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Focus on Tax Strategies & Developments

Table of Contents

Impact of Country-By-Country Reporting on Multinational Enterprises

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Perhaps the most challenging component of the Base Erosion and Profit Shifting (BEPS) initiative adopted by the OECD and G20 countries, Action 13 (Country-by-Country Reporting), represents a fundamental change to the landscape of international tax and transfer pricing for large multinational enterprises (MNEs).

Country-by-Country Reporting (CbCR) provides a template for MNEs to annually report certain tax information with respect to their business in each tax jurisdiction in which they operate. CbCR aims to create a network of real-time sharing and access to taxpayer's data and information in what potentially could be a new era of tax transparency.

Fundamental Changes

CbCR generally applies to MNE groups with total consolidated group revenue of €750 million, although specific jurisdictions may adopt an alternative threshold. For example, in its final regulations (T.D. 9773), the United States has adopted a group annual revenue threshold of $850 million, intended to be the US equivalent of €750 million.

The OECD's final CbCR Action Report has no legal authority *per se*, and is intended to serve as a basis for interested jurisdictions to adopt and implement the recommended approach set out therein.

As a result, domestic legislation is required to be passed by jurisdictions intending to implement CbCR, and this may differ among the various jurisdictions involved.

For example, the UK adoption of CbCR applies to accounting periods commencing on or after January 1, 2016, and companies will have 12 months from the end of the relevant accounting period to file a report with HMRC.

Conversely, the US CbCR rules apply to US MNE groups for their first taxable years that begin on or after June 30, 2016. The effective date of the US final regulations creates a so-called "gap year" in which US-parented MNEs may be subject to CbCR in foreign jurisdictions, but not in the United States, with the result that US-parented MNEs could be required to report their CbCR file directly to foreign jurisdictions (and not to the Internal Revenue Service (IRS)) during the gap year.

To alleviate this situation, the IRS has permitted US-parented MNEs to voluntarily file their CbCR report with the IRS on Form 8975 (forthcoming) (although MNEs must always consider whether or not voluntary filing with the IRS in this manner discharges their obligation to file a CbC report in their local jurisdiction).

Sensitive taxpayer information in CbCR reports remains confidential and access is limited to tax authorities in the respective jurisdictions in which the MNE operates. It is possible, however, to hypothesize a future disclosure or publication of sensitive taxpayer information in a CbCR report, either due to political pressure in a domestic context or an international context (*e.g.*, State aid investigations), other external influences (*e.g.*, WikiLeaks, LuxLeaks, etc.), or even in the course of litigation (*e.g.*, where a CbC report becomes a matter of public record by virtue of having been filed in court proceedings). For example, the United Kingdom has enacted legislation that provides the UK tax authorities with a power (as yet unexercised) to require publication of CbC reports in the future. The UK government has indicated that it does not expect the power to be exercised unless there is multilateral agreement on the publication of CbC reports. MNEs may therefore want to consider the impact of such a disclosure or publication on the operation of their business.

New Approach to Tax Planning?

CbCR aims to shine a light on perceived "dark corners" of the international tax arena. As CbCR requires disclosure of their effective tax rate on a country-by-country basis, the adoption of CbCR could trigger a sea change in MNEs' approach to tax planning.

Tax authorities will likely focus on specific "at-risk" areas of tax planning. In particular, transfer pricing arrangements and IP holding company structures, two key areas of focus for the OECD, are at risk of scrutiny by tax authorities. Other arrangements, including hybrid structures, financing structures (including cash pool arrangements) and commissionaire structures may be subject to heightened scrutiny in the light of the BEPS initiative and CbCR (see Action Reports 2 (Hybrid Mismatch Arrangements), 4 (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments) and 7 (Preventing the Artificial Avoidance of Permanent Establishment Status)).

It remains to be seen what methods tax authorities will employ to assert challenges to MNEs' tax planning strategies in light of CbCR. However, given the pressure points discussed above, the practical effect of CbCR may be a shift from one-sided transfer pricing methodologies (*e.g.*, cost-plus arrangements) to increased reliance on profit split methodologies, as well as a shift toward the use of jurisdictions with preferential tax regimes and incentives (in favor of arrangements that create "nowhere income").

Preparing for CbCR

MNEs should prepare for CbCR by collecting information with respect to their global organizational structure and identifying potential tax risks.

When material changes occur in international tax laws, regulations or guidelines, the changes inevitably open incremental planning opportunities for MNEs, even as some existing strategies are sought to be eliminated. Accordingly, an important element of the MNE responsive process should be identification and exploration of opportunities to preserve current tax planning strategies or to develop new ones – in essence, CbCR can be viewed as an opportunity for forward and pro-active thinking as much as anything else.

An important component of this process is the preservation of attorney-client privilege, given the potential sensitivities in identifying "at-risk" areas of an MNE's structure. It is therefore advisable for MNEs to include legal counsel on any in-house team that is tasked with preparing for CbCR.

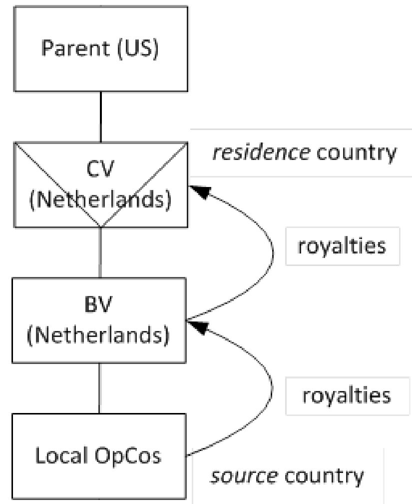
Update on Global Tax Environment

Cym H. Lowell

Overview of the Evolving World

HISTORIC PERSPECTIVE

- League of Nations (1926): *Residence vs. Source*
    - The balance struck between residence country taxation and source country taxation proceeded from the assumption residual income would be repatriated to the residence country.
    - Also assumed—erroneously—that all countries would act consistently.
    - Result was extensive use of interim holding companies in international tax planning, against the backdrop of a paradigm accepting the separateness of discrete juridical entities even where related.
- *Lesson for future:* avoid making the same error
- *MNE Planning paradigm:* in view of the framework that was so established beginning with the League of Nations, multinational enterprises (MNEs) have seen the opportunity to reduce their effective tax costs and, as with any other cost of operations, have taken steps to do so. This has involved, in essence, a process of finding the seams between countries' tax regimes to achieve a low effective tax rate:
    - Example: Common IP holding structure for US MNEs
    - Results:
        - ✓ Full deduction in local operating company jurisdictions
        - ✓ BV taxable on residual spread (differential between royalty income from local operating companies and royalty payments to CV)



- ✓ CV not taxed in Netherlands (Dutch partnership) or the US (reverse hybrid)
- ✓ Results in "nowhere income"

BASE EROSION AND PROFIT SHIFTING (BEPS) PROJECT – KEY DRIVER OF INTERNATIONAL TAX REFORM

- Does not address balance between residence and source country taxation but, rather, the incidents of base erosion and profit shifting stemming from the current international system of taxation
- The new Country-by-Country Reporting (CbCR) rules represent the initial multilateral output of the BEPS project
    - All MNEs, over or close to the threshold, will be undertaking the process of preparing reports and analyzing the resulting data with the assistance of their advisors. The process is likely to prove interesting and to reveal issues and opportunities to be addressed with respect to the MNE's existing effective tax rate planning strategies (ETR Strategies).
    - The most effective means of addressing these issues is to organize a working group of internal or external experts (or both), as appropriate to the situation, to design and supervise the data gathering and analytical process.

    - The immediate objective of such analyses is to prepare the CbC documentation, while the long-term objective should be to assess the group's ETR Strategies to identify risks and opportunities to be addressed in due course. This is a time of epochal change likely to present both opportunities and problems.

- Many other BEPS initiatives are also being implemented
    - Taxation of hybrids and reverse hybrids
    - Revised permanent establishment (PE) standards
    - Caps on interest deductibility
    - Rollout of a multilateral instrument
- Challenges for MNE ETR planning strategies
    - Historic model rejection: The residence vs. source model developed in the post-World War I era largely has been rejected throughout the world, with the evolution of territorial regimes as well as efforts by all countries to defend their tax bases (including the United States). As with any material change, this produces opportunities for MNE ETR strategies as well as some hurdles.
    - Posture of the BRICs (Brazil, Russia, India, China)
        - ✓ Rejection of BEPS outputs
        - ✓ Desire to revisit source/residence status
        - ✓ Increased focus on profit splits
        - ✓ China premium and equivalent theories
        - ✓ Increasingly aggressive assertion of PE (coupled with "force of attraction" principle)
        - ✓ United Nations adoption of withholding on technical service payments
        - ✓ Extra-territorial taxation (*e.g.* Vodafone)—challenge to separate legal entity / holding company orthodoxies.
- EU state aid
- Unilateral actions
    - UK tax reform (Diverted Profits Tax, state aid, Brexit, *etc.*)
    - United States ("border adjustability" below)
- Increasingly divergent approaches of tax administrations in the light of BEPS
    - "Race to the bottom"

HOUSE REPUBLICAN PROPOSAL FOR BORDER ADJUSTMENT TAX (BAT)

- Policy paper only—no details
- Intention:
    - *Export:* full deductibility of costs—exclusion of sales
    - *Import:* no deduction of *foreign* costs—full inclusion of sales
    - In essence, makes the United States a *source* country, seeking to expand its own tax base in its way, as the United Kingdom and other countries are seeking to do the same.
- Potential "baskets" (cost and other allocation): Since the focus of the BAT is to provide differential treatment for costs incurred domestically versus offshore, there will be a need to establish categories of costs to then be sourced. This is a familiar process in other contexts (such as Subpart F-related issues, cost-sharing and so on). For example, are costs incurred by a domestic contract manufacturer for a foreign party domestic or foreign?

- Issues: Cross-basket crediting; currency; and many more to be identified in specific company situations.
- The border adjustability proposal presents clear issues for importers and opportunities for exporters. Of course, in the absence of statutory language or other details as to the contours of border adjustability, one can do no more than ballpark the issues to be addressed if border adjustability becomes a serious issue. For example, if a MNE group has APAs to which the United States is a party, will such a dramatic change in US tax law invalidate the APA?
- Even if border adjustability is not adopted, a territorial system is likely to be a feature of tax reform and this will pose many of the same issues as to situs of income and expense.
- Our experience in working with clients to assess the potential impact of border adjustability, territoriality and the other evolutions noted above on their ETR strategies is that it is an eye-opening process. Whenever there is material change in applicable laws or principles, some doors may close as others open.

Way Forward

In short, it is time for companies to rejuvenate their ETR strategies for the epochal changes already underway and those likely to occur.

Treasury Releases (And Withdraws) Proposed Regulations Regarding New Partnership Audit Rules

Madeline Chiampou Tully, Thomas W. Giegerich, Gary C. Karch, Bradford E. LaBonte and Kevin Spencer

On January 18, 2017, the US Department of the Treasury (Treasury) released proposed regulations (Proposed Regulations) regarding the implementation of Section 1101 of the Bipartisan Budget Act of 2015 (the Act), which was enacted into law on November 2, 2015. The Act instituted a new regime for federal tax audits of entities treated as partnerships for US federal income tax purposes (the New Audit Rules) effective for tax returns filed with respect to tax years beginning after December 31, 2017. For prior coverage of the New Audit Rules, see here and here.

The Proposed Regulations provide some helpful insights for taxpayers with respect to the likely disposition of some interpretive issues under the New Audit Rules, including:

- The scope of the New Audit Rules;
- Electing out of the New Audit Rules;
- Consistency between partner and partnership returns;
- Designating the partnership representative;
- The calculation and modification of imputed underpayments; and
- Electing the alternative regime under which the tax liability is imposed at the partner level (the Push-out Election).

The Proposed Regulations were not published in the Federal Register and were withdrawn in light of the regulatory freeze announced by the Trump administration in a White House memorandum on January 20, 2017. (In addition, the Tax Technical Corrections Act of 2016, which contained corrections and clarifications to the Act, could be reintroduced in the current Congress.) Thus, pending the issuance of official guidance, taxpayers will continue to have significant uncertainty as to their compliance obligations under the New Audit Rules. Treasury and IRS officials nonetheless have stated that the rules will be implemented on schedule in 2018.

Highlights of the Proposed Regulations

It is unclear whether or when the Proposed Regulations will be reissued and, if reissued, with what revisions to the original version. Accordingly, this summary focuses on select highlights only, and only their broad contours.

SCOPE OF THE NEW AUDIT RULES

The Proposed Regulations take an expansive view of the scope of the New Audit Rules to cover all items and information related to or derived from the partnership. To this end, the Proposed Regulations broadly define the phrase “income, gain, loss, deduction, or credit” so that the phrase includes: the character, timing, source and amount of items; the character, timing and source of the partnership's activities; contributions to and distributions from the partnership; the partnership's basis in its assets and the value of those assets; the amount and character of partnership liabilities; the separate category (for purposes of the foreign tax credit limitation), timing and amount of the partnership's creditable foreign tax expenditures; elections made by the partnership; items related to transactions between a partnership and any partner (including disguised sales and guaranteed payments); any items related to terminations of a partnership; and partners' capital accounts. The phrase "a partner's distributive share" is also broadly defined.

SMALL PARTNERSHIP ELECTION OUT

The Act allows eligible partnerships to elect out of the New Audit Rules (the Small Partnership Election Out). An eligible partnership is a partnership with 100 or fewer partners, each of which is an "eligible partner" (generally, an individual, domestic or foreign C corporation, S corporation or an estate of a deceased partner).

The Proposed Regulations provide that the term "eligible partner" does not include partnerships, trusts, foreign entities that are not eligible foreign entities, disregarded entities, nominees, other similar persons that hold an interest on behalf of another person and estates that are not estates of a deceased partner. A partnership with grantor trust or disregarded single-member LLC partners would therefore not be eligible to make the Small Partnership Election Out.

The Preamble notes that the IRS intends to carefully review Small Partnership Elections Out, including situations where two or more partnerships that have elected out should be recast under existing judicial doctrines and general federal tax principles as having formed one or more constructive or *de facto* partnerships for federal income tax purposes. Examples of such situations include those where the profits or losses of partners are determined in whole or in part by the profits or losses of partners in another partnership, and those that purport to be something other than a partnership, such as the co-ownership of property.

PARTNERSHIP REPRESENTATIVE

The Act replaces the tax matters partner framework under TEFRA with the concept of a partnership representative. Under the Act, each partnership is required to designate a partner or other person with a substantial presence in the United States as the partnership representative who shall have the sole authority to act on behalf of the partnership.

The Proposed Regulations provide that a person has a substantial presence in the United States for purposes of the New Audit Rules if three criteria are met: (1) the person must be able to meet in person with the IRS in the United States at a reasonable time and place as is necessary and appropriate as determined by the IRS; (2) the partnership representative must have a street address in the United States and a telephone number with a US area code where the partnership representative can be reached by US mail and telephone during normal business hours in the United States; and (3) the partnership representative must have a US Taxpayer Identification Number.

The Proposed Regulations also clarify that if an entity is designated as the partnership representative, the partnership must identify and appoint an individual to act on the entity's behalf. The appointed individual must also have a substantial presence in the United States and the capacity to act. Unlike the TEFRA rules, the partnership may appoint a non-partner to act as the partnership representative.

CALCULATION OF IMPUTED UNDERPAYMENTS

The Act generally provides that audit adjustments to items of partnership income, gain, loss, deduction or credit, and any partner's distributive share thereof, are determined at the partnership level. In general, unless the partnership makes a Push-out Election, the associated imputed underpayment with respect to a partnership tax year (the reviewed year) is calculated using the maximum statutory income tax rate and is assessed against and collected from the partnership in the year that the audit or any judicial review is completed (the adjustment year), together with any related penalties and interest.

Under the Proposed Regulations, the imputed underpayment is calculated by multiplying the "total netted partnership adjustment" by the highest rate of federal income tax in effect for the reviewed year. The product of that amount is then increased or decreased by any adjustment made to the partnership's credits. If the result of this summation is a net positive adjustment, the resulting amount is the imputed underpayment, and, if it results in a net non-positive amount, the result is an adjustment that does not result in an imputed underpayment.

The Proposed Regulations provide rules for calculating the total netted partnership adjustment that (1) address (a) adjustments that reallocate items among the partners, (b) adjustments to the partnership's credits, and (c) a residual grouping covering remaining adjustments, and (2) contain provisions for groupings, subgroupings and netting within these categories.

Each administrative proceeding that ends with the determination by the IRS of an imputed underpayment will result in a general imputed underpayment. However, the IRS may also determine, in its discretion, a specific imputed underpayment on the basis of certain adjustments allocated to one partner or a group of partners based on the items or adjustments having the same or similar characteristics, based on the group of partners sharing similar characteristics, or based on the partners having participated in the same or similar transactions. A partnership may have multiple specific imputed underpayments depending on the adjustments.

The Proposed Regulations contain several examples that demonstrate the calculation of imputed underpayments.

MODIFYING AN IMPUTED UNDERPAYMENT

The Proposed Regulations describe the procedures for a partnership to request modification of an imputed underpayment, as well as the types of modification that may apply. In general, a partnership that has received a notice of proposed partnership adjustment may request modification of a proposed imputed underpayment.

The Proposed Regulations provide that a partnership may request modification of an imputed underpayment in a variety of specified circumstances, including on the basis of the filing of an amended return by a reviewed year partner (or indirect partner); the status of its tax-exempt and foreign partners in certain circumstances; tax rate differences (*e.g.*, with respect to capital gains and qualified dividends); and, in the case of a publicly traded partnership, a net decrease in a specified passive activity loss for specified partners.

ADJUSTMENTS THAT DO NOT RESULT IN AN IMPUTED UNDERPAYMENT

Under the Proposed Regulations, adjustments that do not result in an imputed underpayment are generally taken into account by the partnership in the adjustment year as a reduction in non-separately stated income or as an increase in non-separately stated loss depending on whether the adjustment is to an item of income or loss. Adjustments to separately stated items and credits are taken into account as separately stated items.

Generally, the Proposed Regulations are silent with respect to the allocation of adjustments that do not result in an imputed underpayment, leaving their allocation to the partnership agreement.

PUSH-OUT ELECTIONS

As an alternative to paying tax at the partnership level, the partnership may elect to "push out" adjustments to its reviewed year partners. Specifically, the partnership may make a Push-out Election with respect to any or all imputed underpayments identified in a final partnership adjustment (FPA).

Under the Proposed Regulations, a partnership may only make a Push-out Election within 45 days of the date the FPA was mailed by the IRS. All reviewed year partners are bound by the election and each reviewed year partner must take the adjustments into account and report and pay additional tax (if any).

A reviewed year partner that is furnished a statement of its share of adjustments is required to pay any additional chapter 1 tax (additional reporting year tax) for the partner's taxable year which includes the date the statement was furnished to the partner. The additional reporting year tax is either the aggregate of the adjustment amounts (which includes "correction amounts" for the reviewed year and for the partner's taxable years after the reviewed year and before the reporting year), or, if an election is made, a "safe harbor" amount. The Proposed

Regulations provide rules for calculating the adjustment amounts and the safe harbor amount.

The Proposed Regulations reserve on the issue of whether the adjustments that are pushed-out to pass-through partners can flow-through to the owners of the pass-through partner.

OPEN ISSUES

There are a number of important and complex issues on which the Proposed Regulations reserve or with respect to which Treasury and the IRS have requested comments, including:

- Whether the list of "eligible partners" for purposes of the Small Partnership Election Out rules should be expanded;
- Whether and how to update the rules regarding calculation and modification of underpayments for (1) items that may require special rules or special subgroupings; (2) situations where foreign partners are subject to gross basis taxation and/or may claim reduced tax rates under applicable income tax treaties; and (3) streamlining the amended return modification process;
- How to allocate partnership adjustments among adjustment year partners;
- Coordination of the Push-out Election with the withholding rules in the case of foreign partners;
- Administration of the Push-out Election in tiered structures; and
- Rules regarding the adjustments to the adjustment year partners' outside bases and capital accounts and a partnership's basis and book value in property.

Conclusion

The Proposed Regulations provide some helpful insights for taxpayers with respect to the likely disposition of some interpretive issues under the New Audit Rules. However, many features of the New Audit Rules are not addressed in the Proposed Regulations, and it is unclear whether or when the Proposed Regulations will be reissued and, if reissued, with what revisions to the original version. Until official guidance is issued, taxpayers will continue to have significant uncertainty as to their compliance obligations under the New Audit Rules. In any event, it is clear that the TEFRA framework will no longer apply once the New Audit Rules go into effect in 2018.

Since the operation of the New Audit Rules remains unclear, partnership and LLC agreements now being drafted should address process issues such as authority or approval needed to designate the partnership representative and make elections, the partnership's obligation (if any) to keep partners informed and allow them to participate and the partners' obligation to provide information to the partnership.

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