Developments at the IRS Advance Pricing and Mutual Agreement (APMA) Program and the OECD pertaining to Advance Pricing Agreements (APAs) and Mutual Agreement Procedure (MAP) cases

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Panel Members

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Today’s Agenda

1. Recently published APMA statistics for APAs and MAP cases and what they mean for current and future case inventory and processing
2. Cross Border Dialogue and how it can be used to address certain TP issues under MAP articles
3. The current state of competent authority relationships with key treaty partners and efforts to improve competent authority dispute resolution processes
4. Profit-Split and its use in competent authority cases
5. BEAT, and how APAs may or may not be able to address BEAT or other TCJA-related issues
6. APMA’s use of “reference” sets
Recently published APMA statistics for APAs and MAP cases and what they mean for current and future case inventory and processing
IRS APA Annual Report for 2018

Bilateral APAs Filed by Country 2018

- Japan: 34%
- India: 21%
- Canada: 9%
- Germany: 7%
- Korea: 6%
- Mexico: 6%
- Italy: 4%
- All Other Countries: 13%

Bilateral APAs Pending by Country 2018

- Japan: 31%
- India: 20%
- UK: 4%
- Mexico: 5%
- Korea: 5%
- Germany: 8%
- Canada: 9%
- Italy: 4%
- All Other Countries: 14%
MAP inventory has increased from 2,352 in 2006 to 7,500 in 2017 (The inventory was 8,002 cases reported for 2016. This decrease in the overall number of cases in MAP inventory is reportedly due to a different counting methodology used for cases received since 2016.)

- In 2017, Germany (1,241), the United States (983), France (882) and India (763) had the largest ending inventories of MAP cases.

GAO Report: Improving Int’l Tax Dispute Resolution

- GAO Dispute Resolution Report:
  (1) Describes IRS’s dispute resolution process,
  (2) Assesses the information IRS provides to taxpayers about the process, and
  (3) Assesses extent to which IRS evaluates its management of dispute resolutions cases.

- GAO made a total of eight recommendations, including that IRS
  - Improve the clarity of information on the dispute resolution process,
  - Track and use dispute resolution case data,
  - Ensure the quality of case data, and
  - Analyze trends in dispute case characteristics.

IRS agreed with GAO’s recommendations and said it will provide detailed corrective action plans.
Cross Border Dialogue and how it can be used to address certain transfer pricing issues under MAP Treaty articles
Cross Border Dialogue

CROSS-BORDER DIALOGUE

→ SCOPE
• Different types of specified international tax issues
  • For example corporate tax issues related to:
    • Permanent establishment
    • Cross-border losses
    • Withholding taxes
    • Transfer pricing

→ OUTCOME
• The outcome of the CBD is not an agreement between tax administrations
• Separate guidance in writing in each country according to the domestic legislation

COUNTRY 1: TAX ADMINISTRATION

EXCHANGE OF INFORMATION (EOI)

COUNTRY 2: TAX ADMINISTRATION

→ LEGAL BASIS
• Exchange of information by the competent authorities as set out in the provision of applicable tax treaties

→ BENEFITS
• Preventing disputes and eliminating potential double taxation
• Bringing certainty to the taxpayer
  All the parties could save significant time and cost.
The current state of competent authority relationships with key treaty partners and efforts to improve competent authority dispute resolution processes
Audit Environment in India

- GAAR effective April 1, 2017
  - Grandfathering rules for pre-effective date investments
  - Only applies for large cases
  - Local examiner must formally submit a request for GAAR to be invoked
  - Still in early stage as FY 3-31-18 returns only being examined now
  - GAAR panel staffed by a mix of specialists
- Indirect tax
  - Applies proportionately only if > 50% of the fair value of transferred entity relates to India
  - Vodafone case still being resolved
  - No step-up in India shares
- Transfer pricing audits
  - India’s expectations of margins are higher than other jurisdictions
India DAPE & Digital Taxation

**Dependent Agent Permanent Establishment**

Playing “principal role” in conclusion of contracts also triggers a PE – Widening of the definition in India’s domestic law

- Proposed modification of agency PE definition will reinforce Indian tax authorities’ position
- India’s stand on MLI position
- Non-residents would have an option to choose the provisions of the Act that are beneficial to them

**Significant Economic Presence**

- Unilateral Actions
- Proposes to tax digital transactions on the basis of ‘Significant Economic Presence’ vis-à-vis ‘physical presence’
- Would treaty-partners agree for re-negotiation of treaty terms?

- Appears that India is adopting a multi-pronged approach to tax e-commerce trade to demand its “fair” share of taxes
- Principles of profit attribution could be complex
Transfer Pricing Environment in India

“TP Week ranked India #1 on Top 10 toughest tax authorities for TP”

Aggressive TP audits with low threshold for cases being picked up

**B E P S**

- Margin focused approach
- Only APA an effective and timely dispute resolution forum
- Rejection of economic adjustments
- Recharacterisation/deeming transaction (AMP spend)

**Dispute resolution forums**

- AO/TPO
- CIT(A) / DRP
- Tribunal
- High Court
- Supreme Court

4 to 7 Years 6 to 10 Years

- Functional Re-characterization (adding new weapons such as survey, information from third parties, social media etc.)
- Value chain analysis (economic activity and value creation)
- Risk based assessments (training provided year on year to TP authorities)
- Adoption of Profit split (focusing beyond comparable(s)/margins)
- Multiple effective and timely dispute resolution forums (APA, MAP, Safe Harbour etc.)
Advance Pricing Agreements in India

- Traditional audit and appeals process can take many years
- APA terms may be more favorable (good for 5 years, option to elect to roll back for up to 4 years)
- Bilateral APAs terms may be more favorable but takes longer
- No-name, informal discussion possible
Profit-Split and its Use in Competent Authority Cases
**Profit Split Method**

- Profit splits are appropriate in situations where there is a fundamental sharing of economically significant risks between the parties, either on a prospective, anticipated basis or in terms of actual profit results*

- At arm’s length, parties entering into such arrangements can be assumed to share profits in proportion to their relative contributions to the joint generation of profits based on information known or reasonably foreseeable at the time the transactions were entered into and in view of the associated risks* undertaken by the parties

- In many situations, each party’s relative investment in long-lived assets, including intangible assets like technology and some marketing intangibles as well as tangible physical and/or financial assets, represents both the contribution to the generation of the relevant profits being shared and the investment at risk

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Profit Split Method (continued)

- Residual analyses refine this paradigm by distinguishing between relatively “routine” contributions of assets that can be valued at arm’s length based on external market benchmarks and “non-routine” assets that constitute the more fundamental contributions to the residual profits that are at risk and that are shared between the parties that contribute such non-routine assets.

- Not all situations appropriate for application of the profit split method are amenable to using costs or capital employed as profit splitting factors, as other profit split factors may be more reliable.

- Alternative split factors that can be applied reliably in view of the underlying value chain profit contributions may be considered.
Profit Split Method (continued)

Profit split method is a potentially suitable method when businesses are highly integrated, both sides of the transaction own valuable, nonroutine intangibles, or when comparable companies are not available.

**Strengths**
- Multi-sided approach
- Less extreme results
- Can reduce potential conflicts with tax authorities
- Particularly appropriate for highly integrated businesses
- Can be used when comparables are unavailable

**Weaknesses**
- More difficult to apply
- Different accounting practices of affiliates
- Dependence on access to data from foreign affiliates
- Need for preparation of segmented financial data depending on the scope of application – lines of business; technology source; geographic market, etc.
- Determination of combined profits and allocation keys
- Involves valuation of intangibles/contribution to value creation activities
- Subjectivity in drawing the line between routine and non-routine functions
- Relatively high compliance costs
Profit Split Method (continued)

OECD’s BEPS initiatives, changes in regulatory requirements, and increased transparency lead to greater use of profit splits

• Increased transparency of location of companies’ profits under the CBCR requirements drives the need for multi-sided methods

• Changing view of tax authorities toward the need for multi-sided analysis, complete disclosure and the defense of the allocation of profits across the value chain all lead to greater use of profit splits

• Multinational businesses becoming increasingly complex where the development of Intellectual Property and other complex value creation activities are often distributed around the world with contributions being made in multiple jurisdictions rather than in a single location
OECD’s Consultation Document “Addressing The Tax Challenges of the Digitalization of the Economy” includes “user participation” and “marketing intangibles” proposals that prescribe profit split methods

“User Participation” Proposal

• Policy rationale
  – Sustained user engagement and active participation create value in the form of valuable data, brand loyalty, critical mass of users and market power

• Application
  – A special profit attribution rule that would only be applicable to companies in the digital economy – social media platforms, search engines, and online marketplaces
  – Attributes a certain proportion of profits of such digital companies to “the user base” regardless of the jurisdiction of the company’s own economic activities
  – Requires split of residual profit between the parent’s technology, marketing, and other intangibles vis-à-vis the user created value
  – The proposal suggests either a fixed percentage or a percentage based on some quantitative/qualitative information in order to quantify user created value
“Marketing Intangibles” Proposal

• Policy rationale
  – “Some marketing intangibles, such as brand and trade name, are reflected in the minds of customers and so can be seen to have been created in the market jurisdiction.”

• Application
  – Applicable not only to highly digitalized companies, but also to a potentially broader range of businesses that have marketing intangibles
  – Attributes a certain proportion of profits of these companies to “users/consumers” regardless of the jurisdiction and/or the level of the company’s own economic activities
  – Requires split of profits attributable to marketing vs. non-marketing intangibles using either cost-based methods or more formulaic approaches
  – Special allocation of some or all non-routine returns from marketing intangibles without an analysis of the DEMPE functions and value creation
  – Potentially different transfer pricing rules and standards for different intangibles, i.e., marketing intangibles vs. other intangibles including technology, R&D, etc.
Recently published APMA Functional Cost Diagnostic Workbook (FCD workbook) and its potential use in determining the best method

APMA may require taxpayers to complete the FCD workbook during the APA process in certain cases, in which two or more controlled taxpayers may make material, non-benchmarkable contributions to their intercompany arrangement.

**Taxpayer Inputs**

- ✔ Identify routine and non-routine functions
- ✔ Prepare segmented financial data for each party and function
- ✔ Identify cost center data for each party and function
- ✔ Estimate lead time and useful life for development costs
- ✔ Input comparables’ benchmark returns
- ✔ Select profit level indicators

**APMA’s FCD Workbook**

- ✔ Organize and analyze functional costs
- ✔ Calculate arm’s length return for routine functional costs
- ✔ Capitalize and amortize development costs
- ✔ Produce a pro forma split of residual profits (losses)
BEAT, and how APAs may or may not be able to address BEAT or other TCJA-related issues}{BEAT}
BEAT Overview

- **Applicability**
  - “Applicable Taxpayers” are corporations (other than RICs, REITs, or S-corporations) with average annual gross receipts of $500 million for the prior 3-year period and a base erosion percentage of at least 3% (2% in the case of banks and securities dealers)
  - Test applied on an aggregated group basis for all affiliates and branches with U.S. operations
  - Separate test required for fiscal and calendar year entities in aggregate group

- **Definition of Base Erosion Payment (BEP)**
  - Generally, tax deductible payment made to foreign related party
  - Measured on a gross basis (except for mark-to-market method positions which must be netted)
  - Related party defined broadly with reference to the transfer pricing definition of “control”
  - Exceptions for 1.) payments subject to U.S. taxation via withholding tax or ECI inclusion; 2.) qualified derivative payments; 3.) cost of goods sold; 4.) service cost method amounts; and 5.) TLAC interest

- **BEAT Liability Calculation**
  - Calculated on an “Applicable Taxpayer” basis
  - BEAT liability = (applicable BEAT rate x modified taxable income) – Regular tax liability
  - Modified taxable income = regular taxable income + BEPs
  - Regular tax liability = does not include certain credits including FTC
BEP or Not a BEP?

- **Service Cost Method Payments**
  - The statute provides an exception for *services that are eligible* to be priced using the services cost method under section 1.482-9(b)
  - The Proposed Regulations takes a broad approach that even where a payment for services includes a markup, the exception applies to the portion of payment that does not exceed the total cost of services

- **Global Dealing Allocations and Residual Profit Splits**
  - Proposed Regulations do not specifically address whether global dealing allocations would be treated as “payments” to related parties for purposes of Section 59A
  - Similarly, the Proposed Regulations do not directly address allocations that result from the use of the profit split methods under Treasury Regulations Section 1.482-6
BEP or Not a BEP? (continued)

• Interest Expense Allocable to Branches
  – The Preamble distinguishes between “Internal Dealings” under a treaty based approach from allocation of interest expense under Treasury Regulations Section 1.882-5
  – By drawing a distinction between Internal Dealings and allocations pursuant to Treasury Regulations Section 1.882-5, the Proposed Regulations create a regime that could be more taxpayer-adverse under a treaty compared to the U.S. Code

• TLAC Securities and Other Regulatory Debt
  – Proposed Regulations provides an exception for a portion of the interest paid or accrued on TLAC securities issued by GSIBs
  – The Proposed Regulations do not address maintenance buffer, transition periods, possible future changes to TLAC regulations and other categories of regulatory debt issued by U.S. subsidiaries and branches of FBOs
Other Issues Presenting Uncertainty to “Applicable Taxpayers”

- **Timing of Final Regulation**
  - Will the final BEAT regulations be issued by June 22, 2019 (i.e., deadline for retroactive application to January 1, 2018)?
  - What should taxpayers do in the event that final BEAT regulations are not finalized by June 22, 2019?

- **Foreign Tax Credit – BEAT**
  - Will BEAT payments qualify as creditable income taxes under applicable tax treaties?

- **More Certainty on BEAT**
  - What issues can APMA address surrounding BEAT?
APMA’s use of “reference” sets
Use of Reference Comparables Sets

- Reference sets are intended to be used as a starting point in certain types of common benchmarking cases, derived using very standard search and selection criteria, largely quantitatively based and with minimal qualitative/subjective filtering.
- These reference sets are then modified, as needed, based on economically significant features specific to the tested party.
- Reference sets are a tool designed to achieve efficiency and some degree of predictability in a given benchmarking case.
Thank You to Our Panel Coordinators

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