer pricing analysis as a result of definitions of the term intangible that are either too narrow or too broad. In the new guidelines, the word "intangible," is intended to address something that is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.

3. The availability and extent of legal, contractual or other forms of protection may affect the value of an item and the returns that should be attributed to it. This existence of this protection is not, however, a

necessary condition for an item to be characterized as an intangible for transfer pricing purposes. Similarly, while some intangibles may be identified separately and transferred on a segregated basis, other intangibles may be transferred only in combination with other assets. Therefore, separate transferability is not a necessary condition for an item to characterized as an intangible for transfer pricing purposes.

4. It is important to distinguish intangibles from market conditions or local market circumstances. Features of a local market, such as the level of disposable income of households in that market or the size or relative competitiveness of the market are not capable of being owned or controlled. While in some circumstances they may affect the determination of an arm's length price for a particular transaction and should be taken into account, they are not intangibles for purposes of Chapter VI.

5. Illustrations of intangibles include patents, know-how and trade secrets, and trademarks, trade names and brands.

6. Depending on the context, the term goodwill can be used to refer to a number of different concepts. In some accounting and business valuation contexts, goodwill refers to the difference between the aggregate value of an operating business and the sum of the values of all separately identifiable tangible and intangible assets. Alternatively, goodwill is sometimes described as a representation of the future economic benefits associated with business assets that are not individually identified and separately recognized. It is generally recognized that goodwill and going concern value cannot be segregated or transferred separately from other business assets.

7. It is not necessary to establish a precise definition of goodwill or going concern value for transfer pricing purposes or define when goodwill or going concern value may or may not constitute an intangible. It is important to recognize, however, that an important and monetarily significant part of the compensation paid between independent enterprises when some or all of the assets of an operating business are transferred may represent compensation for something referred to in one or another of the alternative descriptions of goodwill or going concern value.

8. Group synergies and market specific characteristics are not owned or controlled by the enterprise and therefore are not intangibles within the meaning of Chapter VI.

9. Legal rights and contractual arrangements form the starting point for any transfer pricing analysis of transactions involving intangibles. The terms of a transaction may be found in written contracts, public records such as

patent or trademark registrations, or in correspondence and/or other communications among the parties.

10. When no written terms exist, or where the facts of the case, including the conduct of the parties, differ from the written terms of any agreement between them or supplement these written terms, the actual transaction may be deduced from the facts established, including the conduct of the parties.

11. The legal owner will be considered to be the owner of the intangible for transfer pricing purposes. If no legal owner of the intangible is identified under the applicable law or governing contracts, then the member of the multinational group that, based on the facts and circumstances, controls decisions regarding the exploitation of the intangible and has the practical capacity to restrict others from using the intangible will be considered the legal owner of the intangible for transfer pricing purposes.

12. While determining legal ownership and contractual arrangements is an important first step in the analysis, these determinations are separate and distinct from the question of remuneration under the arm's length principal. For transfer pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the multinational group from exploiting the intangible, even though the returns may initially accrue to the legal owner as a result of its legal or contractual right to exploit the intangible. The return ultimately retained by or attributed to the legal owner depends on the functions it performs, the assets it uses and the risks it assumes, and upon the contributions made by other multinational group members through their functions performed, assets used and risks assumed.

13. Because the actual outcome and manner in which risks associated with the development or acquisition of an intangible will play out over time are not known with certainty at the time members of the multinational group make decisions regarding intangibles, it is important to distinguish between (a) anticipated (or *ex ante*) remuneration, which refers to the future income expected to be derived by a member of the multinational group at the time of a transaction; and (b) actual (or *ex post*) remuneration, which refers to the income actually earned by a member of the group through the exploitation of the intangible.

14. The terms of the compensation that must be paid to members of the multinational group that contribute to the development, enhancement, maintenance, protection and exploitation of intangibles is generally determined on an *ex ante* basis. That is, it is determined at the time the transactions are entered into and before risks associated with the intangible play out. The form of the compensation may be fixed or contingent. The actual (*ex post*) profit or loss of the business after compensating other

members of the multinational group may different from these anticipated profits depending on how the risks associated with the intangible or the other relevant risks related to the transaction actually play out.

15. Each member of the multinational group should receive arm's length compensation for the functions it performs. In cases involving intangibles, this includes functions related to the development, enhancement, maintenance, protection and exploitation of intangibles. The identity of the member or members of the group performing functions related to the development, enhancement, maintenance, protection and exploitation of intangibles, therefore, is one of the key considerations in determining the arm's length consideration for controlled transactions.

16. When associated enterprises other than the legal owner perform relevant functions that are anticipated to contribute to the value of the intangibles, they should be compensated on an arm's length basis for the functions they perform under general transfer pricing principles. If the legal owner neither controls nor performs a function related to the development, enhancement, maintenance, protection or exploitation of the intangible, the legal owner would not be entitled to any ongoing benefit attributable to the outsourced functions.

17. Particular types of risk that may have importance in a functional analysis relating to transactions involving intangibles include (1) risks related to development of intangibles, including the risk that costly research and development of marketing activities will prove to be unsuccessful, and taking into account the timing of the investment; (2) the risk of product obsolescence, including the possibility that technological advances of competitors will adversely affect the value of the intangibles; (3) infringement risk, including the risk that defense of intangible rights or defense against other persons' claims of infringement may prove to be time consuming, costly and/or unavailing; (4) product liability and similar risks related to products and services based on the intangibles; and (5) exploitation risks, uncertainties in relation to the returns to be generated by the intangible.

18. It is especially important to ensure that the group members asserting entitlement to returns from assuming risk actually bear responsibility for the actions that need to be taken and the cost that may be incurred if the relevant risk materializes.

19. The guidelines state that it is quite common that actual (*ex post*) profitability is different from anticipated (*ex ante*) profitability. This may happen because a profitable product is removed from the market. It may result from risks materializing in a different way from what was anticipated through the occurrence of unforeseeable developments. The financial projections on which the calculations of *ex ante* returns and the

compensation arrangements are based may properly have taken into account risks and the probability of reasonably foreseeable events occurring and that the differences between actual and anticipated profitability reflects the playing out of those risks. On the other hand, the financial projections on which the calculations of the *ex ante* returns and the compensation arrangements were based might not have adequately taken into account the risks of different outcomes.

20. Resolution of this question requires a careful analysis of which entity or entities in the multinational group in fact assume the economically and significant risks identified when delineating the actual transaction. The party actually assuming the economically significant risks may or may not be the associated enterprise contractually assuming those risks. A party that is not allocated the risks that caused the anticipated and actual outcomes will not be entitled to the differences between the actual and anticipated profits or required to bear the losses that are caused by these differences if the risk materializes, unless these parties are performing the important functions or contributing to the control of the economically significant risks.

21. If the legal owner of an intangible in substance (1) performs and controls all of the functions related to the development, enhancement, maintenance, protection and exploitation of the intangibles; (2) provides all assets, including funding, necessary to the development, enhancement, maintenance, protection and exploitation of the intangibles; and (3) assumes all of the risks related to the development, enhancement, maintenance, protection and exploitation of the intangible, then it will be entitled to all of the anticipated (*ex ante*) returns derived from the multinational group's exploitation of the intangible.

22. A common situation regarding marketing intangibles arises when an enterprise associated with the legal owner of trademarks performs marketing or sales functions that benefit the legal owner of the trademark, for example, through a marketing arrangement or through a distribution/marketing arrangement. In these cases, it is necessary to determine how the marketer or distributor should be compensated for its activities. One important issue is whether the marketer/distributor should be compensated only for providing promotion and distribution services, or whether the marketer/distributor should also be compensated for enhancing the value of the trademarks and other marketing intangibles by virtue of its functions, assets and risks assumed.

23. Questions often arise regarding the arm's length compensation for the use of group names, trade names and similar intangibles. Resolution of these questions should be based on general transfer pricing principles and on the commercial and legal factors involved. As a general rule, no payment should be recognized for transfer pricing purposes for simple recognition

of group membership or the use of the group name merely to reflect the fact of group membership.

24. When one member of the group is the owner of a trademark or other intangible with a group name, and where use of the name provides a financial benefit to members of the group other than the member legally owning the intangible, it is reasonable to conclude that a payment for use would have been made in an arm's length transaction. Similarly, these payments may be appropriate when a group member owns goodwill in respect of the business represented by an unregistered trademark, use of that trademark by another party would constitute misrepresentation, and the use of the trademark provides a clear financial benefit to a group member other than the one that owns the goodwill and unregistered trademark.

25. Sales of Goods.

(a) Intangibles may be used in connection with controlled transactions in situations where there is no transfer of the intangible or of rights in the intangible. For example, intangibles may be used by one or both parties to a controlled transaction in connection with the manufacture of goods sold to an associated enterprise, in connection with the marketing of goods purchased from an associated enterprise, or in connection with the performance of services on behalf of an associated enterprise.

(b) The need to consider the use of intangibles by a party to a controlled transaction involving a sale of goods can be illustrated as follows:

> Assume that a car manufacturer uses valuable proprietary patents to manufacture the cars that it then sells to associated distributors. Assume the patents significantly contribute to the value of the cars. The patents and the value they contribute should be identified and taken into account in the comparability analysis of the transaction consisting of the sales of cars by the car manufacturer to its associated distributors, in selecting the most appropriate transfer pricing method for the transactions, and in selecting the tested party. The associated distributors purchasing the cars do not, however, acquire and right in the manufacturer's patents. In such a case, the patents are used in the manufacturing and may affect the value of the cars, but the patents themselves are not transferred.

(c) Many intangibles have a limited useful life. The useful life of a particular intangible can be affected by the nature and duration of the legal protection afforded to the intangible. The useful life of

some intangibles also can be affected by the rate of technological change in an industry and by development of new and potentially improved products. Sometimes, the useful life of a particular intangible can be extended.

(d) In conducting a comparability analysis, it is important to consider the expected useful life of the intangibles in question. In general, intangibles expected to provide market advantages for a longer period of time will be more valuable than similar intangibles providing these advantages for a shorter period of time, other things being equal. In evaluating the useful life of intangibles it is also important to consider the use being made of the intangible. The useful life of an intangible that forms a base for ongoing research and development may extend beyond the commercial life of the current generation product line based on that intangible.

(e) The guidelines discuss application of transactional profit split methods and state that caution should be exercised in applying profit split approaches to determine estimates of the contributions of the parties to the creation of income in the years following the transfer.

(f) The guidelines also discuss specific areas of concern in applying methods based on the discounted value of projected cash flows. The guidelines state the reliability of the intangible value produced using a valuation model is particularly sensitive to the reliability of the underlying assumptions and estimates on which it is based. There is no single measure for a discount rate that is appropriate for transfer pricing purposes in all cases.

26. Hard-To-Value Intangibles.[7]

(a) In dealing with hard-to-value intangibles, a tax administration may find it difficult to establish or verify what developments or events might be considered relevant for the pricing of a transaction involving the transfer of intangibles or rights in intangibles, and the extent to which the occurrences of these developments or events, or the direction they take, might have been foreseeable or reasonably foreseeable at the time the transaction was entered into.

(b) In these situations, *ex post* outcomes can provide a pointer to tax administrations about the arm's length nature of the *ex ante* pricing arrangement agreed upon by the associated enterprises, and the existence of uncertainties at the time of the transaction. If there are

[7] The Hard-to-Value Intangibles area will be the subject of follow up that Working Party 6 will do in 2016-7 to more fully develop certain aspects of these rules.

differences between the *ex ante* projections and the *ex post* results that are not due to unforeseeable developments or events, the differences may give an indication that the pricing arrangement agreed upon by the associated enterprises at the time the transaction was entered into may not have adequately taken into account the relevant developments or events that might have been expected to affect the value of the intangible and the pricing arrangements adopted.

(c) The guidelines contain an approach consistent with the arm's length principle that tax administrators can adopt to ensure that they can determine in which situations the pricing arrangements used by taxpayers are at arm's length and are based on an appropriate weighting of the foreseeable developments or events that are relevant for the valuation of certain hard-to-value intangibles, and in which situations this is not the case.

(d) Under this approach, *ex post* evidence provides presumptive evidence as to the existence of uncertainties at the time of the transaction, whether the taxpayer appropriately took into account reasonably foreseeable developments or events at the time of the transaction, and the reliability of the information used *ex ante* in determining the transfer price for the transfer of the intangibles or rights in the intangibles.

(e) This presumptive evidence may be subject to rebuttal if it can be demonstrated that it does not affect the accurate determination of the arm's length price. This situation should be distinguished from a situation in which hindsight is used by taking *ex post* results for tax assessment purposes without considering whether the information on which the *ex post* results are based could or should reasonably have been known and considered by the associated enterprises at the time the transaction was entered into.

(f) Thus, a tax administrator can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing but the consideration of *ex post* evidence should be based on a determination that the evidence is necessary to assess the reliability of the information on which the *ex ante* pricing was based.

(g) This approach will not apply to transactions involving the transfer of hard-to-value intangibles when at least one of the following exceptions applies.

i. The taxpayer provides: (a) details of the *ex ante* projections used at the time of the transfer to determine the

pricing arrangements, including how risks were accounted for in the calculations of determining the price, and the appropriateness of its consideration of reasonably foreseeable events and other risks, and the probability of occurrence; and (b) reliable evidence that any significant difference between the financial projections and actual outcomes is due to unforeseeable developments or events occurring after the determination of the price that could not have been anticipated by the associated enterprises at the time of the transaction or the playing out of the probability of occurrence of foreseeable outcomes and that these probabilities were not significantly overestimated or underestimated at the time of the transaction;

ii. The transfer of the hard-to-value intangible is covered by a bilateral or multilateral advance pricing agreement in effect for the period in question between the countries of the transferee and transferor.

iii. Any significant difference between the financial projections and actual outcomes mentioned above does not have the effect of reducing or increasing the compensation for the hard-to-value intangible by more than 20% of the compensation determined at the time of the transaction.

iv. A commercialization period of five years has past following the year in which the hard-to-value intangible first generated unrelated party revenues for the transferee and in which commercialization period any significant difference between the financial projections and the actual outcomes was not greater than 20% of the projections for that period.

(h) TEI submitted comments on the earlier discussion draft addressing hard-to-value intangibles. The discussion draft assumed that independent enterprises are able to renegotiate agreements if major unforeseen developments occur. In TEI's experience, such renegotiations are extremely rare, and even a "repricing" of some sort or after-the-fact review of contract terms is not common in contracts between unrelated parties. TEI stated that agreements may be structured to minimize the business risks of a "bad deal," such as a shorter contract term, or through the use of a price adjustment or contingent payment mechanism based on meeting certain milestones. Needless to say, however, stated TEI, in contracts between unrelated parties these terms are set at the outset of the contract through negotiations using only before-the-fact information.

(i) Twenty-nine examples illustrate the guidance on intangibles and are set forth in an annex to revised Chapter VI.

(j) Examples 1-5 utilize the same or a similar fact pattern. P is the parent of the multinational group and S is a wholly owned subsidiary. P funds R&D programs and performs ongoing R&D functions in support of its business operations. When its R&D functions result in patentable inventions, it is the practice of the P group that all rights and the inventions be assigned to S in order to centralize and simplify global patent administration. All patent registrations are held and maintained in the name of S.

(k) P performs all functions related to the development, enhancement, maintenance, protection and exploitation of the intangibles except for patent administration services. The actual transaction undertaken between P and S could be described as a patent administration service arrangement. An arm's length price would be determined based on patent administration services.

(l) In Example 2, the facts are the same except that S, acting under the direction and control of P, grants licenses of its patent to associated and independent enterprises throughout the world for periodic royalties. S is the legal owner of the patents. However, S employees do not control or participate in the licensing transactions involving the patents, and its three employees are limited to the activities of registering the patents and maintaining patent registrations.

(m) As in Example 1, the true nature of the arrangement is a patent administration service arrangements. The compensation due to P for the patentable inventions is equal to the licensing revenue of S less an appropriate return for the functions S performs.

(n) In Example 3, the facts are the same as in Example 2 except that S, again acting under the direction and control of P, sells the patents to an independent enterprise reflecting the appreciation and value of the patents. Under these circumstances, the income of S should be the same as in Example 2.

(o) In Example 4, the facts are the same as in Example 3 except that S has employees capable of making, and who actually make, the decision to take on the patent portfolio. All decisions relating to the licensing program are made by S employees, all negotiations with licenses are handled by S employees and S employees monitor compliance of independent licensees with the terms of the patents. It is assumed for purposes of the example that the initial price paid by S in exchange for the patents was an arm's length

price. It also is assumed that the approach for hard-to-value intangibles does not apply. Further, the value of the patents increased significantly because of external circumstances unforeseen at the time the patents were assigned to S. Under these circumstances, S is entitled to retain the proceeds of the sale, including amounts attributable to the appreciation in value of the patents resulting from unanticipated external circumstances.

(p) In Example 5, the facts are the same as in Example 4 except that instead of appreciating, the value of the patents decreases during the time they are owned by S as a result of unanticipated external circumstances. S is entitled to retain the proceeds of sale, meaning that it will suffer the loss.

(q) In Example 6, a multinational group comprised of A and B decides to develop an intangible that is anticipated to be highly profitable based on B's existing intangibles, its track record and its experienced R&D staff. Development will take five years and the intangible is anticipated to have value for 10 years. B will perform and control all activities related to development, enhancement, maintenance, protection and exploitation of the intangible.

(r) A will provide all funding associated with development of the intangible and will become the legal owner of the intangible once developed. A will license the intangible to B for contingent payments.

(s) A functional analysis determines that the actual transaction is that, although A is the legal owner of the intangibles, its contribution to the arrangement is solely funding for the development of the intangible. A contractually assumes financial risk, has the financial capacity to assume that risk, and exercises control over that risk. Thus, A's anticipated remuneration should be its risk-adjusted return on its funding commitment. B, accordingly, would be entitled to all remaining anticipated income after accounting for A's anticipated return.

(t) Example 7 describes P, a pharmaceutical company, and S, its subsidiary that distributes product throughout Europe and the Middle East on a limited risk basis. In the first three years of operation, S earns returns from its distribution function that are consistent with its limited risk characterization. After three years, the product involved causes serious side effects and S incurs substantial costs in connection with a recall. P does not reimburse S for these recall-related costs or the resulting product liability claims.

(u) Under these circumstances, there is an inconsistency between P's asserted entitlement to returns derived from exploiting the product and its failure to bear costs associated with the risks supporting that assertion. If it is determined that the true nature of the relationship is that S is a limited risk distributor, then the most appropriate adjustment would be in the form of an allocation of the recall costs from S to P. Alternatively, although unlikely, if it is determined on the basis of the facts that the true nature of the relationship includes the exercising of control over product liability and recall by S, and if an arm's length price can be based on the basis of a comparability analysis, an increase in distribution margins of S for all years might be made.

(v) Examples 8-13 are based on the same general fact pattern. Example 8 involves P, a manufacturer of watches marketed in countries around the world utilizing P's name, which is widely known. P decides to enter the Country Y market and incorporates S, a new subsidiary there to act as a distributor. P enters into a long-term royalty-free marketing and distribution agreement with S. Under the contract, S purchases the watches from P, takes title and performs distribution functions. P incurs associated carrying costs, and so forth. P develops the overall marketing plan, and S assists in developing the market. S consults on local market issues related to advertising. S receives a service fee from P.

(w) Assume that it is possible to conclude that the price S pays P for the watches should be analyzed separately from the compensation S receives for the marketing it undertakes on behalf of P. Assume further that the price paid for the watches is arm's length.

(x) S embarks on a strategy consistent with its agreement with P to develop the Y market. S is reimbursed by P for marketing expenses, and is paid a markup. By the end of year 2, the trademark and trade name have become well established in Country Y.

(y) Under these circumstances, P is entitled to retain any income derived from exploiting the trademark and trade name in the Country Y market that exceeds the arm's length compensation to S for its functions and no transfer pricing adjustment is warranted under the circumstances.

(z) In Example 9, S is now obligated to develop and execute the marketing plan without detailed control of specific elements by P. S receives no direct reimbursement from P, which exercises a lower level of control over marketing activities of S. As a result of

these differences, P and S adopt a price for the watches lower than in Example 9.

(aa) Given that Company S performs functions and bears the costs of associated risks of its marketing activities under a long-term contract of exclusive distribution rights for the watches, there is an opportunity for S to benefit (or suffer a loss) from the marketing and distribution activities it undertakes. These activities are similar to those of independent marketers and distributors and comparable uncontrolled transactions. S's return reflects arms-length consideration for S's contributions and accurately measures a share of the income derived from exploitation of the trademark and trade name in Country Y.

(bb) In Example 10, the facts are the same as in Example 9, except that the market development functions undertaken by S are far more extensive than those undertaken by S in Example 9. The level of marketing expense S incurs in Years 1 through 5 exceeds that incurred by identified comparable independent marketers and distributors. P and S expect those additional functions to generate higher margins or increased sales volume for the products. Thus S has made a larger functional contribution to development of the market and the marketing intangibles and has assumed significantly greater costs and assumed greater risks than previously identified.

(cc) Based on these facts, it is evident that by performing functions and incurring marketing expenditures substantially in excess of the levels of function and expenditures of independent marketers/distributors in comparable transactions, S has not been adequately compensated by the margins it earns on re-sale of the watches. It would be appropriate for the Country Y tax administration to propose a transfer pricing adjustment. This could be based on reducing the price paid by S for the watches, applying a residual profit split that would split the combined profits by first giving P and S a basic return for their functions and then splitting the residual profit on a basis that takes into account the residual contributions of P and S, or directly compensating S for the excess marketing expenditure that it has incurred over and above that incurred by comparable independent enterprises.

(dd) In Example 11, the facts are the same as in Example 9, except that S enters into a three-year royalty-free agreement to market and distribute the watches in the Country Y market, with no option to renew. At the end of the three-year period, S does not enter into a new contract with P. The evidence derived from comparable independent enterprises shows that they do not invest large sums of

money in developing marketing and distribution infrastructure where they obtain only a short-term marketing and distribution agreement, with the attendant risk of non-renewal without compensation. Thus, S could not, or may not, be able to benefit from the marketing and distribution expenditure that it incurs at its own risk.

(ee) In this case, S has undertaken market development activities and borne marketing expenditures beyond what comparable independent enterprises with similar rights would incur for their own benefit. S is entitled to compensation for its at-risk contribution to the value of the trademark and trade name during the term of its agreement with P.

(ff) Example 12 is based on the same facts except that at the end of Year 3, P and S renegotiate their earlier agreement and enter into a new long-term licensing agreement. S agrees to pay a royalty to P based on gross sales of all watches bearing the trademark. Assume there is no evidence that independent marketers or distributors of similar products have agreed to pay royalties under similar circumstances. For transfer pricing purposes it would not generally be expected that a royalty would be paid where a marketing and distribution entity obtains no rights for transfer pricing purposes in trademarks and similar intangibles, other than the right to use the intangibles in distributing branded product supplied by P. Namely, a transfer pricing adjustment disallowing the royalties paid as a deduction would be appropriate.

(gg) Example 13 is similar except that at the end of Year 3, P stops manufacturing watches and contracts with a third party to manufacture them on its behalf. As a result, S will import unbranded watches directly from the manufacturer and undertake secondary processing to apply the trade name and logo and package the watches before sale to the final customer. As a consequence, at the beginning of Year 4, P and S re-negotiate their earlier agreement and enter into a new long-term licensing agreement. S is granted exclusive rights within Country Y to process, market and distribute watches bearing the R trademark. S pays a royalty to P.

(hh) The Country Y tax administration determines, based on a functional analysis, that the level of marketing expenses S incurred during Years 1 through 3 far exceeded those incurred by independent marketers and distributors with similar long-term marketing and distribution agreements. It is also determined that the level and intensity of marketing activity undertaken by S exceeded that of independent marketers and distributors.

(ii) The Country Y audit also identifies that in Years 4 and 5, S bears the cost and associated risks of its marketing activities under the new long-term licensing agreement with P. Based on these facts, S should be compensated with an additional return for the market development functions it performs, the assets it uses and the risks it assumes. For Years 1 through 3, the possible bases for such an adjustment would be as described in Example 10. For Years 4 and 5, the bases for an adjustment would be similar, except that the adjustment could reduce the royalty payments from S to P, rather than the purchase price of the watches.

(jj) Examples 14, 15 and 16 are based on a similar fact pattern. In Example 14, P is the parent of a multinational group that is involved in the purchase and sale of consumer goods. It operates an R&D center. Its subsidiary, S, also has an R&D operation. The P R&D center designs research programs, develops and controls budgets, makes decisions as to where R&D activities will be carried on, and so forth. The S R&D Center operation operates on a separate project basis to carry on specific projects assigned to it by the P R&D Center. P establishes budgets and supervises the S R&D center. Contracts specify that the P R&D Center will bear all risks and costs related to R&D undertaken by S. All patents, designs and other intangibles developed by S are owned by P.

(kk) P is entitled to earn compensation derived from the R&D. S should be paid for its services.

(ll) Example 15 is similar, except that the S R&D Center performs its activities with respect to product line B, which is handled by S. The S R&D Center operates autonomously and its employees report to the Product Line B management team in S. P neither performs nor exercises control over the research function carried out by S.

(mm) Even though P is the legal owner of the intangibles, this does not entitle P to retain or be attributed any income related to the Product Line B intangibles. S should not pay a royalty or make other payments to P for the right to use the successfully developed S intangibles. If P were to use them, P should pay a royalty to S.

(nn) In Example 16, the facts are similar, except that P sells all rights to patents and other technology-related intangibles to a new subsidiary, T. T establishes a manufacturing facility in Country Z and begins to supply products to members of the P group around the world.

(oo) It is assumed that the compensation paid by T in exchange for the transferred patents and related intangibles is based on evaluation of anticipated future cash flows generated by the transferred intangibles at the time of the transfer.

(pp) T enters into a contract research agreement with P, and a separate contract research agreement with S. T contractually agrees to bear the financial risk associated with possible failure of future R&D projects, agrees to assume the costs of all future R&D activity, and agrees to pay P and S a service fee based on the costs of the R&D activities undertaken, plus a markup. T has no technical personnel capable of conducting or supervising the research activities. P and S continue to conduct R&D activities as in the past.

(qq) T functions as a manufacturer and performs no activities in relation to the acquisition, development or exploitation of the intangibles and does not control risks in relation to the acquisition of the intangibles or contribute to their further development. Instead, all development activities and risk management functions relating to the intangibles are performed by P and S, with P controlling the risks. As a result, in addition to its manufacturing reward, T is entitled to no more than a risk-free return for its funding activities.

(rr) In Example 17, P is a fully integrated pharmaceutical company that transfers patents and related inventions related to Product M, an early-stage pharmaceutical preparation believed to have high potential value, to S. The price is based on evaluation of anticipated future cash flows. S has no technical personnel capable of designing, conducting or supervising required ongoing research activities. P continues to perform and control all functions and to manage risks related to the intangibles owned by S. S is entitled to a financing return.

(ss) Example 18 describes P, which licenses patent invention and manufacturing know-how to S for use in Country B. S uses the patents and know-how to manufacture Product X in Country B and it sells the product to distribution entities based around Africa and Asia. The conduct of the parties suggests the transaction is a license for Country B plus Asia and Africa.

(tt) Example 19 involves P with a unique marketing concept that is used by new subsidiary S. The example deems a license between the two.

(uu) Example 20 involves the transfer of a business to a related company. The value of the business should include amounts that may be treated as the value of goodwill for accounting purposes.

(vv) Example 21 involves the establishment of a re-invoicing company that performs no functions. Thus, it is not entitled to earn any income.

(ww) Example 22 describes a government license for mining activity and a government license for the exploitation of a railway. An unrelated buyer pays $100 for the business, including $70 for goodwill based on synergies created between the mining and railway licenses. The buyer then transfers the mining and railway licenses to its subsidiary S. The goodwill associated with the licenses transferred to S would need to be considered, as it generally would be assumed that value does not disappear, nor is it destroyed, as a part of an internal business restructuring.

(xx) In Example 23, P acquires 100% of the equity interests in an unrelated party, T, for $100. T engages in R&D and has partially developed several promising technologies but has only minimal sales. The price for accounting purposes is treated as $20 for tangible property and identified intangibles, including patents, and $80 for goodwill. Immediately following the acquisition, T transfers all of its rights in the partially developed technologies, including patents, trade secrets and technical know-how to S, a subsidiary of P. S enters into a contract research agreement with T, pursuant to which the T workforce will continue to work exclusively on the development of the transferred technologies and on the development of new technologies on behalf of Company S. It will be compensated on a cost-plus basis plus a markup. All rights to the intangibles will belong to S.

(yy) The $100 paid by P for the shares of T represents an arm's-length price for shares of the company. The full value of that business should be reflected either in the value of the tangible and intangible assets transferred to S or in the value of the tangible and intangible assets and workforce retained by T. Depending on the facts, a substantial portion of the value described in the purchase price allocation as goodwill of T may have transferred to S together with the other T intangibles. Some portion of the goodwill may also have been retained by T. T should be entitled to compensation for that value, either as a part of the price paid by S for the transferred rights to technology intangibles, or through the compensation T is paid in the years following the transaction for the R&D services of its workforce. It should generally be assumed that value does not disappear, nor is it destroyed, as a part of an internal restructuring.

(zz) P engages in software development consulting in Example 24. In the past, P developed software supporting certain banking

transactions. S, its subsidiary, enters into an agreement to develop software supporting operations for another bank (Bank B). P agrees to support S by providing employees who were involved with the previous project. Those employees have access to software designs and know-how developed by P. That software code and the services of the P employees are utilized by S in executing its Bank B engagement. For transfer pricing purposes, S has received two benefits from P which require compensation. First, it received services from the P employees who were made available to work on the Bank B engagement. Second, it received rights in P's proprietary software that was utilized as the foundation for the software system delivered to Bank B.

(aaa) In Example 25, P has been involved in several large litigations. Its internal legal department had become adept at managing large-scale litigation. P also developed proprietary document management software tools unique to its industry. S, a subsidiary of P, becomes involved in complex litigation. P agrees to make two individuals from its legal team available to S to work on the S litigation. It would not be appropriate to treat P as having transferred rights and intangibles to S. However, the fact that the P employees have experienced and available software tools that allowed them to more effectively and efficiently perform this service should be considered in a comparability analysis related to the amount of the service fees to be charged for the services of the P employees.

(bbb) Example 26 describes an acquisition for $160. P acquired S, a public company, whose market capitalization was $100. P's management justified the $160 purchase price in presentations to its board of directors by reference to the complementary nature of the existing products of the P group and the products and potential products of S. For accounting purposes, the purchase price was allocated $90 to goodwill, with the rest going to tangible and intangible assets.

(ccc) Immediately following the acquisition of S, P liquidates S and grants an exclusive and perpetual license to related company T for intangible rights related to the S products in European and Asian markets. In determining the arm's length price for the intangibles S licensed to T, the premium over the trading value of the S shares included in the acquisition price should be considered. To the extent the premium reflects the complementary nature of the P products with the acquired products licensed to Company T, T should pay an amount for the transferred S intangibles and rights to the intangibles that reflects an appropriate share of the purchase price premium. To the extent the purchase price premium is

attributable exclusively to products outside of T's markets, the purchase price premium should not be taken into account.

(ddd) In Example 27, P is the parent of the multinational group. S is a subsidiary that conducts operations in Country B. For sound business reasons related to the coordination of its group's patent protection, P decides to centralize ownership of the group's Product M patents in P. S sells its patents to P for a lump-sum price. P assumes responsibility to perform all ongoing functions and assumes all risks related to the patents following the sale.

(eee) Valuation personnel apply a valuation method that directly values property and patents to arrive at an after-tax net present value for the patents of $80. The analysis is based on royalty rates, discount rates, and useful lives typical in the industry in which Product M competes. However, there are material differences between the S patents and the relevant patent rights related to those products, and those typical in the industry. The valuation seeks to make adjustments for those differences.

(fff) P also conducts a discounted cash flow-based analysis of the relevant business in its entirety. That analysis, based on valuation parameters typically used by P in evaluating potential acquisitions, suggests that the Product M business has a net present value of $100. The $20 difference between the $100 valuation of the entire business and the $80 valuation of the patents on their own appears to be inadequate to reflect the net present value of routine returns for functions performed by S and to recognize any value for the trademarks and know-how attained by S. Under these circumstances, further review of the reliability of the $80 value ascribed to the patents would be called for.

(ggg) Example 28 describes P, the parent of a multinational group with operations in Country S. For valid business reasons, the multinational group decides to centralize all its intangibles related to business conducted outside of Country S in a single location. Accordingly, intangibles owned by subsidiary B are sold to a related party, subsidiary C, for a lump-sum, including patents, trademarks, know-how and customer relationships. At the same time, C retains B as a contract manufacturer of products previously produced and sold by B on a full risk basis. C has the personnel and resources required to manage the acquired line of business, including the further development of intangibles necessary to the B business. The group is unable to identify comparable uncontrolled transactions that can be used in the transfer pricing analysis of the arm's length price to be paid by C to B. Valuation techniques are used. In conducting its valuation, the group is unable to reliably

segregate particular cash flows associated with all of the specific intangibles.

(hhh) Under these circumstances, in determining the arm's length compensation to be paid by C for the intangibles sold by B, it may be appropriate to value the transferred intangibles in the aggregate rather than attempt valuation on an asset-by-asset basis. This would particularly be the case if there is a significant difference between the sum of the best available estimates of the value of individually identified intangibles and other assets when valued separately and the value of the business as a whole.

(iii) In Example 29, P transfers all of its production of Product F to newly-formed subsidiary S. P sells the patents and trademarks related to Product F to S for a lump-sum. P and S seek to identify an arm's length price for the transferred intangibles by utilizing a discounted cash flow valuation technique. According to this valuation analysis, P could have generated after-tax residual cash flows (after rewarding all functional activities of other members of the multinational group on an arm's length basis) having a present value of $600 by continuing to manufacture Product F in P's country. The valuation from the buyer's perspective shows that S could generate after-tax residual cash flows having a present value of $1,100 if it owned the intangibles and manufactured the products in its country.

(jjj) Another option open to P would be for P to retain ownership of the intangible, and to retain S or an alternative supplier to manufacture products on its behalf in S's country. In this scenario, P calculates it would be able to generate after-tax cash flows with a present value of $875.

(kkk) In defining the arm's length compensation for the intangibles transferred by P to S, it is important to take into account the perspectives of both parties, the options realistically available to each of them, and the particular facts and circumstances involved. P would certainly not sell the intangibles at a price that would yield an after-tax residual value with a present value lower than $600, the residual cash flow it could generate by retaining the intangibles and continuing to operate in the manner that it has done historically. Moreover, there is no reason to believe P would sell the intangibles for a price that would yield an after-tax residual cash flow with the present value lower than $850. If P could capture the production cost savings by retaining another entity to manufacture on its behalf in a low cost environment, one realistically available option to it would be to establish a contract manufacturing operation. This realistically available option should

be taken into account in determining the selling price of the intangibles.

(lll) S would not be expected to pay a price that would, after taking into account all relevant facts and circumstances, leave it with an after-tax return lower than it could achieve by not engaging in the transaction. According to the discounted cash flow valuation, the net present value of the after-tax residual cash flow it could generate using the intangible in its business would be $1,100. A price might be negotiated that would give P a return equal to or greater than its other available options, and give S a positive return on its investment considering all the relevant facts, including the manner in which the transaction itself would be taxed.

(mmm) A transfer pricing analysis utilizing a discounted cash flow approach would have to consider how independent enterprises dealing at arm's length would take into account the cost savings and projected tax effects in setting a price for the intangibles. That price should, however, fall in the range between a price that would yield P after-tax residual cash flow equivalent to that of its other options realistically available, and a price that would yield S a positive return on its investments and risks, considering the manner in which the transaction itself would be taxed.

C. Low Value-Adding Intra-Group Services.

1. This section of the report introduces an elective, simplified approach for low value-adding services. It is responsive to Action 10 of the BEPS Action Plan regarding the development of transfer pricing rules to provide protection against common types of base eroding payments, such as management fees and head office expenses. The report makes some changes and clarifications in Chapter VII of the OECD's Transfer Pricing Guidelines. Sections A to C are changed to provide context to new section D on low value-adding intra-group services.

2. In section B, the benefits test is described as initially raising the question whether an intra-group service has been rendered when an activity is performed for one or more group members by another group member. The analysis should depend on whether the activity provides a respective group member with economic or commercial value to enhance or maintain its business position. This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. If the activity is not one for which an independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle.

3. In describing “shareholder activities,” the Transfer Pricing Guidelines state that a more complex analysis is necessary when an associated enterprise undertakes activities that relate to more than one member of the group or to the group as a whole. An example would be where a group member (usually the parent company) performs an activity solely because of its ownership interest in one or more other group members, *i.e.*, in its capacity as a shareholder. This type of activity would not be considered an intra-group service and thus would not justify a charge to other group members. Instead, the costs associated with this type of activity should be borne and allocated at the level of the shareholder. Examples would include cost of the juridical structure of the parent company itself, such as meetings of shareholders of the parent, issuing of shares in the parent company, a stock exchange listing for the parent company and the cost of its supervisory board.

4. In contrast, if, for example, the parent company raises funds on behalf of another group member which uses them to acquire a new company, the parent company would generally be regarded as providing a service to the group member.

5. In general, no intra-group service should be found for activities undertaken by one group member that merely duplicates the service that another group member is performing for itself, or that is being performed for the other group member by a third party. An exception may be where the duplication of services is only temporary, for example, where the multinational group is reorganizing to centralize its management functions. Another exception would be where the duplication is undertaken to reduce the risk of a wrong business decision.

6. There are some cases where an intra-group service performed by a group member such as a shareholder or coordinating center relates only to some group members but incidentally provides benefits to other group members. The incidental benefits ordinarily would not cause these other group members to be treated as receiving and intra-group service because the activities producing the benefits would not be ones for which an independent enterprise ordinarily would be willing to pay.

7. In trying to determine the arm’s length price in relation to intra-group services, the matter should be considered both from the perspective of the service provider and from the perspective of the recipient of the service. In this respect, the relevant considerations include the value of the service to recipient and how much a comparable independent enterprise would be prepared to pay for that service in comparable circumstances, as well as the costs to the service provider.

8. Depending on the method being used to establish an arm’s length charge for intra-group services, the issue may arise whether it is necessary that

the charge be such that it results in the profit for the service provider. In an arm's length transaction, an independent enterprise normally would seek to charge for services in a way as to generate a profit, rather than providing the services merely at cost. The economic alternatives available to the recipient of the service also need to be taken into account in determining the arm's length charge. However, there are services in which an independent enterprise may not realize a profit from the performance of services alone, for example, where a supplier's costs (anticipated or actual) exceed market price but the supplier agrees to provide the service to increase its profitability, perhaps by complementing its range of activities.

9. New section D deals with low value-adding intra-group services. This section provides guidance relating to a particular category of intra-group services and provides an elective simplified approach for determining an arm's length charge. It also provides a simplified benefits test.

10. Low value-adding intra-group services performed by one member or more than one member of a multinational group on behalf of one or more other group members include those which (1) are of a supportive nature; (2) are not part of the core business of the multinational group; (3) do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and (4) do not involve the assumption of control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

11. The following activities would not qualify for the simplified approach: (1) services constituting the core business of the multinational group; (2) research and development services; (3) manufacturing and production services; (4) purchasing activities relating to raw materials or other materials that are used in the manufacturing or production business; (5) sales, marketing and distribution activities; (6) financial transactions; (7) extraction, exploration or processing of natural resources; (8) insurance and reinsurance; and (9) services of corporate senior management.

12. Examples of services that likely would meet the definition of low value-adding services: (1) accounting and auditing; (2) processing and management of accounts receivable and accounts payable; (3) human resources; (4) monitoring a compilation of data related to health, safety, environment and other standards regulating the business; (5) information technology services where they are not a principal activity of the group; (6) internal and external communications in public relations support; (7) legal services; (8) activities related to tax obligations; and (9) general services of an administrative or clerical nature.

13. As noted, the rule provides a simplified benefits test. Because of the nature of the low value-adding intra-group services under consideration,

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the determinations regarding benefit may be difficult and may require a greater effort than the amount of the charge warrants. Tax administrators should therefore generally refrain from reviewing or challenging the benefits test when the simplified approach has been applied under the conditions and circumstances discussed in the new Section D, in particular in conformity with the documentation and reporting requirements.

14. While low value-adding intra-group services may provide benefits to all recipients of those services, questions may arise about the extent of the benefit and whether independent parties would have been willing to pay for the service or perform it themselves. Where the group has followed the guidance of the simplified approach including the documentation or reporting, it should provide sufficient evidence that the benefits test is met given the nature of low value-adding intra-group services. In evaluating benefits, tax administrators should consider benefits only by categories of services and not on a specific charge basis. Thus, the taxpayer need only demonstrate that assistance was provided with, for example, payroll processing, rather than being required to specify individual acts undertaken that give rise to the costs charged.

15. In determining the arm's length charge for low value-adding intra-group services, the multinational group's provider of services should apply a profit mark-up to all costs in the pool with the exception of any past-through costs as determined in the guidelines. The same markup should be utilized for all low value-adding services irrespective of the categories of services. The markup should be equal to 5% of the relevant cost.

D. Cost Contribution Agreements**.**

1. Cost contribution agreements are special contractual arrangements among business enterprises to share contributions and risk involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that the these intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants. The report revises Chapter VIII of the OECD's Transfer Pricing Guidelines. It is in response to Action 8 of the BEPS Action Plan covering the transfer pricing of intangibles and requires the development rules to prevent base erosion and profit shifting by moving intangibles among group members without arm's length compensation, as well as an update on the guidance concerning cost sharing agreements.

2. For the conditions of a cost sharing agreement to satisfy the arm's length principle, the value of participants' contributions must be consistent with what independent enterprises would have agreed to contribute under comparable circumstances given their proportionate share of the total anticipated benefits they reasonable expect to derive from the arrangement. Because the concept of mutual benefit is fundamental to a

cost sharing agreement, it follows that a party may not be considered a participant because the party does not have a reasonable expectation that it will benefit from the objectives of the cost sharing agreement activity itself, for example, from exploiting its interest or rights in the intangibles or tangible assets, or from the use of services produced through the cost sharing agreement.

3. A party would also not be a participant in a cost sharing agreement if it does not exercise control over the specific risks it assumes under the cost sharing agreement and does not have the financial capacity to assume these risks, as this party would not be entitled to a share in the output that is the objective of the cost sharing agreement based on the functions it actually performs.

4. To the extent of specific contributions made by participants to a cost sharing agreement are different in nature, *e.g.*, the participants perform very different types of R&D activities or one of the parties contributes property and another contributes R&D activities, specific guidance is applicable. This means the higher development risk attached to the development activities performed by the other party and the closer the risk assumed by the first party is related to the development risk, the more the first party will need to have the capability to assess the progress of the development of the intangible and the consequences of this progress for achieving its expected benefits, and the more closely the party may need to link its actual decision-making required in relation to its continued contributions to the cost contribution agreement to key operational developments.

5. Contributions to a cost sharing agreement may take many forms. For services cost sharing agreements, contributions primarily consist of the performance of services. For development cost sharing agreements, contributions typically include the performance of development activities (*e.g.*, R&D, marketing), and often include additional contributions relevant to the development of the cost sharing agreement such as pre-existing tangible assets or intangibles. All contributions of current or pre-existing value must be identified and accounted for appropriately in accordance with the arm's length principle.

6. The cost sharing agreement will considered consistent with the arm's length principle where the value of each participants proportionate share of the overall contributions to the arrangement (taking into account any balancing payments already made) is consistent with the participant's share of the overall expected benefits to be received under the agreement. Where the value of a participant's share of overall contributions under a cost contribution agreement at the time the contributions are made is not consistent with that participant's share of expected benefits under the agreement, the contributions made by at least one of the participants will

be inadequate, and the contributions made by at least one other participant will be excessive. In such a case, an adjustment must be made. This will generally take the form of an adjustment to the contribution through making or imputed a balancing payment.

7. Five examples are set forth. I will discuss only Examples 4 and 5. Example 4 was a cause for concern when it appeared in an earlier discussion draft, and Example 5 was the example that greatly troubled commenters.

> In Example 4, Company A and B are members of a multinational group and decide to undertake the development of an intangible though a cost sharing agreement. The intangible is anticipated to be highly profitable based on Company B's existing intangibles, its track record and its experienced research and development staff. Company A performs, through its own personnel, all of the functions of a participant in the development of a cost sharing agreement, obtaining an independent right to exploit the resulting intangible, including functions required to exercise control over the risks it contractually assumes in accordance with the principles outlined in the new rules.
>
> Company A will contribute the funding associated with the development of the intangible ($100 million per year for 5 years). Company B will contribute the development rights associated with its existing intangibles, to which Company A is granted rights under the cost sharing agreement irrespective of the outcome of the agreement's objectives, and will perform all activities related to development, maintenance and exploitation of the intangible. The value of B's contributions (encompassing the performance of activities as well as the use of pre-existing intangibles) would need to be determined and would likely be based on the anticipated value of the intangible expected to be produced under the cost sharing agreement less the value of the funding contribution provided by Company A.
>
> Once developed, the intangible is anticipated to result in global profits of $550 million per year (year 6 to 15). The agreement provides that Company B will have exclusive rights to exploit the resulting intangible in Country B (anticipated to results in profits of $220 million per year in year 6-15) and Company A will have exclusive rights to exploit the intangible in the rest of the world (anticipated to result in profits of $330 million per year).
>
> Taking into account the realistic alternatives of Company A and Company B, it is determined that the value of Company A's contribution is equivalent to a risk adjusted return on its R&D funding commitment. Assume this is determined to be $110 million per year (for years 6-15). However, under the cost sharing agreement Company A is anticipated to reap benefits amounting to

$330 million of profits per year in years 6-15 (rather than $110 million). This additional anticipated value in the rights a company obtains (that is, the anticipated value above and beyond the value of Company A's funding investment) reflects the contribution of B's pre-existing contributions of intangibles and R&D commitment to the cost sharing agreement.

A needs to pay for this additional value it receives. Accordingly, the balancing payments from A to account for differences are required. In effect, A would need to make a balancing payment associated with those contributions to B equal in present value, and taking into account the risks associated with this future income, to $220 million per year anticipated in years 6-15.

In Example 5, the facts are the same as in Example 4 except that the functional analysis indicates Company A has no capacity to make decisions to take on or decline the risk-bearing opportunity represented by its participation in the cost sharing agreement or to make decisions on whether and how to respond to the risks associated with the opportunity. It also has no capacity to mitigate the risks or to assess or to make decisions relating to the risk mitigation activities of another party conducted on its behalf.

In accurately delineating the transaction associated with the cost sharing agreement, the functional analysis therefore indicates that Company A does not control the specific risks under the cost sharing agreement in accordance with the revised OECD Transfer Pricing Guidelines and consequently is not entitled to a share in the output that is the objective of the cost sharing agreement.

XV. 2016 BEPS DEVELOPMENTS.

A. Andrew Hickman, the former head of the OECD's transfer pricing unit, spoke July 21 at a Transfer Pricing Symposium in Washington, D.C. His comments were reported by Ryan Finley at 2016 TNT 141-5 and further discussed in an article by Mindy Herzfeld at 2016 WTD 147-1.

1. Hickman defended the guidance provided in the OECD's BEPS report on Actions 8-10 against claims that it fails to uphold the arm's-length principle. The report's emphasis on control of risk when allocating the returns from intangibles is viewed by critics is inappropriate because it is the investors – not those with operational control – who are entitled to a company's residual profits in arm's-length dealings.

2. Hickman was quoted as stating "perhaps [critics] will say we fudged it, but I would say it's a pragmatic fudge." He added that "It may be that we haven't got a pure version of the arm's-length principle, but perhaps we're looking for something that is just as equitable and might work."

3. I agree very much with the critics. However, there is an even bigger problem if, as Hickman implies or believes, the BEPS approach is not a pure arm's length approach. The arm's-length standard has long been the bedrock of transfer pricing adjustments in the United States, and prior to BEPS, had evolved into a nearly worldwide standard for allocating income among members of multinational enterprises. In the U.S., Treas. Reg. § 1.482-1(b)(1) makes clear that the boundary of the IRS's authority under § 482 is the arm's length standard which must be applied "in every case." Determining whether the arm's length standard has been met necessarily requires some sort of evidence as to how unrelated parties price transactions. *See Xilinx v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010), *aff'g* 125 T.C. 37 (2005); *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015). It would appear the U.S. has no intention to revise § 482 or the § 482 regulations as a result of BEPS Actions 8-10, which is good.

4. Further, United States tax treaties contain language requiring use of the arm's length method. Article 9 of the U.S.-U.K. Treaty, for example, provides that in the case of conditions made or imposed between two related enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises, then any profits that, but for those conditions, would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of the enterprise and taxed accordingly. The United States Treasury Department Technical Explanation states that "This article incorporates in the convention the arm's-length principle reflected in the U.S. domestic transfer pricing provisions, particularly Code § 482."

5. Most or all U.S. tax treaties provide for a similar application of the arm's length principle. Presumably, the United States has no plan to renegotiate its treaties to change the application of this principle.

6. If key persons such as Hickman believe that BEPS does not set forth a pure version of the arm's-length principle, then BEPS presents especially serious problems. The U.S. and its treaties require the arm's-length method. Countries that signed those treaties also are required to use the arm's-length method, at least to the extent of their dealings with the U.S. Other than that, under Hickman's view, a less than pure version of the arm's-length method apparently can exist. Can it be that where a U.S. parent company owns a U.K. subsidiary both of which sell goods to a related French company, two different transfer pricing regimes will co-exist?

7. As discussed in Herzfeld's article, Hickman's comments leave the impression that the BEPS changes to the OECD Transfer Pricing Guidelines have not solved the problems they were intended to solve, but instead have left the field in a state of confusion. Herzfeld states that

neither the professionals who tried to interpret the rules at the seminar nor the officials who drafted them seemed able to explain them.

8. Herzfeld notes that U.S. Treasury officials have expressed the view that the revised transfer pricing guidelines do not constitute a substantive change to the arm's-length standard and instead reflect best practices under the old guidelines. Many practitioners disagree. The idea that the residual return on intangibles should go to a management company rather than to the investor and owner of intangibles is a violation of fundamental economic principles. Residual profits inure to the investor of capital, who bears the economic risk, and control over the risk has virtually no correlation with profits in the real world.

9. Herzfeld expressed the view that the new guidelines also are unlikely to provide the results that their advocates -- countries that feel victimized by multinationals' use of transfer pricing rules to maximize profits in low-tax jurisdictions -- have hoped for. Policy officials have pointed to two types of egregious structures in justifying the need for the new rules: the cashbox and supply chain restructuring. She says the revised guidelines are unlikely to produce the outcomes many countries want. The focus on control of risk means the return on that risk might belong in the United States. For many high-tech companies, management decisions – that is, the control of risk – take place there. Reallocating profits to the United States is probably not the result the advocates of the new rules want. And unless the United States changes its controlled foreign corporation rules to assert tax jurisdiction over those profits, the profits will remain trapped in the cashbox company.

10. In the case of supply chain restructuring, such as with a principal company structure and low-risk distributors, the risk controllers here, too, would seem not to be based in the countries that advocated for the new rules.

B. <u>BEPS: Conforming Amendments Regarding Business Restructurings</u>. This "document for public review" contains conforming changes to Chapter IX of the transfer pricing guidelines entitled "Transfer Pricing Aspects of Business Restructurings." The purpose is to conform the OECD transfer pricing guidelines to the BEPS changes incorporated elsewhere in the OECD transfer pricing guidelines. The document is not entitled "Discussion Draft." It seems simply to be a request to review amendments that are proposed to be made to the transfer pricing guidelines. Accordingly, I will not cover this document further here.

C. <u>BEPS: Profit Splits</u>.

1. The OECD issued a BEPS discussion draft on profit splits. The BEPS writers' last attempt at a discussion draft on profit splits seemed more to be a discussion draft on the subject of formulary apportionment. It was roundly criticized. The new discussion draft is an improvement, but still

leaves a lot to be desired. Curiously, it states that it does "not represent consensus views" but is intended to provide stakeholders with substantive proposals for analysis and comment.

2. The discussion draft starts by stating that the transactional profit-split method seeks to eliminate the effect on profits of special conditions made or imposed in controlled transactions by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions. The transactional profit-split method first *identifies the profits to be split* for the associated enterprises. It then splits those combined profits on an *economically valid basis*. It seems to me that these statements emphasize the problems with the proposed profit-split rules rather than a solution or an application of workable rules.

3. Splitting profits on an economically valid basis can be described in two broad ways. The discussion draft states that one approach is splitting profits using *anticipated profits*. A second approach involves combining and splitting *actual profits*. Application in both cases is performed in a manner that is similar to that which the associated enterprises would have experienced, *i.e.*, on the basis of information known or reasonably foreseeable by the associated enterprises at the time when the transactions were entered into, and hindsight must be avoided.

4. The second section of the discussion draft addresses strengths and weaknesses of utilizing a profit-split method. The main strength is stated to be that this method can offer a pricing solution in circumstances in which the accurate delineation of the actual transaction shows that two or more associated enterprises undertake activities involving the sharing of economically significant risks. This may happen in highly integrated operations in which the parties each perform similar functions, and in some instances share core assets used to the produce the income stream.

5. On the other hand, the sharing of economically significant risks is not likely to occur where one party to the transaction performs only simple functions and does not make any significant unique contribution. In these cases, use of a transactional profit split of actual profits would not be appropriate.

6. Other strengths are stated to be that the method offers flexibility by taking into account specific, possibly unique, facts and circumstances that are not present in independent transactions, and that it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result.

7. The discussion draft states that a weakness of the transactional profit split method relates to difficulties in its application. On first review, the

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transactional profit split method may appear readily accessible to both taxpayers and tax administrations because it tends to rely less on information about independent enterprises. However, associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates. In addition, it may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions. This would require identifying from the financial records of the parties to the transaction the revenues, costs and profits arising from the transaction and separating them from the parties' other activities.

8. The way in which profits are split may also require detailed analyses of past, current, and expected expenditures relating to the combined profits from the transactions concerned. For example, the profit split between a global manufacturer and a regional distributor, in circumstances where both enterprises contribute intangibles, would require the combined profits for the products manufactured by the global manufacturer to be identified and separated from its other activities, and where the regional distributor sells other products or performs additional activities, similar separation would be required.

9. A third section discusses when profit split may be the most appropriate method. The discussion draft states that a lack of comparables alone is insufficient to warrant use of a transactional profit split of actual profits under the arm's length principle. It also says a sharing of risks by parties to a transaction may be accompanied by a high degree of integration of functions or the making of unique and valuable contributions by each of the parties. However, it says the contribution alone of an intangible or rights in an intangible by one of the parties is not sufficient to justify the splitting of combined actual profits of the parties to the transaction under a transactional profit split of actual profits. A transactional profit split of anticipated profits does not require the level of integration or risk sharing required for a transactional profit split of actual profits.

10. In a section entitled "Highly Integrated Operations," a series of new undefined terms is used. It says the accurate delineation of the actual transaction may determine that multiple parties share significant risks in relation to a transaction in cases in which the transaction is part of a "highly integrated business operation" of the parties. The discussion draft states that although most business operations taken by a multinational group are integrated to some degree, a "high degree of integration" means that the way in which one party to the transaction performs functions, uses assets and assumes risks is "interlinked with," and cannot reliably be evaluated in isolation from, the way in which another party to the transaction performs functions, uses assets and assumes risks.

11. The discussion draft says that in some cases there will be a "high degree of commonality" in the functions performed, the assets used and risks assumed. This commonality is more likely to be the case where there is "parallel integration" by the associated enterprises in the "value chain," rather than "sequential integration." In the case of sequential integration, in which the parties perform discrete functions in an integrated value chain, it will often be the case that it is possible to find reliable comparables for each stage or element in the value chain since the functions, assets and risks involved in each discrete stage may be comparable to those involved in uncontrolled arrangements.

12. In contrast, where parallel integration occurs, multiple parties to the transaction are involved in the same stage of the value chain. For example, the parties may each contribute intangibles, share functions in jointly developing products, and exploit the marketing of those products together. In the case of parallel integration, it may be the case that the accurate delineation of the actual transaction determines that each party shares economically significant risks, and a transactional profit split, using an approach that splits actual profits, may be found to be the most appropriate method.

13. Another section states that the transactional profit split may be the most appropriate method where multiple parties to a transaction make unique and valuable contributions, such as unique and valuable intangibles.

14. Other sections discuss group synergies, value chain analyses, guidance for application, various approaches for splitting profits and measures of profits.

D. BEPS: Attribution of Profits to PEs.

1. The BEPS discussion draft entitled "Additional Guidance on the Attribution of Profits to Permanent Establishments," dated July 4, 2016, states that an important issue that now needs to be taken into account regarding the PE rules is the effect of the transfer pricing work under BEPS Actions 8-10. The discussion draft states that it is important to note that the issue arises regardless of whether one is dealing with a PE arising from the post-BEPS version of Article 5(5) or from its pre-BEPS equivalent.

2. The practical effect of the changes made to Article 5(4) and the addition of the anti-fragmentation rule is to restrict the scope of the exceptions currently found in Article 5(4). To take one example, under pre-BEPS version of Article 5, an associated enterprise of one state that operates, through its own employees, a warehouse situated in another state for the purposes of the storage and delivery of goods and merchandise belonging to third parties is not entitled to the exception of Article 5(4) unless that

activity is merely preparatory or auxiliary. As a result of the changes in report on Action 7, the same will now be true if the enterprise carries on identical storage in delivery functions at a similar location with respect to its own goods or merchandise. It is not clear what is the difference between these two cases that would require additional guidance in relation to the issue of attribution of profits.

3. The discussion draft states that the same can be said with respect to the splitting-up of contracts. These changes do not create a new type of PE; they merely deny, in certain limited cases, the application of the exception of Article 5(3), which applies to an Article 5(1) permanent establishment that is a "building site or construction or installation project" provided that the permanent establishment does not meet the time threshold provided in Article 5(3).

4. At this point one might ask what guidance and/or practical changes would result from the new discussion draft? One commentator noted that it's an unusual discussion draft in that it is not clear that any new guidance on determining the amount of profits attributable to a permanent establishment is currently needed.

5. The discussion draft, however, states "This is not to say that there is no need for additional guidance on the attribution of profit issues. … The aim of the additional guidance covered is therefore, to illustrate how the rules for the attribution of PEs apply, taking into account both the changes made in the Report on Action 7 and the changes made to the transfer pricing guidelines." Thus, as opposed to new rules, the discussion draft proposes to *illustrate* the new transfer pricing rules' application to PEs.

6. The discussion draft sets forth potentially helpful examples. The examples are built on the assumption that a PE exists, either under Article 5(1) or Article 5(5), considering the revisions to the definition of PE introduced by the BEPS Report on Action 7.

7. It states that for purposes of its analysis the approach is performed by reference to Article 7 in the 2010 version of the Model Tax Convention ("MTC"), and under the principles in the 2010 commentary to the MTC, and the 2010 Report on the Attribution of Profit to Permanent Establishments, which endorses and attributes profits to a PE under the "Authorized OECD Approach ("AOA"). The AOA mandates that tax authorities use transfer pricing to determine the proper profit allocation to a PE as though it were a separate entity.

8. The discussion draft notes, however, that relatively few treaties include the new provisions of Article 7, and that through reservations and positions included in the OECD model, a number of OECD and non-OECD countries have expressly stated their intention not to include the new

version of Article 7 in their treaties. Inclusion of the new version of the Article in the U.N. model has also been expressly rejected by the U.N. Commission on Experts and International Cooperation in Tax Matters.

9. The four examples illustrating the attribution of profits to a dependent agent permanent establishment ("DAPE") present the following fact patterns:

   (a) In Example 1, the non-resident enterprise acting as a principal engages an associated enterprise resident in the host jurisdiction to perform activities that give rise to a DAPE under Article 5(5). This example illustrates the attribution of profits to the DAPE under the AOA in a fact pattern in which an analysis under Article 9 is also required.

   (b) In Example 2, the non-resident enterprise acting as a principal engages an associated resident in the host jurisdiction to perform activities that give rise to a DAPE under Article 5(5). The difference in this example compared with Example 1 is that the Article 9 analysis results in the allocation of risk not to the party contractually assuming the risk, but to the party that has control over the risk and that has a financial capacity to assume the risk. This example illustrates the impact that such an allocation of risk may have for the AOA analysis.

   (c) In Example 3, the facts are the same as in Example 2, except that the non-resident enterprise acting as a principal sends an employee to the host country to perform activities that give rise to a DAPE under Article 5(5). This example illustrates the attribution of AOA profits to the DAPE in a fact pattern in which an analysis under Article 9 is not required.

   (d) In Example 4, based on the facts in Example 2, the analysis focuses in on the activities related to the provision of credit to customers performed by the dependent agent enterprise and the non-resident enterprise. This example illustrates the consequences for the attribution of profits to the DAPE resulting from the attribution of risk under the AOA and the allocation of risk under Article 9.

10. In a separate section of the guidelines entitled "Guidance on the Attribution of Profits to Permanent Establishments Arising from Activities Not Covered by Specific Exceptions in Article 5(4)," an example, termed "Example 5," considers a fixed PE arising from the use of facilities, a warehouse, solely for purpose of storage, display or delivery of goods or merchandise belonging to a non-resident enterprise, and not qualifying as preparatory or auxiliary to the overall business activity of the enterprise.

11. The discussion draft states that given the difficulties of identifying profits when the warehousing activity is carried out as a cost center representing only one aspect of the multinational group's activities, this example first supposes that the warehousing activities are conducted as a profit center by a multinational group specializing and providing warehouse services to third party customers.

12. Profiling the warehouse in this manner provides a basis for developing guidance on the approach for determining the profits arising from the arrangements when carried out as a cost center as part of the multinational group's total activities.

E. BEPS: Groupwide Ratio Limitation for Interest Expense. The BEPS Report on Action 4, "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments," indicates that the OECD will continue to conduct detailed work on the design and operation of the group ratio rule, to be completed in 2016. This discussion draft is a part of that follow-up work. It's entitled "Elements of the Design and Operation of the Group Ratio Rule," and it focuses on approaches to calculate a group's net third-party interest expense, a definition of group-EBIDTA, and approaches to deal with the impact of losses on the operation of the group ratio rule.

F. Multilateral Instrument. During a July 7 public consultation on the OECD's BEPS-related Multilateral Instrument ("MLI"), multiple stakeholders and tax practitioners told the OECD that the text of MLI should be made public. This was discussed in a Tax Notes report by Alexander Lewis on July 8, 2016. Commenters said that publishing the text of the MLI would help practitioners to provide more meaningful comments as well as to help ensure the success of the instrument. One practitioner stated that the consultation was very unusual: "it's a consultation on a document which is not in the public domain."

G. Transparency in CbC reporting might be next.

1. The G-22 leaders approved an automatic exchange of information by 2018. This was at the September 2016 Hangzhou Summit. The G-20 leaders also endorsed the OECD's proposed criteria for identifying and listing those that do not cooperate regarding the tax transparency standard.

2. The UK government adopted a proposal to publish CbC reports, but said that international agreement on a reporting model is important.

H. BEPS Branch Mismatches.

1. The OECD issued a BEPS Discussion Draft on Branch Mismatch Structures. It provides recommendations for rules targeting payments made by or to a hybrid entity that give rise to one of three types of mismatches. The Discussion Draft identifies five basic types of branch mismatch arrangements. It includes specific recommendations, and 25

separate questions for public consultation. The document does "not necessarily reflect the consensus views of Working Party 11."

2. The Discussion Draft focuses on three types of mismatches:

   (a) Deduction/No Inclusion (D/NI) outcomes, where the payment is deductible under the rules of the payor jurisdiction but not included in the ordinary income of the payee;

   (b) Double Deduction (DD) outcomes, where the payment triggers two deductions in respect of the same payment; and

   (c) Indirect Deduction/No Inclusion (Indirect D/NI) outcomes, where the income from a deductible payment is set-off by the payee against a deduction under a hybrid mismatch arrangement.

3. The five basic types of branch mismatch arrangements addressed in the discussion document are:

   (a) Disregarded branch structures where the branch does not give rise to a permanent establishment (PE) or other taxable presence in the branch jurisdiction;

   (b) Diverted branch payments where the branch jurisdiction recognizes the existence of the branch, but the payment made to the branch is treated by the branch jurisdiction as attributable to the head office, while the residence jurisdiction exempts the payment from taxation on the grounds that the payment was made to the branch;

   (c) Deemed branch payments where the branch is treated as making a notional payment to the head office that results in a mismatch in tax outcomes under the laws of the residence and branch jurisdictions;

   (d) DD branch payments where the same item of expenditure gives rise to a deduction under the laws of both the residence and branch jurisdictions; and

   (e) Imported branch mismatches, where the payee offsets the income from a deductible payment against a deduction arising under a branch mismatch arrangement.

4. An example of the first category, a disregarded branch structure, is illustrated in the Discussion Draft by describing the type of structure that the European Commission has used as a basis for attacking Luxembourg. The U.S. and Luxembourg have also agreed to a protocol to their tax treaty that would eliminate this type of structure. Under the structure, A

Co (Luxembourg) has a branch in B Country (the U.S.). A Co lends money to C Co (a related company) through the branch located in Country B. Country C permits C Co to claim a deduction for the interest payment. Country A exempts or excludes the interest payment from taxation on the grounds that it is attributable to a foreign branch. The interest income is not, however, taxed in Country B because A Co does not have a sufficient presence in Country B.

5. An example of the second category, a diverted branch payment, is illustrated with the same basic structure described above. A Co has a branch in County B. A Co lends money to C Co. In this example, both the residence and branch jurisdictions recognize the existence of the branch. The mismatch arises due to the fact that the branch treats the interest payment as if it were paid directly to the head office in Country A, while the head office continues to treat the payment as made to the branch. As a consequence, the payment is not subject to tax in either jurisdiction.

6. The third category, deemed branch payment, again, is illustrated with the same basic structure. A Co has a branch in B. However, in this example, A Co supplies services to a related company (C Co) through the branch located in Country B. The services supplied by the branch exploit underlying intangibles owned by A Co. Country B attributes the ownership of those intangibles to the head office and treats the branches as making a corresponding arm's-length payment to compensate A Co for the use of those intangibles. This deemed payment is deductible under Country B law, but is not recognized under Country A law (because Country A attributes the ownership of the intangibles to the branch). The service income received by the branch is exempt from taxation under Country A law due to an exemption or exclusion for branch income in Country A.

7. The fourth category, DD branch payments, is illustrated with A Co, a company established and resident in Country A, that has lent money to a customer located in Country A (Customer A). A Co borrows additional funds from a bank and uses those funds to make a loan to a customer located in Country B (Customer B) through a branch established in that Country B. Income attributable to the branch is exempt or excluded from Country A taxation under Country A domestic law or under the Country A–B tax treaty. A DD results because Country A applies a fungibility approach to the deduction of interest expense, which results in half the amount of the interest expense on the bank loan being deductible under Country A law, and the domestic law of Country B allows the branch to apply a tracing approach which results in the full amount of the interest expense being deductible under Country B law.

8. The fifth and last category is imported branch mismatches. The related example starts with A Co that has a Country B branch. A Co also has a

subsidiary, C Co. C Co pays a fee for services to the branch. As a consequence, the deductible service fee paid by C Co (which is treated as exempt under Country A law) is offset against a deduction under a branch mismatch arrangement resulting in an indirect D/NI outcome because B branch is treated as paying a deemed royalty to A Co. A Co is not subject to tax in its country on the deemed royalty payment, which is not recognized in Country A.

9. The new Discussion Draft's expansion of the BEPS Action 2 Report's rules will add even more complexity to the already very complex hybrid-mismatch area. The BEPS Action 2 Report itself was an amazing 454 pages in length.

I. Mutual Agreement Procedures. The OECD released BEPS-related documents that will form the basis of the Mutual Agreement Procedure (MAP) peer review and monitoring process under BEPS Action 14. The OECD will also publish updated MAP profiles of all members. The actual peer reviews will be conducted in batches, starting in December 2016.

J. Common Reporting Standard. The OECD also announced that the first series of bilateral automatic exchange relationships were established among the first batch of jurisdictions committed to the automatic exchange of information as of 2017 pursuant to the Common Reporting Standard (CRS). The announcement also said there are now more than 1,000 bilateral relationships in place across the globe, most of them based on the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information (the CRS MCAA).