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by Jason Osborn, Brian Kittle, and Kenneth Klein

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BEPS CORNER

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Jason Osborn


Brian Kittle


Kenneth Klein

Jason Osborn and Kenneth Klein are partners with Mayer Brown LLP in Washington, and Brian Kittle is a partner with Mayer Brown in New York.

In this article, the authors discuss the impact of the final BEPS actions 8-10 reports, which contain final, currently applicable revisions to the OECD transfer pricing guidelines.

Ten months have passed since the OECD published final reports on its base erosion and profit-shifting project. (Prior coverage: *Tax Notes Int'l*, Oct. 12, 2015, p. 103.) The October 2015 final reports are the culmination of over two years of work undertaken by the OECD and commissioned by the G-20 to develop specific international consensus-based proposals for fundamental changes to the international tax system to address perceived problems of corporate income tax avoidance and double nontaxation. Although there are 15 final reports in all, corresponding to each of the 15 items of the BEPS action plan,[1] this article focuses primarily on the far-reaching and current impact of the BEPS actions 8-10 reports (aligning transfer pricing outcomes with value creation).

These reports contain final, currently applicable revisions to the OECD transfer pricing guidelines. Among other substantive changes, the revisions to the OECD transfer pricing guidelines made by these reports would allow tax administrations broad discretion to ''non-recognise'' and recharacterize related-party transactions that they deem to be not ''commercially rational,''[2] require that a related party ''control'' any risk that it intends to assume under a contract,[3] and place a premium on the performance of functions, especially development, enhancement, maintenance, protection, and exploitation (DEMPE) functions, in determining the arm's-length allocation of income from a controlled transaction.[4]

Reports Are Fundamentally Different

While the October 2015 final BEPS reports undoubtedly raise the level of uncertainty for multinational enterprises operating around the world, most of the proposed guidance — with the notable exception of

[1]Published initially in July 2013, the BEPS action plan had set forth proposals for 15 actions intended to address perceived problems of corporate income tax avoidance and double nontaxation in areas such as transfer pricing, the permanent establishment threshold, controlled foreign corporation rules, and hybrid entities and instruments.

(Footnote continued in next column.)

[2]*See* para. 1.122 of the revised OECD transfer pricing guidelines contained in the BEPS actions 8-10 reports.

[3]*See* para. 1.98 of the revised OECD transfer pricing guidelines contained in the BEPS actions 8-10 reports.

[4]*See* para. 6.50 of the revised OECD transfer pricing guidelines contained in the BEPS actions 8-10 reports.

the actions 8-10 reports — takes the form of model domestic legislation (for example, action 2 on hybrid mismatch arrangements, action 3 on controlled foreign corporation rules, and the implementation aspects of action 13 on country-by-country reporting) or proposed changes to the OECD model income tax convention (for example, action 6 on treaty benefits and action 7 on permanent establishment status). Thus, for the most part the final BEPS reports are not self-executing but rather depend on the individual OECD and G-20 countries to adopt the recommendations in their local laws and in their network of bilateral income tax treaties and/or to adopt and ratify the ambitious multilateral instrument contemplated by action 15.[5]

However, the actions 8-10 reports are fundamentally different from these other BEPS reports because of their far-reaching *current — and potentially even retroactive* — impact on pending transactions and disputes. Unlike the other final BEPS reports, the final actions 8-10 reports do not depend on future domestic law or treaty changes to become effective.[6] Instead, they present fundamental revisions to the OECD transfer pricing guidelines that are effectively self-executing.

Although the OECD has not yet published a new version of the OECD transfer pricing guidelines incorporating the actions 8-10 revisions, the OECD Council announced in a press release on June 15 that it had formally approved the amendments to the OECD transfer pricing guidelines contemplated in the actions 8-10 reports. Before that, the OECD had clarified that the revisions to the transfer pricing guidelines contained in the actions 8-10 reports are intended to be final and immediately applicable. In addressing when the new guidance will become applicable, the OECD's BEPS FAQ webpage states in no uncertain terms that:

> The revisions can be seen as shared interpretations of how article 9, paragraph 1 of the OECD and UN Model Tax Convention should be applied. This provision can be found in almost all tax treaties around the world. Therefore, these shared interpretations between countries *will have immediate application* through the existing treaties.[7] [Emphasis added.]

However, despite the intended ''immediate application'' of the actions 8-10 reports, no effective date is stated, so there is still uncertainty regarding the extent of their potential retroactive effect.

What Applies Now?

Under Tax Treaties

The stated intent that the actions 8-10 reports have ''immediate application'' for purposes of interpreting article 9 (associated enterprises) of income tax treaties suggests, at a minimum, that the actions 8-10 reports can be taken into account immediately by OECD and other G-20 countries in negotiating mutual agreement procedures (MAPs) and bilateral advance pricing agreements, where the OECD transfer pricing guidelines provide the common framework for resolution under article 9 of the applicable treaty. In the authors' experience, and consistent with public statements of IRS officials,[8] the actions 8-10 reports are already being invoked in both MAP and APA negotiations.

It would also appear that taxpayers could in some cases affirmatively rely on the actions 8-10 reports to support a treaty-based reporting position.[9] However, on the flip side it seems that a tax administration should not be able to rely *solely* on the actions 8-10 reports as an authoritative interpretation of article 9 of a treaty to support a taxpayer-adverse position, whether in MAP or APA negotiations or otherwise. After all, the overarching purpose of income tax treaties is to limit, not expand, the taxing rights of governments over their residents.[10] Thus, conceptually, a treaty jurisdiction seeking to prevail on a BEPS-like theory should not be able to rely solely on the actions 8-10 reports as a consensus interpretation of article 9, but rather would need to show that a no less favorable result is supported by its own domestic law.[11]

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[5]With the notable exception of action 13 on transfer pricing documentation and country-by-country reporting, there has been no specific action in the United States to directly and specifically implement the recommendations of the final BEPS reports.

[6]The final action 13 report also includes final revisions to the OECD transfer pricing guidelines, but unlike the substantive guidance in the actions 8-10 reports, the action 13 report contemplates ultimate implementation through domestic law changes. The ''implementation package'' for action 13 consists of model legislation and model competent authority agreements.

[7]*See* http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm.

[8]*See* Ryan Finley, ''APMA Deputy Director Addresses Goals and Challenges,'' *Tax Notes Int'l*, Oct. 5, 2015, p. 34 (quoting APMA deputy director as stating that APMA frequently encounters ''BEPS-type arguments'' from other countries).

[9]For example, in instances in which the actions 8-10 reports would arguably allow a U.S. taxpayer a different, more favorable result on a transaction involving a treaty partner jurisdiction than the section 482 regulations, it might not be unreasonable for that taxpayer to take such a position under article 9 of the applicable treaty on its return, albeit with disclosure on Form 8833, ''Treaty-Based Return Position,'' if appropriate.

[10]Consistent with this overarching purpose, Article I, para. 2 of the U.S. model income tax convention states:

> This Convention shall not restrict in any manner any benefit now or hereafter accorded:
> a) by the laws of either Contracting State; or
> b) by any other agreement to which both Contracting States are parties.

[11]Nevertheless, as we discuss below, many countries have adopted the OECD transfer pricing guidelines (which now encompass actions 8-10) into their domestic law. While the United States has not adopted the OECD transfer pricing guidelines, the U.S. Treasury Department maintains the position that the OECD

(Footnote continued on next page.)

Under Domestic Law

Outside MAP or APA negotiations under a treaty, do taxpayers need to fear the impact of the actions 8-10 reports, for example, in domestic audits, administrative proceedings, and litigation? Unfortunately, the answer would seem to be yes. This is because many OECD countries, including many of the U.S.'s treaty partners, explicitly incorporate the OECD transfer pricing guidelines into their own domestic laws.[12] Because, as noted, the actions 8-10 reports were intended to amend the OECD transfer pricing guidelines with immediate applicability, it would appear that the tax authorities in these countries could invoke the actions 8-10 guidance with the force of law in domestic audits, administrative appeals, and litigation to support proposed adjustments, albeit subject to some uncertainty about the extent the actions 8-10 can be applied retroactively. For instance, an official of HM Revenue & Customs has publicly stated that HMRC inspectors will directly consider the final actions 8-10 reports on audit.[13]

In contrast to the United Kingdom and other OECD countries that have directly adopted the OECD transfer pricing guidelines, the United States enforces transfer pricing compliance at the examination and administrative appeals levels solely by reference to its own domestic regulations under IRC section 482, without direct reference to the OECD transfer pricing guidelines.[14] For this reason, the impact of actions 8-10 on an IRS audit of a U.S. taxpayer may therefore be less direct and explicit than the impact would be in other jurisdictions.

Nevertheless, the United States has historically maintained that its section 482 regulations and the OECD transfer pricing guidelines are fully consistent.[15] And despite some public statements of resistance to some aspects of the earlier drafts of the actions 8-10 guidance,[16] U.S. Treasury Department officials have more recently endorsed the final actions 8-10 reports and stated the view that these reports are consistent with the arm's-length standard of the section 482 regulations and prior versions of the OECD transfer pricing guidelines.[17] Such statements from Treasury could arguably provide an avenue for IRS examiners seeking to apply BEPS-like concepts to support transfer pricing adjustments under the current section 482 regulations. Indeed, we have seen such BEPS-like concepts raised in transfer pricing examinations *before* the final reports (and even before the BEPS action plan itself) were published. Furthermore, IRS examiners are now explicitly instructed to consult with the advance pricing and mutual agreement program early in any transfer pricing examination involving a treaty partner jurisdiction, so that the views of the treaty partner (including, conceivably, the treaty partner's views on BEPS) can be taken into account in developing the IRS's position.[18]

How Might U.S. Taxpayers Respond?

In light of the foregoing, it is prudent for U.S. taxpayers to assume that the actions 8-10 guidance could directly or indirectly influence the positions taken by examiners in the United States and virtually every other OECD or G-20 country in which they operate. There are several things U.S. taxpayers can do now to respond effectively to actions 8-10 with a view to mitigating their potential exposure.

Stress Test Existing Structures

Taking into account this uncertainty, taxpayers might consider ''stress testing'' or risk assessing both existing and proposed new structures and pricing methods under the revised OECD transfer pricing guidelines contained in the final actions 8-10 reports. A stress test could be particularly useful for purposes of identifying ways to reduce the taxpayer's exposure to BEPS-like theories. In many cases, the recommendations resulting from a stress test may be relatively incremental and not require restructuring or fundamentally changing the way the business operates. For example, as part of a

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transfer pricing guidelines (including the BEPS actions 8-10 revisions) are fully consistent with its own transfer pricing regulations under section 482.

[12]A few examples of countries that make direct reference to the OECD transfer pricing guidelines in their domestic transfer pricing rules are the United Kingdom, Australia, the Netherlands, France, and Japan. *See* OECD Transfer Pricing Profiles, *available at* http://www.oecd.org/tax/transfer-pricing/transferpricingcountryprofiles.htm.

[13]*See* Lee A. Sheppard, ''U.K. to Refer to BEPS Transfer Pricing Report on Audit,'' *Tax Notes Int'l*, Feb. 15, 2016, p. 559.

[14]IRS AM-2007-07 (Mar. 15, 2007).

[15]*Id.*

[16]*See* Amanda Athanasiou, ''Observers Question BEPS Transfer Pricing Drafts,'' *Tax Notes Int'l*, Apr. 6, 2015, p. 56 (''If the OECD's base erosion and profit-shifting drafts on risk and recharacterization and on profit splits were final deliverables, 'I would absolutely tell you that they're going too far,' Brian Jenn, attorney-adviser in the Treasury Office of International Tax Counsel, said March 30'').

(Footnote continued in next column.)

[17]*See* testimony of Robert Stack, deputy assistant secretary (International Tax Affairs) U.S. Department of the Treasury, before the House Ways and Means Subcommittee on Tax Policy (Dec. 1, 2015) (''Because the transfer pricing work is based on the arm's length principle, it is consistent with U.S. transfer pricing regulations under section 482''); and Finley, ''BEPS Reports Retain Concept of Control, Treasury Official Says,'' *Tax Notes Int'l*, Oct. 19, 2015, p. 231 (reporting remarks of Brian Jenn, attorney-adviser, Treasury Office of International Tax Counsel regarding the continuity between the actions 8-10 reports and both the prior OECD transfer pricing guidelines and the section 482 regulations).

[18]IRS Transfer Pricing Audit Roadmap (Feb. 2014), at 11 (''Upon a determination that there may be an issue with respect to a transaction that involves a treaty partner, the exam team/TPP should notify relevant APMA personnel of treaty partner implications'').

stress test of a principal structure, one might identify specific options to increase the ''control,'' including decision-making, the principal entity exercises over the key business risks it assumes.

Distinguish Actions 8-10 From Current Law

Taxpayers should also be aware that despite statements from Treasury officials that the actions 8-10 reports and the current section 482 regulations are fully consistent, there are nevertheless key differences that may be readily apparent to an appeals officer or a judge. A key example is that the actions 8-10 reports would allow tax administrators discretion not granted to the IRS in the section 482 regulations to ''non-recognise'' transactions that they deem not ''commercially rational.''[19] A second example is that the actions 8-10 reports would essentially *require* a legal entity that bears a risk under a contract to ''control'' that risk in order to be respected as the risk-taker for transfer pricing purposes.[20] In contrast, under the section 482 regulations, the extent of ''managerial or operational control'' exercised by a risk-taking entity is just one nondispositive factor that the IRS can consider in evaluating a contractual assumption of risk.[21]

As a third example, the actions 8-10 reports attach special significance to DEMPE functions, which the reports describe as ''one of the key considerations in determining arm's length conditions for controlled transactions.''[22] In contrast, the section 482 regulations do not differentiate DEMPE functions from other functions or place any special emphasis on functions of this type.

Given these differences both in terms of the actual rules (for example, regarding nonrecognition and ''control'') and in points of emphasis (for example, regarding DEMPE functions), the mere possibility of more examination-level positions inspired by BEPS may not necessarily translate into more IRS adjustments that are ultimately sustained. After all, it is well established that ''[t]axpayers are merely required to be compliant, not prescient.''[23] In current disputes, U.S. taxpayers may therefore be able to prevail against BEPS-like theories by demonstrating inconsistencies of such theories with taxpayers' current law obligations under section 482.

Watch for Proposed Law Changes

Since the differences between actions 8-10 and the section 482 regulations would presumably subject any attempt by the IRS to rely on a BEPS-like theory to significant hazards of litigation, it is possible that the U.S. Treasury and the IRS may eventually amend the section 482 regulations to conform more closely with the actions 8-10 reports. Thus, in the long term, simply distinguishing the actions 8-10 reports from taxpayers' current law obligations under the section 482 regulations may not be a sufficient response and defense. U.S. taxpayers should therefore be vigilant and ready to respond to potential new proposed regulations in the future, including by participating in the official comment process as appropriate. Nevertheless, in the short term, specific changes to the section 482 regulations seem unlikely because Treasury officials have publicly stated that they believe changes to the section 482 regulations to conform with actions 8-10 are unnecessary.[24]

Consider APAs or MAPs

Finally, in appropriate cases taxpayers might consider a bilateral or multilateral APA and/or to initiate a MAP to facilitate resolution of an ongoing transfer pricing dispute. While, as discussed above, taxpayers should expect BEPS concepts to influence MAP and APA negotiations under treaties, the bilateral nature of the procedures may provide a more controlled and efficient forum for the IRS and one or more other competing tax administrations to reconcile differing interpretations of the actions 8-10 reports with a view to reaching a mutual agreement that avoids double taxation.[25] ◆

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[19] *See* para. 1.122 of the revised OECD transfer pricing guidelines contained in the BEPS actions 8-10 reports.

[20] *See* para. 1.98 of the revised OECD transfer pricing guidelines contained in the BEPS actions 8-10 reports.

[21] *See* Treas. reg. section 1.482-1(d)(3)(iii)(B)(3).

[22] *See* para. 6.50 of the revised OECD transfer pricing guidelines contained in the BEPS actions 8-10 reports.

[23] *Veritas Software Corp. v. Commissioner,* 133 T.C. 297, 316 (2009), *nonacq.* AOD 2010-05 (Nov. 12, 2010).

[24] *See* David D. Stewart, ''U.S. Doesn't Need New BEPS Transfer Pricing Regs, Official Says,'' *Tax Notes Int'l*, June 29, 2015, p. 1181.

[25] *See* Jason Osborn and Elena Khripounova, ''Advance Pricing Agreements in the Post-BEPS Era,'' *Tax Notes*, Mar. 7, 2016, p. 1179.