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Proposed Regulations Regarding Country-by-Country Reporting

IRS and Treasury Department Issue Proposed Country-by-Country Reporting Regulations

SUMMARY

On December 21, 2015, the Treasury Department and the Internal Revenue Service (the "IRS") issued proposed regulations (the "Proposed Regulations") describing a new country-by-country ("CbC") reporting requirement based on model legislation created by the OECD/G20 Base Erosion and Profit Shifting Project ("BEPS") Action Plan (the "BEPS Action Plan"). The Proposed Regulations closely follow BEPS's model legislation by requiring that a US ultimate parent entity (determined under accounting consolidation principles) of a substantial multinational enterprise ("MNE") group file an annual CbC report detailing the MNE group's global operations, with the intention that such CbC reports be shared with other tax jurisdictions pursuant to information exchange agreements.

Prior to the release of the Proposed Regulations, members of Congress and business groups expressed concerns that CbC reporting would be cumbersome, costly and potentially result in sensitive business information being improperly used and/or disclosed. In a somewhat lengthy Preamble to the Proposed Regulations (the "Preamble"), the Treasury Department and the IRS appear to respond to these concerns as well as explain why CbC reporting will better assist enforcement of US tax laws. However, unmoved by the Preamble, certain members of Congress criticized the Proposed Regulations shortly after their release and have promised to delay the implementation of CbC reporting.

Part I of this memorandum provides background on the BEPS model legislation, Part II of this memorandum discusses the Preamble's response to the pre-release concerns of CbC reporting and

explains the provisions of the Proposed Regulations, Part III of this memorandum highlights some of the criticism of the Proposed Regulations and Part IV of this memorandum offers some concluding thoughts.

BACKGROUND

Action 13 of the BEPS Action Plan requires the development of "rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template." As part of the response to this requirement, the OECD and G20 countries created a CbC reporting requirement. The model implementation package requires that large MNE groups (generally with annual group revenues exceeding EUR 750 million) file an annual CbC report detailing such group's global operations, including the tax jurisdictions in which they and their constituent entities do business and the group's revenues, profits, taxes paid and accrued, employees, stated capital, retained earnings and tangible assets. Notably, this model implementation package requires MNE groups to report less information than had been originally proposed due to opposition to the breadth of the original discussion draft by the United States, other member countries and industry groups (the draft CbC template had 18 columns for different data required to be reported on an entity-by-entity basis; the model template was narrowed to eight columns).[1]

The Executive Summary to the model implementation packages says that the CbC reports are intended to provide taxing authorities with "useful information to assess transfer pricing risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit inquiries." As such, the CbC reports are intended to be filed with the ultimate parent entity's jurisdiction of residence but then shared freely among different tax jurisdictions through automatic exchanges of information, bilateral tax treaties and other government-to-government mechanisms. The model template for a CbC report (the "Model Template"), the model legislation to implement CbC reporting (the "Model Legislation"), and the model competent authority agreements to exchange CbC reports, were finalized in October 2015, and are intended to be adopted in similar form by countries participating in BEPS for fiscal years beginning on or after January 1, 2016.

THE PROPOSED REGULATIONS

A. THE PREAMBLE AND CONCERNS WITH CBC REPORTING

On December 1, 2015, prior to the release of the Proposed Regulations, both the Senate Finance Committee and the House Ways & Means Tax Policy Subcommittee held hearings on BEPS that included significant discussion of CbC reporting. Chairman of the Senate Finance Committee, Senator Orrin Hatch (R-Utah), remarked that the BEPS CbC reporting requirements "could impose significant compliance

costs on American businesses and force them to share highly sensitive proprietary information with foreign governments." Similarly, House Ways and Means Tax Policy Subcommittee Chairman Charles Boustany (R-Louisiana) began the Subcommittee hearing by criticizing the BEPS project for creating a "highly subjective standard… that seems to unnecessarily target American companies." The practitioners and business groups invited to speak at the hearings echoed many of the concerns that Senator Hatch and Representative Paul Ryan (R-Wisconsin) had previously raised in letters to Treasury Secretary Jacob Lew,[2] including the costs and risk for US businesses and questioning both the Treasury Department's statutory authority to request, collect and share information with foreign governments and the benefits the US government would receive from the new reporting requirement given the IRS's ability to access much of this information already. For example, Catherine Schultz of the National Foreign Trade Council raised numerous issues with CbC reporting in front of the House Ways & Means Tax Policy Subcommittee, addressing information confidentiality, safeguarding and improper use, the potentially high cost of compliance, and the cumbersome process of reconciling different accounting standards in different jurisdictions. However, Schultz's statement seemed to encourage the United States to adopt the relevant rules regarding information gathering, exchanging and confidentiality for US MNE groups in order to prevent other countries from demanding that subsidiaries of US MNE groups produce CbC reports under local rules that are expensive and may expose confidential information to improper disclosure.

In what appears to be at least a partial response from the Treasury Department and the IRS, the Preamble provides a somewhat lengthy discussion of the origin and objectives of the Proposed Regulations, how CbC reports will be used by the IRS and how US CbC reports will be exchanged with other jurisdictions.

First, the beginning of the Preamble appears to focus on legitimizing the Proposed Regulations and to reduce concerns about the cost of information gathering. After noting the specific statutory authority for the new reporting requirement,[3] the Preamble describes the background to the BEPS implementation package, and says that the Treasury Department and the IRS believe it is appropriate to tailor the Proposed Regulations to the BEPS model because the model was developed in consultation with stakeholders "to appropriately balance the benefits to tax administrations against the compliance costs and burdens imposed on MNE groups." In addition, the Preamble highlights that MNE groups have "flexibility" in the ways in which they can meet the reporting requirement in light of their different structures and system capabilities.

Second, the Preamble addresses how the IRS intends to use information reported on CbC reports. The Preamble states that the information reported on CbC reports (provided by both US MNE groups and foreign MNE groups) will assist in identifying and assessing transfer pricing risks, but that such information will only be used to "help" the IRS perform "high-level" transfer pricing assessment. In particular, the Preamble reaffirms the supremacy of the arm's-length standard in US transfer pricing

analysis by stating that information on a CbC report will not be "conclusive evidence" of a group's transfer pricing practices or "a substitute for an appropriate transfer pricing determination."

Third, the Preamble details the circumstances under which US CbC reports will be exchanged. The Preamble says that, while it is expected that the US competent authority will enter into competent authority arrangements for the automatic exchange of CbC reports under the authority of the information exchange agreements currently in place, the Treasury Department and the IRS will "closely review the tax jurisdiction's legal framework for maintaining confidentiality of taxpayer information" and must be satisfied that "the tax jurisdiction has the necessary legal safeguards in place to protect exchanged information, such protections are enforced, and adequate penalties apply to any breach of that confidentiality." Furthermore, the Preamble states that the United States will "pause" automatic exchange of CbC reports with a tax jurisdiction if the United States determines that such jurisdiction is not in compliance with the "confidentiality requirements, data safeguards, and the appropriate use [of information] standards."

B. THE PROPOSED REGULATIONS

The Proposed Regulations hue closely to the Model Legislation. However, the Treasury Department and the IRS note that they are still seeking input on some key issues, including which entity should file the CbC report, which entities will be treated as "constituent entities," whether the items required to be reported should be refined, and whether additional guidance is necessary with respect to determining how such items are to be reported.

1. The Filer and the Constituent Entities

Similar to the Model Legislation, the Proposed Regulations would generally require a CbC report to be filed with the IRS by the "ultimate parent entity" (generally, the parent entity that consolidates accounts under US GAAP with its domestic and foreign subsidiaries) of a MNE group if (i) the ultimate parent entity of the MNE group is an entity (not an individual) organized or has its tax jurisdiction in the United States (such MNE groups are referred to as "US MNE groups") and (ii) the US MNE group had revenues equal to or greater than $850 million for the preceding annual accounting period. However, unlike the Model Legislation, which contains special rules that would broaden the types of entities that would be allowed and/or required to report,[4] the Proposed Regulations would only allow and require a US ultimate parent entity to report. In another departure from the Model Legislation, the Preamble questions whether an exception to filing should be created for national securities reasons, and the Treasury Department and the IRS request comments on the procedure a filer should be required to follow to demonstrate whether a national security exemption is warranted. Finally, the Preamble makes clear that, because the ultimate parent entity is determined by accounting consolidation principles, it is of no bearing whether the ultimate parent entity is the parent of any (or none) of the tax consolidated groups within the US MNE group.

Like the Model Legislation, the Proposed Regulations would require that the CbC Report include the ultimate parent entity and its "constituent entities," which are generally defined as the business entities

that are required (or would be required if the ultimate parent entity was publicly traded) to consolidate their accounts with the ultimate parent entity (the Preamble notes that a constituent entity would presumably exclude a business entity that is accounted for under the equity method because such entity would not consolidate its accounts with its equity owner). However, even if the accounting rules would otherwise require consolidation of a foreign entity, the Proposed Regulations would not treat a foreign corporation or foreign partnership as a constituent entity if the ultimate parent entity is not currently required to include with its US tax return a report with respect to such foreign entity under the currently applicable information reporting rules that require US entities to report information about foreign entities that they own (*e.g.*, a foreign corporation or foreign partnership that is less than 10% owned directly, indirectly and constructively by the US ultimate parent entity). This again shows the Treasury Department's and the IRS's sensitivity to criticism that current law does not permit such information gathering. In addition, while the Proposed Regulations would generally require the partners of an entity that is treated as a partnership in its jurisdiction of organization to report their share of the partnership's items, the Preamble notes that the Treasury Department and the IRS are considering whether a different rule should be required for hybrid entities.

2. The US CBC Report

The CbC report that the ultimate parent entity of a US MNE group would be required to file (a "US CbC report") would be essentially identical to the Model Template. In particular, a US CbC report would require information reporting in three general categories: (i) information about each constituent entity of the US MNE group (*e.g.*, its tax identification number, tax residency, tax jurisdiction of organization, and its main business activity or activities); (ii) information regarding the US MNE group's finances, taxes, employees and assets, in each case segmented on a country-by-country basis; and (iii) any additional relevant information about the US MNE group. In what appears to be an attempt to provide flexibility to the MNE groups to meet the reporting requirements without imposing too great a burden on them, the Proposed Regulations do not generally provide specific detail regarding how these reported items are to be determined, but rather says that the reported items "should be based on certified financial statements, books and records maintained with respect to the constituent entity, or records used for tax reporting purposes." Furthermore, the Preamble confirms that there is no requirement that the filer reconcile reported items to the consolidated financial statements of the US MNE group or such group's tax returns in any particular jurisdiction, nor any requirement to make adjustments for differences in accounting principles applied in different jurisdictions.

A US CbC report would be required to be filed with a taxpayer's timely filed income tax return (with extensions), which is sooner than the Model Legislation's filing deadline of 12 months after the last day of the MNE group's reporting fiscal year. This filing inconsistency could potentially create situations where an MNE group is required to produce CbC reports at different times for different jurisdictions.

C. APPLICABILITY DATE

The Proposed Regulations are proposed to apply to taxable years of ultimate parent entities that begin on or after the date of publication of the final regulations in the Federal Register and that include the taxable years (or annual accounting periods) of all the US MNE group's constituent entities that begin on or after such date. As a result, even if the Proposed Regulations were quickly finalized, reporting will not be required for tax years beginning on January 1, 2016, which is the date recommended by the Model Legislation.

CRITICISM OF THE PROPOSED REGULATIONS

Following the release of the Proposed Regulations, members of Congress have questioned the Treasury Department's and the IRS's authority to request and obtain MNE group information, and continued to express concerns that CbC reporting would be cumbersome, costly and potentially result in sensitive business information being improperly shared and/or disclosed.

On December 21, 2015, House Ways and Means Chairman Kevin Brady (R-Texas) released a statement in response to the Proposed Regulations announcing that he and Representative Boustany would "closely review" the Proposed Regulations. Representative Brady's statement also asserted that the Proposed Regulations must be "limited," "should not make it even harder for [US] companies to compete" and that "Congress will not allow Treasury to move forward with BEPS policies that enable foreign governments to misuse information reporting and exploit American companies."

The following day, Representative Boustany announced legislation called the Bad Exchange Prevention (BEPS) Act that would "provide more time for the US government to prepare for these new requirements while putting strong protections against abuse in place to ensure American companies can compete and succeed." Of note, Representative Boustany's act would delay the exchange of US CbC reports with any foreign jurisdiction until 2017.

CONCLUDING THOUGHTS

While the Preamble indicates that the Treasury Department and the IRS intend to take steps to avoid misuse of the information shared with other taxing authorities, the discussion of potential misuse has focused primarily on confidentiality and ensuring that highly proprietary information is not made available to competitors, suppliers and customers (including state-owned enterprises). Another form of misuse, however, which may equally damage MNE groups with high-value intangibles, is that the information may also become the basis for tax authorities to implement, either explicitly or implicitly, formulary apportionment of income rather than the arm's-length standard that is required by treaties.

It is clear that the United States, at least, remains officially committed to the arm's-length standard,[5] and is potentially concerned that the reports may become the basis for applying other standards. The

Preamble states that "[u]nder the contemplated competent authority arrangements for the exchange of CbC reports, the competent authorities of the United States 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." Implicitly, this would exclude using the reports for purposes of formulary apportionment. It remains to be seen, assuming the Proposed Regulations are adopted, whether in fact the United States will decline to provide reports to jurisdictions that use the reports, either explicitly or otherwise, to depart from the arm's-length standard and, even if the United States were to adopt such a policy, whether it would be able to recognize such departures and react on a timely basis.

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ENDNOTES

1 *See* "Discussion Draft on Transfer Pricing Documentation and CbC Reporting" (Jan. 2014), Appendix III, *available at* http://www.oecd.org/ctp/transfer-pricing/discussion-draft-transfer-pricing-documentation.pdf and "Public Comments Received", Volumes I-IV (Feb. 2014), *available at* http://www.oecd.org/ctp/transfer-pricing/volume1.pdf and similar.

2 Senator Hatch and Representative Ryan sent Treasury Secretary Lew a letter on June 9, 2015, outlining concerns with CbC reporting in advance of a June BEPS conference held in Washington, DC, and then reiterated these concerns in an August 27, 2015, letter sent in response to the Treasury Department's announced plans to prioritize work on the Proposed Regulations.

3 The Treasury Department and the IRS cited Sections 6001, 6011, 6012, 6031, 6038 and 7805 of the US Internal Revenue Code of 1986, as amended (the "Code"), as the statutory authority for the Proposed Regulations, but did not provide a broader discussion of the implementing authority. In their June 9 letter to Treasury Secretary Lew, Senator Hatch and Representative Ryan requested that "the Treasury Department and IRS provide the tax-writing committees with a legal memorandum detailing its authority for requesting and collecting this CbC information" and, in the event that they do not receive this and other information, "Congress will consider whether to take action to prevent the collection of the CbC [reports]."

4 Specifically, the Model Legislation would require reporting by a constituent member of an MNE group in such member's jurisdiction of tax residence if such jurisdiction is generally not permitted access to the CbC report of the MNE group because (i) the ultimate parent entity is not required to file a CbC report, or (ii) the jurisdiction in which the ultimate parent entity filed its CbC report is not obligated to exchange such report with the constituent member's jurisdiction due to the lack of an information exchange agreement or because such agreement has been paused or suspended. In addition, the Model Legislation would allow an MNE group to designate as the sole substitute for the ultimate parent entity a "Surrogate Parent Entity" that would file CbC reports on behalf of the MNE group in the Surrogate Parent Entity's jurisdiction of tax residence.

5 *See, e.g.*, the Preamble ("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 regulations under section 482, and transfer pricing adjustments will not be based solely on a CbC report"), and the testimony of Robert Stack, Treasury Deputy Assistant Secretary for International Tax Affairs, before the Senate Finance Committee (July 22, 2014) ("In the area of transfer pricing, we must ensure that the currently-used arm's-length standard is clearly articulated and that profits are attributable to the place of economic activity…The arm's-length standard has been a bedrock of international taxation for over 50 years, and while it is not perfect, it is the best tool available to deal with the difficult issue of pricing among affiliates of a multinational group. We must steadfastly avoid turning longstanding transfer pricing principles into a series of vague concepts easily manipulated by countries to serve their revenue needs at the expense of the U.S. tax base and our multinationals.").

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