I.R.S. PUSHES TO EASE IMPLEMENTATION OF COUNTRY-BY-COUNTRY REPORTING FOR U.S. M.N.E.'S

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While the U.S. still refuses to sign onto the O.E.C.D.'s Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (the "CbC M.C.A.A."), the I.R.S. is making progress toward bilateral exchange of tax information. The I.R.S. recently released two model agreements for exchanging country-by-country ("CbC") reporting information – one based on tax treaties and the other based on Tax Information Exchange Agreements ("T.I.E.A.'s") – and in May, it confirmed that the U.S. signed its first bilateral competent authority agreement. To date, agreements have been signed with 12 jurisdictions: Canada, Denmark, Guernsey, Iceland, Ireland, Korea, Latvia, the Netherlands, New Zealand, Norway, Slovakia, South Africa.[1] The U.S. is currently negotiating additional agreements in the hope of enabling U.S. multinationals to file CbC reports for 2016 with the I.R.S., rather than with foreign jurisdictions.

COMPARISON OF U.S. AND O.E.C.D. REGIMES

On June 30, 2016, the I.R.S. published final regulations[2] that require annual CbC reporting by U.S. persons that are ultimate parent entities of a multinational enterprise ("M.N.E.") group that has annual revenue for the preceding annual accounting period of $850 million or more. This action followed proposed I.R.S. rulemaking published as a direct response to the O.E.C.D.'s final B.E.P.S. reports issued in October 2015, which included recommendations for Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting), according to which M.N.E.'s with annual consolidated group revenues equal to or exceeding €750 million will submit a standardized report.

The standardized report, at the minimum, should include (i) a master file with high-level information about global operations and transfer pricing policies, (ii) a local file with detailed transactional transfer pricing documentation that is specific to each country, and (iii) an annual CbC report that includes more detailed information about each jurisdiction where the business is conducted. While the O.E.C.D. recommended that the master and local reports be filed directly with an entity's local tax administration, it called for the annual CbC report to be filed in the jurisdiction of the tax residence of the ultimate parent entity and shared between taxing jurisdictions through the CbC M.C.A.A., a bilateral tax treaty, or a Tax Information Exchange Agreement ("T.I.E.A.").

To date, 57 countries have signed on to the CbC M.C.A.A. and are publishing local guidance on CbC reporting – the U.S. is not among the 57. The O.E.C.D.

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1 Agreement status, including available texts, can be found on the I.R.S. website; see Country-by-Country Reporting Jurisdiction Status Table.

2 See Treas. Reg. §1.6038-4.

recommendation for implementation of Action 13 calls for CbC reporting for fiscal years beginning on or after January 1, 2016. However, according to local guidance, some countries have deviated from this date. For example, Switzerland will require reporting for fiscal years beginning on or after January 1, 2018, but will allow reporting to be filed voluntarily for years beginning in 2016 to avoid exposure to penalties or other consequences in countries where CbC reporting begins earlier.[3]

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The final I.R.S. regulations are effective as of June 30, 2016, the date of publication in the Federal Register. Therefore, U.S. parent entities of M.N.E. groups that use a calendar year as their taxable year generally will not be required to file a CbC report with the I.R.S. for the taxable year beginning January 1, 2016; the initial reporting period for such entities will be for the year beginning January 1, 2017. However, as mentioned above, many jurisdictions will require filing for 2016, and thus, entities that are members of a U.S. M.N.E. group may be subject to CbC reporting requirements outside the U.S. prior to the date applicable to the U.S. reporting requirement.

If the ultimate parent entity resides in a jurisdiction that has a CbC reporting requirement for the same annual period as requested by a local foreign jurisdiction, an M.N.E. member resident in such jurisdiction will not be required to file separately in that jurisdiction. Accordingly, the I.R.S. allows U.S. parent companies to file voluntary CbC reports for periods beginning on or after January 1, 2016, but before June 30, 2016, and is working to reach agreements with many foreign jurisdictions to facilitate exchanges of such disclosures. These efforts have resulted in 12 agreements signed within the past month. All of these signed agreements, except the one signed with Iceland, contain language similar to that in Section 3(2) of the model agreement for exchanging CbC reporting information, which provides that first the exchange is intended to take place with respect to fiscal years beginning on or after January 1, 2016. This language indicates that voluntary filings with the I.R.S. with respect to 2016 will be respected by partner jurisdictions.

Additionally, CbC reports filed with the I.R.S. and exchanged pursuant to a competent authority agreement benefit from confidentiality requirements, data safeguards, and appropriate use restrictions under the agreement, which the I.R.S. is committed to monitor.

U.S. REPORTING: FORM 8975, COUNTRY-BY-COUNTRY REPORT

The information requirement provided for in the regulations will be satisfied by submitting a new reporting form – Form 8975, *Country-by-Country Report* – with the income tax return for the year reported. To date, only a draft form and draft instructions are available.

As mentioned above, the first required U.S. reporting period is 2017. The time to file is the due date for that income tax return, including extensions.

Form 8975, which must be filed by the ultimate parent entity of the U.S. M.N.E. group, must include Schedule A, *Tax Jurisdiction and Constituent Entity Information*, for each tax jurisdiction in which the group has one or more business entities. In

[3] See the O.E.C.D. website for Country-Specific Information on Country-by-Country Reporting Implementation.

general, Schedule A lists the group's business entities (*i.e.*, constituent entities) and reports, on a CbC basis, items such as related and unrelated party revenue, profit before income tax, income tax paid on a cash basis, income tax accrued, stated capital, accumulated earnings, number of employees, non-cash tangible assets, jurisdictions of organization and residence, and primary business activity by entity.

U.S. M.N.E. Group

A U.S. M.N.E. group is a group of entities whose ultimate parent entity is a U.S. entity. The U.S. M.N.E. group is comprised of the ultimate parent company and all business entities that are required to consolidate their accounts with the parent under U.S. generally accepted accounting principles ("G.A.A.P.").

An ultimate parent entity of a U.S. M.N.E. group is a U.S. entity that owns, directly or indirectly, a sufficient interest in one or more other business entities, at least one of which is organized or tax resident outside the U.S., such that the U.S. business entity

- is required to consolidate the accounts of the other business entities with its own accounts under U.S. G.A.A.P., and
- is not owned, directly or indirectly, by another business entity that consolidates the accounts of the U.S. business entity with its own accounts under G.A.A.P. in another jurisdiction.

A "business entity" is any entity other than a trust, including a disregarded entity and any permanent establishment ("P.E.") that prepares financial statements separately from its owner for financial or tax reporting, regulatory, or internal management control purposes. A grantor trust owned by a person other than an individual is also considered a business entity.

Constituent Entity

A constituent entity of a U.S. M.N.E. group is defined as any separate business entity in the group, except a corporation or partnership for which a Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, or Form 8865, *Return of U.S. Persons with Respect to Certain Foreign Partnerships*, is not required to be filed.

Note that if any entity is consolidated under U.S. G.A.A.P. and therefore included in the U.S. M.N.E. group, it will also be controlled and subject to reporting on the appropriate above-mentioned form. However, in some cases (*e.g.*, variable interest entities where the investor has a controlling interest in the value but not the vote), an entity may be consolidated under U.S. G.A.A.P. and not controlled for other reporting purposes.

P.E.

Under the regulations, a P.E. includes any of the following:

- A branch or business establishment of a constituent entity in a tax jurisdiction that is treated as a P.E. under an income tax treaty
- A branch or business establishment of a constituent entity that is liable to tax in the tax jurisdiction in which it is located pursuant to the domestic law of

such jurisdiction

- A branch or business establishment of a constituent entity that is treated as an entity separate from its owner by the owner's tax jurisdiction of residence

Tax Residence

A business entity is resident in a tax jurisdiction if it is subject to tax under the laws of that country (the "subject-to-tax test"), provided that the tax is not imposed solely with respect to income from sources in that jurisdiction or capital situated in that jurisdiction and provided that such tax is not imposed solely on a gross basis. A corporation that is organized or managed in a tax jurisdiction that does not impose an income tax on corporations will be treated as resident in that tax jurisdiction unless treated as resident in another jurisdiction under the subject-to-tax test. A P.E., on the other hand, is resident in the jurisdiction in which it is located. If the residency of an ultimate parent of a U.S. M.N.E. group cannot be determined by the subject-to-tax test, then residency shall be determined by its country of organization.

A business entity that does not have a tax residence under the subject-to-tax test is considered "stateless" for reporting purposes. Information for stateless entities is reported on an aggregate basis for all stateless entities in a U.S. M.N.E. group. Note that under the residence test, entities that are treated as partnerships in the jurisdiction in which they were organized will not be subject to tax in such jurisdiction and thus will be treated as stateless (for purposes other than for determining their status as an ultimate parent entity of a U.S. M.N.E.) under the general rule, unless they create a P.E. in that or another jurisdiction.

Each stateless entity's owner reports its share of the stateless entity's revenue and profits in the owner's tax jurisdiction of residence, regardless of whether the stateless entity's owner is liable for tax on that income in such jurisdiction (*i.e.*, regardless of whether the owner's country residence treats the stateless entity as a separate entity for tax purposes or not).

If an entity has a residence in more than one jurisdiction, then applicable income tax treaty rules should determine residency. If no treaty provisions apply, residency will be determined based on the entity's place of effective management in accordance with the O.E.C.D.'s model treaty or as provided in Form 8975. Note that the draft Form 8975 is silent on that point.

Surrogate Entity

A foreign parent of an M.N.E. group cannot designate a U.S. business entity that it controls to be a "surrogate entity" for filing purposes. However, a U.S. parent can designate another U.S. business entity that it controls to be surrogate parent entity and file on its behalf.[4]

Confidentiality & Exchange of Information with Non-U.S. Jurisdictions

Transfer pricing adjustments will not be made solely based on the CbC report, but the report may serve as a basis for further inquiries into transfer pricing practices or other matters that may lead to adjustments.[5]

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[4] Treas. Reg. §1.6038-4(j).

[5] I.R.S., "Country-By-Country Reporting," REG-109822-15, December 23, 2015.

Persons that have access to a return are prohibited from disclosing information about the return.[6] "Return information" includes information such as, *inter alia*, the taxpayer's identity, sources and amounts of the taxpayer's income, the taxpayer's net worth, whether the return is being examined, the taxpayer's possible liability, or any written determination or background file document that is not open to public inspection.[7]

State agencies can access the CbC report to assess state taxes.[8] Disclosures are permitted to persons designated by the taxpayer, congressional committees, tax administrators, and Federal departments for statistical use.[9]

If a U.S. government employee knowingly or negligently discloses any return or return information, the taxpayer can bring a civil action against the U.S. government.10 The taxpayer can also bring a civil action case against a non-employee if the non-employee discloses the taxpayer's identity or information.[11] The taxpayer must commence the action two years after discovering the disclosure.[12] If the taxpayer's claim prevails, the taxpayer may be entitled to the costs of the action, plus possible damages.[13] A willful disclosure may also be punishable with a felony conviction.[14]

CONCLUSION

Numerous multinational businesses – such as McDonalds, Starbucks, and Google – have been "named and shamed" in European State Aid cases for possibly engaging in overly-aggressive tax planning.[15] These types of incidents have caused U.S. companies to be wary of direct information disclosures to foreign governments, which could result in their information being released by those governments for partisan political purposes. While the U.S. has not signed onto the CbC M.C.A.A., the 12 agreements signed in the last month demonstrate a U.S. commitment to negotiating bilateral sharing agreements that align with the interests of U.S. businesses. It is expected that I.R.S. efforts to conclude as many agreements as possible prior to the date for filing the 2016 tax return (for U.S. entities that are filing their return on an extension) will enable U.S. M.N.E. groups to file CbC reports with the I.R.S. and thus enjoy the confidentiality that the I.R.S. is committed to promote.

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6 Code §6103(a).

7 Code §§6103(b)(2), 6110.

8 Code §6103.

9 Code §§6103(c)-(f), (h).

10 Code §7431(a).

11 Code §7431(a)(2).

12 Code §7431(d).

13 Punitive damages may be assessed if the disclosure was willful or the result of gross negligence (Code §7431(c)).

14 Code §7213(a).

15 Kenneth Lobo, "McDonalds Accused of Re-routing Royalty Payments to Avoid Billions in European Taxes," *Insights* 3 (2015); Beate Erwin and Christine Long, "E.U. State Aid—The Saga Continues," *Insights* 6 (2016).