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In this article, Osborn and Khripounova examine why implementation of the OECD's base erosion and profit-shifting project will likely make bilateral advance pricing agreements more attractive than ever to multinational enterprises.

Multinational enterprises have long used bilateral advance pricing agreements to obtain prospective certainty that tax administrations in key jurisdictions will accept their transfer pricing methods. With the ongoing implementation of the OECD's action plan on base erosion and profit shifting, bilateral APAs are likely to become more attractive than ever, particularly in comparison with the alternatives. The final BEPS reports on actions 8-10,[1] released October 5, 2015, fundamentally revises the OECD transfer pricing guidelines, giving tax administrators new impetus not only to scrutinize related-party transaction pricing but also to determine whether transactions should be recognized at all. These changes will likely lead to more inconsistent positions and more characterizations of transactions that give rise to double taxation. This risk, however, could in many cases be reduced or eliminated by seeking an upfront bilateral or multilateral APA. Further, because of the implementation of the new master file, local file, and country-by-country (CbC) reporting requirements in accordance with BEPS action 13,[2] tax administrations will have access to more information than they have ever had. An APA could help manage the risks associated with this coming wave of new disclosure by giving taxpayers a controlled forum in which they can work through the facts in a disciplined and objective fashion before having to file the first CbC reports. MNEs considering seeking the certainty of an APA may be prudent to file now, before the full implementation of BEPS places even more strain on the competent authorities around the world.

BEPS Actions 8-10 Reports: New Uncertainty

The actions 8-10 reports contain both fundamental, final revisions to the OECD transfer pricing guidelines (the revised TPG),[3] as well as the promise of further guidance in 2016 and beyond. These changes introduce a level of uncertainty that MNEs have not experienced since before the publication of the 1994 section 482 regulations and the 1995 OECD transfer pricing guidelines, if even then. Despite the emphasis of the OECD and the G-20 on the need for international consensus and consistency in implementing the BEPS action plan, the reality is that the final BEPS guidance leaves tremendous room for interpretation by individual tax administrations and thus the potential for double taxation.

Perhaps the most disconcerting change with the potential to bring about new instances of double taxation is the guidance regarding nonrecognition, which gives tax administrations license to recharacterize related-party transactions that they deem not to be "commercially rational." Specifically, paragraph 1.122 of the revised TPG provides:

> The transaction as accurately delineated may be disregarded, and if appropriate, replaced by an alternative transaction, where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction.

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[1]OECD, "Aligning Transfer Pricing Outcomes With Value Creation, Actions 8-10 — 2015 Final Report" (Oct. 5, 2015).

[2]OECD, "Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 — 2015 Final Report" (Oct. 5, 2015).

[3]Hereinafter, the revisions to the OECD transfer pricing guidelines contained in the BEPS actions 8-10 reports will be referred to as the "revised TPG." The term "BEPS actions 8-10 reports" will be used to refer to the report as a whole.

This goes far beyond the economic substance provisions in the regulations under section 482[4] and the 2010 OECD transfer pricing guidelines[5] insofar as it encourages tax administrators to second-guess the commercial rationality of related-party transactions and recharacterize transactions that they deem, in their own substituted judgment, not to be rational. Although paragraph 1.123 of the revised TPG attempts to limit nonrecognition by clarifying that "the key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties," this nuance can easily be lost in practice.[6] The potential for new disputes and double taxation posed by this massive expansion of tax administration discretion is readily apparent — indeed, the report itself acknowledges that "nonrecognition can be contentious and a source of double taxation."[7] Yet few safeguards exist to prevent abuse other than effective mutual agreement procedures (MAPs) and bilateral APA processes.

Assuming a related-party transaction avoids nonrecognition under the revised TPG, it will be subject to pricing scrutiny under new, fundamentally changed transfer pricing guidance. While a detailed discussion of all the BEPS actions 8-10 changes in the revised TPG is beyond the scope of this article, very generally the changes shift the emphasis of an arm's-length analysis from an objective one that is based on comparable uncontrolled transactions to a more subjective inquiry. For example, the revised TPG effectively divides related parties that provide "funding" of intangible development (such as the principal in a research and development-services arrangement) into three categories, based on the level of control they exercise over the risk: (1) related parties that exercise no control are entitled to only a risk-free return;[8] (2) related parties that exercise control over the financial risks of intangible development are entitled to an "appropriate risk-adjusted return" on their investment;[9] and (3) only related parties that control additional business risks (other than the mere financial risk) or perform specific key functions themselves can apparently receive more than an investor's return.[10] These provisions not only encourage tax administrations to challenge the returns on intangible investment realized by related parties but also require a highly subjective inquiry into the extent and nature of the control that virtually every principal exercises in an R&D-services, cost-sharing, or other intangible-development arrangement. Further, this new guidance will likely lead to more questions than answers as to what exactly an "appropriate risk-adjusted return" is under any particular set of facts and circumstances. Still further questions exist regarding which related party is entitled to ex post profits (or losses) exceeding the profits expected ex ante, a key issue that the revised TPG largely leave unresolved.[11]

A second example of revised TPG's subjectivization of the arm's-length principle is the new guidance on "group synergies."[12] Similar to the section 482 regulations and prior versions of the OECD transfer pricing guidelines, the actions 8-10 report distinguishes benefits attributable to an active service ("deliberate concerted group action"), which support an arm's-length charge, from benefits attributable to passive association with the related-party group, which of course do not support an arm's-length charge.[13] While the historic active-passive dichotomy is generally accepted as a practical necessity from a tax administration viewpoint, the revised TPG transforms what was once a black or white issue into infinite shades of gray, suggesting that even transactions of an overall active character (such as explicit guarantees or procurement services) should be bifurcated into passive and active elements. For instance, a new example illustrates a fact pattern in which a subsidiary's stand-alone credit rating is Baa and its parent's credit rating is AAA. According to the example, the measure of the compensable benefit is not the difference between AAA and Baa but, rather, the difference between AAA and A, with A being the credit rating at which the example assumes the subsidiary could borrow because of its passive

[4]Reg. section 1.482-1(d)(3)(ii)(B) and (iii)(B).

[5]OECD, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," at paras. 1.48-1.49 and 1.64-1.69 (July 2010).

[6]Revised TPG, para. 1.123, further states: "The non-recognition of a transaction that possesses the commercial rationality of an arm's length arrangement is not an appropriate application of the arm's length principle. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured. It should again be noted that the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm's length arrangement."

[7]Revised TPG, at para. 1.122.

[8]Revised TPG, at para. 1.103; actions 8-10 report, at 65.

[9]Revised TPG, at paras. 6.61, 6.62.

[10]*Id.* at paras. 6.59, 6.61.

[11]*Id.* at paras. 1.78, 6.44-6.46, 6.69-6.72.

[12]*Id.* at paras. 1.157-1.173.

[13]*Id.* at paras. 1.159-1.162, 1.167.

association with its parent company.[14] This result turns the arm's-length principle on its head, effectively changing the inquiry from what truly unrelated parties would charge for the property or service to what these particular related parties would charge.

As a third example of how BEPS is making the arm's-length principle more subjective and less certain, actions 8-10 reports place new emphasis on profit splits over so-called one-sided or comparables-based methods. While further guidance is expected in 2016 and 2017, the actions 8-10 reports indicate that this guidance will address the use of the transactional profit split to address "highly integrated business operations," situations in which more than one controlled taxpayer makes "unique and valuable contributions," and situations involving "synergistic benefits."[15] Consistent with prior discussion drafts, the report also indicates that the forthcoming guidance may promote the use of transactional profit splits to determine a transactional net margin method (TNMM) range,[16] which at face value seems to be a contradictory proposition (because in any given case, the profit split method and the TNMM cannot both be the best method). This new guidance may lead tax administrations to apply profit splits to relatively routine transactions for which taxpayers and tax administrations alike would have previously agreed to apply as the best method a comparable uncontrolled price/comparable uncontrolled transaction method or comparable profit method/TNMM. Further, because profit splits are potentially the most subjective of transfer pricing methods and require more input parameters than either CUPs/CUTs or CPMs/TNMMs, the increased use of profit splits will likely make it more difficult to resolve disputes and will increase instances of double taxation.

Further compounding the uncertainty are the different tax administration roles that the OECD transfer pricing guidelines play in different countries and, thus, how the changes made by the BEPS actions 8-10 reports will likely take effect. The IRS, for instance, enforces transfer pricing compliance at the examination and administrative appeals levels by reference to its own section 482 regulations, without any reference to the OECD transfer pricing guidelines.[17] However, the United States maintains that the OECD transfer pricing guidelines are fully consistent with the section 482 regulations, and the IRS can and does consider the OECD transfer pricing guidelines as a common reference point with foreign competent authorities in MAP and bilateral APA negotiations.[18] In contrast, other countries' transfer pricing laws directly incorporate or make reference to the OECD transfer pricing guidelines,[19] such that the revised TPG in the actions 8-10 reports may effectively be self-executing. Moreover, other countries that follow the OECD transfer pricing guidelines (or not) to varying degrees have in recent years enacted their own legislation or regulations to change the applicable rules in an attempt to get ahead of the BEPS curve.[20]

The European Union has been particularly proactive in implementing both the OECD's BEPS agenda and additional measures, a recent example of which is the draft antitax avoidance directive released on January 28.[21] The proposed directive includes a number of measures that go far beyond what is envisioned by the OECD's BEPS action plan, including a sweeping proposed general antiavoidance rule that states:

> Non-genuine arrangements or a series thereof carried out for the essential purpose of obtaining a tax advantage that defeats the object or purpose of the otherwise applicable tax provisions shall be ignored for the purposes of calculating the corporate tax liability.[22]

This proposed GAAR would provide tax administrations in Europe with another means — in addition to the guidance in the revised TPG on nonrecognition — to recharacterize related-party transactions. However, this proposed GAAR is perhaps even more troubling than the BEPS nonrecognition guidance because it is more sweeping in its scope and because tax administrations could assert that MNEs facing double taxation as a result of the GAAR do not have the right to relief through MAP because the GAAR is a domestic provision outside the purview of the applicable treaty.

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[14]Revised TPG, at paras. 1.164-1.167. This new example appears to enshrine in the OECD transfer pricing guidelines the controversial decision of the Canadian courts in *General Electric Capital Canada Inc. v. R.*, 2 CTC 2187 (2009), *aff'd*, 2010 FCA 344 (Fed. Ct. 2010).

[15]Actions 8-10 reports, at 55-62.

[16]*Id.* at 59-60.

[17]AM 2007-007.

[18]*Id.*

[19]A few examples of countries that make direct reference to the OECD transfer pricing guidelines in their domestic transfer pricing rules are Australia, the Netherlands, France, and Japan. *See* OECD, "Transfer Pricing Country Profiles" (2013).

[20]*See, e.g.*, Lee A. Sheppard, "U.S. 'Extremely Disappointed' in DPT and BEPS Output, Stack Says," *Tax Notes*, June 15, 2015, p. 1218; and Yansheng Zhu, "Do China's Revisions to Circular 2 Localize BEPS Actions?" *Tax Notes Int'l*, Nov. 9, 2015, p. 519.

[21]*See* European Commission, "Proposal for a Council Directive: Laying Down Rules Against Tax Avoidance Practices That Directly Affect the Functioning of the Internal Market" (2016).

[22]*Id.* at 19.

In many cases, a bilateral or multilateral APA may be an effective tool to reduce the uncertainty associated with the ongoing implementation of BEPS and other local BEPS-inspired measures. While APA negotiations are by no means immune from the BEPS taint, the APA process allows taxpayers to take a proactive role in presenting a complex transaction or issue to the relevant tax administrations with a view to minimizing the adverse effects of BEPS. Through detailed submissions and effective advocacy with each tax administration, taxpayers can leverage the APA process to frame the relevant tax issues upfront as article 9 transfer pricing issues under the applicable tax treaties. Early framing of the issue can by itself provide a significant advantage, by reducing the risk that the transaction will be recharacterized under the new BEPS guidance or subjected to domestic provisions such as GAARs.

Even if the relevant issue is successfully framed as a transfer pricing matter, principles of the BEPS actions 8-10 reports are likely to influence the APA negotiations, just as they could if the transaction were instead left to be audited. However, the APA process is in many ways better suited than domestic processes, with or without a subsequent MAP, for resolving the difficult and novel transfer pricing issues likely to arise post-BEPS. As noted, the revised TPG contained in the BEPS actions 8-10 reports makes the arm's-length principle more subjective and leave so much open for interpretation that inconsistent applications — both internally within a single country and externally between countries — are all but inevitable.

APAs can reduce or eliminate the effects of both forms of inconsistency. First, because APAs are generally negotiated by a national office function (usually, the office of the competent authority) responsible for ensuring across-the-board consistency among cases, taxpayers requesting APAs may be less likely to face an outlier or results-oriented position under an aggressive interpretation of BEPS by one of the tax administrations. The position that a tax administration takes in an APA negotiation is more likely to be internally vetted in light of bigger-picture issues of principle and consistency than a position taken by a local examiner. Second, while persuading two or more tax administrations to take a consistent position on a difficult transfer pricing issue post-BEPS will never be easy, the APA process will in many cases be the most efficient means to bring about consensus on principled terms because of the prospective nature of the process.

For many of the same reasons, the traditional advantage of APAs in terms of eliminating double taxation will be even more pronounced in the post-BEPS world. The BEPS concepts will inevitably give rise to double taxation, which, in the absence of an APA, could be relieved only through MAP (if at all). There is no doubt that an effective MAP process is critical to reducing double tax in the post-BEPS world, and in recognition of this, the BEPS action plan devotes an entire item — action 14 — to proposals and best practices for making MAP and other dispute resolution mechanisms more effective.[23] Nevertheless, MAPs, unlike APAs, are reactive rather than proactive, generally do not operate prospectively, and may not prevent the same issue from recurring again and again. Moreover, the MAP process can generally be initiated only after an assessment is proposed by the examination function in either country. The shortcomings of MAP are another reason why MNEs should consider APAs more often in the post-BEPS world.

BEPS Action 13: New Transparency Landscape

The IRS and other tax administrations have always held MNEs using the voluntary APA process to a higher standard of transparency and cooperation than is expected of MNEs in the ordinary transfer pricing examination process. Tax administrations can and do request information during APA negotiations that would not be required during an examination, including documents or analyses that might not otherwise exist or be maintained in the ordinary course of business.

While many MNEs find the increased transparency expectations to be an acceptable price for certainty, others may decide to avoid the APA process for this reason. Taxpayers seeking APAs will continue to be held to a high standard of transparency and cooperation, which if anything, will only increase over time.[24] Meanwhile, the implementation of the BEPS action 13 three-part transfer pricing documentation regime, consisting of a master file, local file, and CbC report, will substantially increase the amount of information that all MNEs must furnish to tax administrators in their parent company's country and in other jurisdictions in which they operate.

As contemplated by the final BEPS action 13 report (and subject to local implementation), MNEs will be required to provide the tax administrations in potentially every jurisdiction in which they operate with a master file containing a ''blueprint'' of

[23]*See* OECD, ''Making Dispute Resolution Mechanisms More Effective, Action 14 — 2015 Final Report'' (Oct. 5, 2015).

[24]This is certainly the case in the United States, where a new revenue procedure adopted last year and effective for all APA requests filed after December 29, 2015, requires a substantial increase in the amount and detail of information that taxpayers must include upfront in their APA submissions. *See* Rev. Proc. 2015-41, 2015-35 IRB 263.

the MNE's global business.[25] Among other requirements, the master file must include a description of the supply chain for the MNE's five largest products or service offerings (and any other products that comprise 5 percent or more of group turnover), a functional analysis describing the principal contributions to value creation by individual entities in the group (regardless of whether they operate in the jurisdiction to which the transfer pricing documentation is being provided), and a list of intangibles or groups of intangibles of the MNE that are important for transfer pricing purposes and which entities legally own them.[26] While the master file is unlikely to provide the parent company's jurisdiction with any new information, the significant change is that the information must be filed locally with potentially every country in which the MNE operates.

The new CbC reporting rules — generally effective for large MNEs (those with revenues in excess of €750 million) beginning with the 2016 calendar year[27] — require reporting on a CbC basis of related-party and unrelated-party revenue, profit (or loss) before income tax, income tax paid and accrued, stated capital, accumulated earnings, number of employees, and tangible assets.[28] Unlike the master file, the CbC report must generally only be filed with the parent jurisdiction. However, there are several exceptions in which local filing would nevertheless still be required, and in any event, the report would be subject to automatic exchange of information with the MNEs' subsidiaries jurisdictions, subject to specific conditions.[29]

The coming wave of disclosure under BEPS action 13 is relevant to the decision to seek an APA for two reasons. First, given the glut of additional information that MNEs will now be compelled to disclose to a greater number of tax administrations, the "transparency gap" between MNEs that seek APAs and those that do not may be narrowing. While, if anything, MNEs will be expected to be more transparent than ever before in APA negotiations, the additional transparency expected of all taxpayers in the post-BEPS world may reduce the opportunity cost involved. Second, the APA process can reduce the effects of BEPS action 13 by providing taxpayers with a controlled forum in which to work through the facts in a disciplined and objective manner before CbC reports must be first filed in 2017. Because the financial and tax information required to be included in the CbC reports can be misleading without additional context that neither the template nor the master or local file components may allow the MNE to adequately explain, requesting an APA before the first CbC reports are filed may in some cases be an effective means to reduce risk.

That said, MNEs seeking APAs need to be cognizant that in the post-BEPS world, APAs may be subject to additional transparency and disclosure requirements to nonparty tax administrations. Unilateral APAs will be subject to mandatory spontaneous exchange of information[30] and will need to be disclosed and described in the master file provided to potentially every country in which the MNE operates.[31] Further, copies of certain unilateral, bilateral, and multilateral APAs relevant to the transactions of a particular legal entity will need to be included in that legal entity's local file.[32]

Now Is the Time to 'Get in Line'

The potential new BEPS-related disputes and incidences of double taxation will inevitably further strain the MAP process and encourage more MNEs to request APAs. This effect is already being seen, given that the IRS received more APA requests in the first nine months of 2015 than in all of 2014, an increase that a senior IRS official specifically attributed to BEPS.[33] The official further acknowledged that the IRS is already frequently encountering "BEPS-type arguments" from other countries in APA negotiations.[34] These effects mean that the APA process in many cases will not be quick, particularly as tax administrations face increasing resource constraints that render them less able to handle an influx of new cases. MNEs considering APAs should therefore be willing to play the "long game" and approach the process with realistic expectations.

Nevertheless, in our experience, the APA process can still be the most efficient and expeditious means to resolve an actual or potential multiyear transfer pricing dispute on terms that avoid double taxation, particularly if best practices are followed. While the

[25]OECD action 13 report, *supra* note 2, at para. 19.

[26]OECD action 13 report, *supra* note 2, at 25, annex I to ch. V.

[27]Under U.S. proposed regulations for implementing CbC reporting, there would be a one-year lag in implementation until 2017 because the regulations would not be effective until the tax year that begins on or after the date of publication of the final regulations (presumably in 2016). *See* prop. reg. section 1.6038-4(g), REG-109822-15.

[28]OECD action 13 report, *supra* note 2, at 29-35, annex III to ch. V.

[29]OECD action 13 report, *supra* note 2, at 47-49, 61-62, 67-68, annex IV to ch. V.

[30]*See* OECD "Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance, Action 5 — 2015 Final Report" (Oct. 5, 2015).

[31]Action 13 report, *supra* note 2, at 26, annex I to ch. V.

[32]Action 13 report, *supra* note 2, at 28, annex II to ch. V.

[33]*See* Parker, "McComber: 2015 U.S. APA Requests Already Top 2014 Total," 24 *Transfer Pricing Report* 669 (Sept. 25, 2015).

[34]*See* Ryan Finley, "APMA Deputy Director Addresses Goals and Challenges," *Tax Notes*, Oct. 5, 2015, p. 37.

process can still be very efficient, there may currently be a narrow window of opportunity akin to the relative calm before a storm.[35] MNEs considering the certainty of an APA may therefore be prudent to file as soon as possible to secure their place in line before the demand for MAPs and APAs peaks in the next several years after BEPS is fully implemented.

[35]We describe the present as a "relative" calm because, as noted, BEPS is already influencing the APA process through increased demand and BEPS-inspired arguments.