2017 U.S. Transfer Pricing and Intra Group Pricing Update

Kluwer International Tax Blog
October 2, 2017

William Byrnes (Texas A&M University Law)

Please refer to this post as: William Byrnes, ‘2017 U.S. Transfer Pricing and Intra Group Pricing Update’, Kluwer International Tax Blog, October 2 2017, http://kluwertaxblog.com/2017/10/02/2017-u-s-transfer-pricing-intra-group-pricing-update/

IRS Operational Update: Reorganization and Risk-Based Approach

The IRS new Large Business and International (LB&I) risk approach has been implemented in the form of “campaigns”, focusing on weighing the size of the compliance risk, how often the risk is occurring, where it is occurring and if the risk is a result of a promoted scheme. The 2016 Reorganization’s shift in strategy includes identifying issues that should be made part of issue-focused campaigns that would be developed centrally. A campaign may consider other measures than labor-intensive audits such as soft letters asking a taxpayer to consider its compliance in the reporting of certain transactions. Under the new campaign approach, the newly renamed Treaty and Transfer Pricing Operations resources will focus on identifying and providing audit resources for particular transfer pricing issues that may have common elements among multiple taxpayers. The IRS has already announced a campaign in the transfer pricing area focused on in-bound distributors.

In 2016, LB&I continued its reorganization with a complete revamp of its 2010 structure. From 2010 until 2016, LB&I functions were split into international and domestic divisions. Under the new 2016 structure, the position of Deputy Commissioner (International) has been eliminated and its responsibilities transferred to a single Commissioner of LB&I. LB&I is now organized into ‘practice’ areas and ‘support’ elements. Each practice area is led by a Director. The practice areas that are to leverage knowledge-sharing capabilities with an international dimension include a Director of Program and Business Solutions, an Assistant Deputy Commissioner of Compliance Integration, and the Assistant Deputy Commissioner International. The practice areas study compliance issues within their area of expertise and suggest campaigns to be included in the compliance plan. The support elements use data analysis and an integrated feedback loop to support LB&I's new risk framework.

For examination purposes, the IRS is divided into four operating 'divisions' of which the LB&I is the one with jurisdiction over virtually all transfer pricing audits. The renamed Treaty & Transfer Pricing Operations practice area is the compliance organization within LB&I responsible for transfer pricing issues. It is led by the Director of Treaty & Transfer Pricing Operations, Sharon Porter, who is responsible for transfer pricing activity in the field and for allocating specialists and other resources to the most important transfer pricing cases. Under the Director of Treaty & Transfer Pricing Operations are a Director of Field Operations for the Transfer Pricing Practice (TPP), Cheryl Teifer, a Director of the Advance Pricing and Mutual Agreement Program (APMA), John Hughes, and a Director of Treaty Administration, Jennifer Best. Under this newest reorganization, LB&I's TPP has retained autonomy and can be expected to garner more authority over audit issues that are identified for a campaign and perhaps more authority generally in the audit of transfer pricing.

As of August 2017 LB&I's staffing has been reduced to below 5,500 from a high of 7,500 in 2010. Of the approximate 5,500 LB&I positions, between 500 and 600, it is reported, are international trained examiners in addition to 2,800 domestically trained. TPP includes 92 professionals, down from 99 last year. Although the IRS reports that 80 percent of the issues, by revenue, are international in nature, only 20 percent of the resources are allocated to these issues. The new issue-based campaigns developed from a risk management perspective, with potential overlapping practice areas and support elements, will likely bring a spotlight onto international issues that may have previously lacked resources. The measurement of performance may shift from the number of case closures to the number of case openings and time expended on each case.

LB&I has established 18 International Practice Networks (IPNs) which are knowledge bases (intellectual nerve centers). The networks are staffed by up to a dozen professionals in the form of a steering committee of technical specialist staff, an international manager sponsor, LB&I, SB/SE and Associate Chief Counsel

(International) attorneys, who maintain a database of relevant materials and operate a chatroom for IRS transfer pricing professionals to share information. The IPNs operate as a clearinghouse for issues and questions, both related to generic issues and to specific cases, connecting IRS people who were previously not connected. The IRS has released more than 150 International Practice Units, including more than 20 on transfer pricing issues.

On February 14, 2014, the IRS released a Transfer Pricing Audit Roadmap (hereinafter, the "road map"). The road map contains a three-phase timeline in the audit process and includes tax code citations and references to relevant Internal Revenue manual sections for each period of the audit to assist both the taxpayer and the Service. The three phases outlined in the roadmap are (i) planning; (ii) execution; and (iii) resolution. With an emphasis in the planning phase, the roadmap seeks to encourage more robust and consistent dialogue between examiners and taxpayers early in the progression of the audit. However, given the reorganization and new campaign approach, while this roadmap may still represent good practices, it is no longer clear how future IRS audits will develop and be executed.

APA and Mutual Agreement Procedure Updates: Resolving Backlogs

On August 12, 2015, the IRS released two final revenue procedures: Procedures for Advance Pricing Agreements (Revenue Procedure 15-40) and Procedures for Requesting Competent Authority Assistance under Tax Treaties (Revenue Procedure 15-41). These two final revenue procedures contained 13 principal differences from the previous 2013 draft revenue procedures. User fees are increased for APA requests from $50,000 to $60,000 and will continue to increase to double that by 2020 to capture the IRS' full cost of an APA, yet the total user fees may be reduced for multiple APA requests filed by the same controlled group within a 60-day period. Also, the user fee for requests for discretionary LOB relief is increased under the competent authority procedure to $32,500 and to $37,000 in 2016.

Since the APA program's inception in 1991, and through the end of 2015, over 1,500 APAs have been executed. Foreign multinationals have been the heaviest users of the procedure. On August 12, 2015 the IRS released the final revenue procedures: Procedures for Advance Pricing Agreements (Revenue Procedure 15-40) and Procedures for Requesting Competent Authority Assistance under Tax

Treaties (Revenue Procedure 15-41). A notable milestone achieved by APMA in 2015 was the execution of the first bilateral APA between the United States and Italy and in 2016 a bilateral APA with India.

Arbitration is effectively mandatory for the tax authorities and optional for the taxpayers and has become a reality with several cases having been decided by arbitration. It is available as a backstop to MAP under the income tax treaties with Belgium, Canada, France, and Germany. Moreover, in the case of Belgium and Canada, if the MAP case is for an APA, the TPM of the prevailing party is to be used for the future APA years. Moreover, the OECD has initiated a MAP framework in 2016 that requires peer review to assess a country's implementation. On February 17, 2016, the Treasury Department released a revised 2016 U.S. Model Income Tax Convention (the 2016 Model analyzed here on this blog) including a mandatory and binding arbitration between competent authorities. The U.S. Model Income Tax Convention was last updated in 2006 (the 2006 Model). However, as of September 31, 2017, Treasury has not released an updated technical explanation.

Up from the 96 lodged in 2014 by India with $1.2 billion of adjustments and 56 in 2013 of $900 million of adjustment, by June of 2015, the IRS reported that the Revenue Authority of India lodged 61 new transfer pricing mutual agreement procedures with total proposed adjustments of $1.25 billion. Following the agreement between the U.S. and India on a framework to resolve the backlog of competent authority matters, the U.S. announced in February 2016 that it will begin accepting requests for bilateral APAs between the U.S. and India. In April 2016, the IRS director of the APMA reported that India had agreed to the resolution of 93 of the cases pursuant to the framework agreement. APMA will begin accepting requests for pre-filing conferences ("PFCs") for bilateral APAs between the United States and India. In 2015, the MAP backlog has grown to 762 open cases with an average cycle time of 24 months, leading to an average per senior manager of 109 MAP cases and 13 MAP cases per team leader, in addition to the APA open cases mentioned above. However, in late 2016 the U.S. and India resolved 66 MAP cases relating to transfer pricing issues and 42 MAP cases relating to treaty interpretation issues of one billion dollars for 1999-2000 to 2011-12. The resolved cases addressed royalties, management fees, cost contribution arrangements, engineering design services, contract R&D services, investment advisory services, marketing support services, software development services, IT-enabled services (both BPO and KPO services) and treaty interpretative issues in the nature of presence of permanent establishment in India and profit attribution to such PEs, as well as categorization of royalty income versus business income. The competent authorities reached an agreement on the terms and conditions of the first bilateral APA involving India and USA.

Controversy Update: The Death of the Cost Sharing Regulations?

In late 2011 the temporary cost sharing regulations were finalized including the controversial Income Method and its discount rates, the requirement that the cost of stock-based compensation must be included in the cost pool to be shared, and the application of the cost-sharing methods outside of cost sharing. On August 27, 2013, the IRS finalized a proposed cost-sharing rule describing a new specified application of the income method for determining the arm's length charge for platform contribution transactions, or buy-in-payments. But the Income Method and the stock-based cost requirements of the cost sharing regulations are contrary to the court decisions of *Altera* and *Xilnix*, albeit the taxable years involved in *Xilnix* were subject to regulations that did not have such provisions. On July 27, 2015, in a "reviewed opinion", the U.S. Tax Court struck down in *Altera* the final cost sharing regulations which required participants in qualified cost-sharing arrangements to share stock-based compensation costs to achieve an arm's length result. The court held that Regs. § 1.482-7(d)(2) violates the arm's length standard because there is no evidence that unrelated parties ever share such costs. According to the ruling, the final 2003 regulations lack a "basis in fact", are invalid as a matter of law and failed to satisfy the U.S. Supreme Court's "reasoned decision-making" standard of the State Farm case.

The $2.2 billion *Amazon* case concluded December 23, 2014 and the decision issued March 23, 2017, which was analyzed earlier on this blog here. An analysis will be included in future posts for the ongoing litigation of *Microsoft*, *Coca-Cola*, and *Facebook*, and for the lower court decisions of *Altera*, *Eaton*, and *Medtronic* as these are examined on appeal.

Intangible Property Update: 376(d) Regulations In Force But …

Final regulations expand the scope of intangible property for purposes of IRC Sections 367(d) and 482 to include "workforce in place, goodwill, and going concern value." The new regulations codify certain approaches to valuing intangible property that are consistent with the post-2009 cost sharing regulations, particularly permitting the IRS to value intangibles on an aggregate basis in cases where an aggregate valuation of multiple transferred intangibles "achieves a more reliable result," and permitting the IRS to value intangibles based on the prices or profits that could have been realized if the taxpayer chose a "realistic alternative" to the related-party transfer of the intangibles. The final Treasury regulations 367(d) were published December 16, 2016, with the retroactive effect of the 2015 proposed regulations. The significant change concerns Treasury backing off the elimination of the 20-year limitation, albeit subject to caveats. Overall, Treasury has put forward five significant changes. Yet on April 21, 2017, President Donald J. Trump issued Executive Order 13789 to review all "significant tax regulations" issued on or after January 1, 2016, and to follow promptly with concrete action to alleviate the burdens of regulations. Based on that reexamination, Treasury issued Notice 2017-38 identifying these final regulations. Thus, though applicable currently, the future of these regulations is uncertain.

On October 4, 2017, Treasury published a report that after considering the comments and studying further the legal and policy issues, Treasury and the IRS have concluded that an exception to the current regulations may be justified by both the structure of the statute and its legislative history. Thus, to address taxpayers' concerns about the breadth of the regulations, the Office of Tax Policy and IRS are actively working to develop a proposal that would expand the scope of the active trade or business exception described above to include relief for outbound transfers of foreign goodwill and going-concern value attributable to a foreign branch under circumstances with limited potential for abuse and administrative difficulties, including those involving valuation. Treasury and the IRS currently expect to propose regulations providing such an exception in the near term.

Treasury published new Temporary Regulations Sections 1.721-1T through 7T addressing that an adjustment under IRC Section 482 does not prevent the application of the rules regarding certain transfers by U.S. persons to foreign-owned partnerships.

Litigation Procedures Update: Privilege for Non-Lawyers but IRS Hires Outside Law Firms to Litigate its Cases

The 2016-17 EY transfer pricing survey found that MNEs are experiencing a substantial increase in transfer pricing controversy this year including 79 percent of transfer pricing examinations by the Indian Revenue examinations resulting in an adjustment. Tax risk management has increased as the top transfer pricing priority. With transfer pricing litigation becoming more frequent, *Wells Fargo* decision (June 4, 2013) is highly relevant because it held that work product protection may apply to tax accrual work papers as well as to tax accrual work papers created by non-lawyers at an auditor.

On July 14, 2016, the Treasury issued its final regulations clarifying that the IRS may contract with outside third-party firms and provide the third parties with taxpayer's confidential information in order to assist the IRS interview a summoned witness. The interview must take place in the presence and under the guidance of an IRS officer or employee. Section 6103(n) authorizes the IRS to disclose confidential taxpayer information to persons who provide services to the IRS, including outside experts. Such taxpayer confidential information may include the summoned books, papers, records, or other data. In response to concerns raised in comments about misuse of information, the IRS included a statement that the third party contractors are bound by the same confidentiality standards and penalties for unauthorized disclosure of IRS employees. This regulation evolved in response to the current IRS' transfer pricing audit of Microsoft. The IRS has contracted the litigation firm Quinn Emanuel for $2,185,500 to assist with its transfer pricing case development. IRS officials have stated that this transfer pricing audit may become the IRS' largest adjustment of any issue to date.

However, on October 4, 2017, Treasury announced that pursuant to Executive Order 13789 and after reviewing and considering concerns and public comments received, Treasury and the IRS are looking into proposing a prospectively effective amendment to these regulations in order to narrow their scope *by prohibiting* the IRS from enlisting outside attorneys to participate in an examination, including a summons interview. Under the amendment currently contemplated by Treasury and the IRS, outside attorneys would not be permitted to question witnesses on behalf of the IRS, nor would they be permitted to play a behind-the-scenes role, such as by reviewing summoned records or consulting on IRS legal strategy. However, Treasury and the IRS currently intend that the regulations *would continue* to allow outside subject-matter experts to participate in summons proceedings. In certain highly complex examinations, effective tax administration may require the specialized knowledge of an economist, an engineer, a foreign attorney who is a specialist in foreign law, or other subject-matter experts. In some cases, there is a compelling need to look outside the IRS for expertise that the IRS's own employees lack. Because experts have a circumscribed role in providing subject-matter knowledge, outside experts do not pose the same risks as outside attorneys. Outside experts should thus continue to be permitted to assist IRS by reviewing summoned materials and, if necessary, *by* posing *questions to witnesses under the guidance and in the presence of IRS employees*. Such a role would be limited to the small subset of cases in which the IRS requires the assistance of a subject-matter expert to ensure effective tax administration.But Treasury did not in this announcement issue such an amendment. Stay tuned .....

State Aid & APAs Update: Refreshed Focus on Intercompany Financing

IRS developments in the area of intercompany loans and the application of the arm's length standard to certain intercompany interest payments are indicative of the public attention of intragroup financing resulting from the LuxLeaks papers. This development is the subject of a forthcoming Kluwer blog post. The LuxLeaks papers, published by the International Consortium of Investigative Journalists, disclosed hundreds of multinationals' advanced pricing agreements (APAs) with the Luxembourg tax authority. These APAs provided certainty regarding the identification of arm's length interest rates for intragroup loans. However, several newspaper articles condemned the Luxembourg APAs as promoting BEPS and shortchanging national treasuries. The resulting public outcry led to the European Union's State Aid investigation of Luxembourg's Fiat APA as a test case for the determination of whether several hundred multinationals will be required to pay back Luxembourg for the difference in what the EU Commission has determined is the arm's length rate and what the Luxembourg tax authority has determined it is by agreement with the taxpayer on financing arrangements.

Other state aid cases addressing the transfer pricing of intangibles, services, and commodities include Starbucks, Amazon (decision rendered Oct 4), and Apple, have been analyzed earlier in the Kluwer International Tax blog. See here in this blog and here as well as here.

Practical Guide to U.S. Transfer Pricing Professor William Byrnes seminal treatise, provides the expertise multinationals require to cope with transfer pricing rules, regulations, compliance reports, and controversy, taking into account the international norms established by the Organisation for Economic Co-operation and Development (OECD) Guidelines (2017) and the UN Manual (2017). It is also designed for use by tax administrators, both those belonging to the U.S. Internal Revenue Service and those belonging to the tax administrations of other countries and tax professionals in and out of government. **Free download of chapter 2 here**