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BEPS Actions 8-10: How MNEs Can Take Control of Their Exposure by Taking Control of Their Risks

by Jason Osborn and Kenneth Klein

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BEPS Actions 8-10: How MNEs Can Take Control of Their Exposure by Taking Control of Their Risks

by Jason Osborn and Kenneth Klein

Jason Osborn

Kenneth Klein

Jason Osborn and Kenneth Klein are both partners with Mayer Brown LLP in Washington.

In this article, the authors discuss the revised transfer pricing guidelines developed along with the final reports on actions 8-10 of the OECD's base erosion and profit-shifting project, examine the interplay of the OECD's framework with U.S. regulations, and consider how a hypothetical multinational enterprise could limit its transfer pricing risk.

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The final reports on actions 8-10 of the OECD's action plan on base erosion and profit shifting provide game-changing guidance on the role of risk in evaluating and pricing related-party transactions. This new guidance reconsiders fundamental questions that were considered relatively settled for decades, such as what it means to assume a risk in a related-party transaction, what related parties must do to have the assumption of a risk respected by the tax authorities, and the consequences for assuming (or not assuming) a given risk. Because the reports' new guidance took the form of final revisions to the OECD's transfer pricing guidelines (OECD guidelines), codified in a new version of the OECD guidelines published on July 10 (revised guidelines),[1] the guidance is now an official part of the international consensus for interpreting the arm's-length standard. If this new guidance influences the IRS's approach to evaluating related-party transactions, it could fundamentally change the tax planning landscape and potentially make common international structures used for decades by U.S.-based multinational enterprises less advantageous.[2]

This article begins by discussing the BEPS actions 8-10 risk framework in detail and examining what U.S.-based MNEs should consider when planning new related-party transactions and stress-testing existing ones, particularly regarding the new putative requirement that a related party must control any risk that it assumes.[3] Next, the article discusses how the existing Internal Revenue Code section 482 regulations are not consistent with the revised

[1] OECD, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (July 10, 2017) (revised guidelines).

[2] Of course, U.S. corporate tax reform could also make these structures less advantageous in absolute terms, and the reduction in the corporate income tax rate could make the structures less advantageous in relative terms. Needless to say, the BEPS actions 8-10 guidance is significant since it could render these structures less advantageous regardless of any congressional action (or inaction).

[3] While this article focuses primarily on the potential impact of BEPS actions 8-10 on U.S. MNEs seeking to reduce their IRS audit exposure, MNEs should also be mindful of new domestic BEPS-inspired legislation or regulations that may be in effect in the other jurisdictions in which they operate. For example, as part of their BEPS risk assessment, MNEs with EU operations may want to consider the potential impact of Council Directive 2016/1164 of July 12, 2016, which introduces five new antiabuse measures now applicable in EU member states. These new measures include a general antiabuse rule that would allow EU tax authorities to disregard a "non-genuine" arrangement or series of arrangements. In effect, the GAAR imposes heightened requirements for substance that are similar in some ways to the new guidance in the revised guidelines discussed here.

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guidance. Unlike many countries, the U.S. does not directly incorporate the OECD guidance into its domestic law.[4] Lastly, we revisit a fact pattern used in a previous article by our colleagues based on a structure commonly used by U.S.-based MNEs.[5] In that article, our colleagues recommended incremental changes that a hypothetical MNE could use to reduce its BEPS exposure by improving the robustness of its country-by-country reports. Beyond the recommendations in that article, we recommend other changes the hypothetical MNE might consider to reduce its exposure under the BEPS actions 8-10 risk framework, such as increasing the principal company's control over the risks it assumes, thereby reducing the chance that the IRS (or another taxing authority) could use BEPS risk concepts to argue that the principal entity is entitled to a far lower return than would have historically been acceptable. By taking specific, definitive measures to increase the principal company's control over the MNE's business risks, the MNE can also proactively take control of its transfer pricing exposure under the BEPS framework.

I. BEPS Actions 8-10 Risk Framework

A. It's All About Risk

A key concern behind BEPS actions 8-10 is the perception that MNEs have been allocating risks for transfer pricing planning purposes with insufficient supporting substance. While the reports acknowledge the basic economic principle that the greater the risk, the greater the expected reward, the reports go on to state that:

> this economic notion that higher risks warrant higher anticipated returns made MNE groups pursue tax planning strategies based on contractual re-allocations of risks, sometimes without any change in the business operations.

In response to this concern, the reports fundamentally revise the OECD guidelines to provide a new, detailed multistep framework for evaluating and pricing risk in a related-party transaction.[6]

B. Not All Risks Are Treated Equally

Chapter 1 of the revised guidelines on the arm's-length principle emphasizes the paramount importance of properly evaluating risk in a transfer pricing analysis. But not all risks are given equal weight. Rather, the revised guidelines emphasize that the analysis should focus on "economically significant risks," which must be identified with specificity as the first step in any risk analysis.[7] For this purpose, "the significance of a risk depends on the likelihood and size of the potential profits or losses arising from the risk."[8] Stated simply, the economically significant risks of any business are those with the largest potential effect on the bottom line.

For purposes of identifying and assigning appropriate weight to economically significant risks, a facts and circumstances analysis is required since risks can (and do) vary from industry-to-industry and business-to-business. The revised guidelines identify potential economically significant risks that include (but are not necessarily limited to) strategic risks, marketplace risks, infrastructure risks, operational risks, financial risks, transactional risks, and hazard risks (largely, adverse external events).[9] For intangibles, the revised guidelines identify development risk, product obsolescence, infringement risk, product liability risk, and exploitation risk as potential economically significant risks.[10]

C. Contracts Matter, but Control Controls

Under the revised guidelines, contractual terms remain an appropriate starting point for

[4] *See* Jason Osborn, Brian Kittle, and Kenneth Klein, "BEPS Corner: Are the Final BEPS Reports on Actions 8-10 Effective Now?" *Tax Notes Int'l*, Aug. 22, 2016, p. 709.

[5] Astrid Pieron, Lewis Greenwald, and Lucas Giardelli, "Performing a BEPS Diagnostic — The CbC Report as a Tool for Taxpayers," *Tax Notes Int'l*, Feb. 20, 2017, p. 749.

[6] While the following discussion addresses key points from the revised guidelines' risk framework, a detailed discussion of each of the steps in the framework is beyond the scope of this article.

[7] Revised guidelines, *supra* note 1, at para. 1.71 et seq.

[8] *Id*. at para. 1.71.

[9] *Id*. at para. 1.72.

[10] *Id*. at para. 6.65.

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analyzing risks in a related-party transaction. As a general proposition, the revised guidelines acknowledge that it is appropriate for related parties to assume or decline risk by contract as long as the pricing is at arm's length, noting that "[i]t is economically neutral to take on (or lay off) risk in return for higher (or lower) anticipated nominal income as long as the net present value of both options are equal."[11]

That said, the revised guidelines go on to state that if the party that assumes a risk under a contract:

> does not exercise control over the risk or does not have the financial capacity to assume the risk, then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk.[12]

In effect, control of risk (along with financial capacity) is not just one factor considered in the analysis, but a seemingly hard-and-fast requirement that *must* be satisfied for any contractual assumption of risk to be respected by the relevant tax authorities.[13]

D. True Decision-Making, Not Rubber-Stamping

The revised guidelines provide very detailed and elaborate guidance on the meaning of control over risk, explaining generally that:

> Control over risk involves . . . (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function.[14]

[11] *Id*. at para. 1.79.

[12] *Id*. at para. 1.98. In instances in which multiple parties exercise control and have financial capacity to bear a risk, a tiebreaker rule allocates the risk to the party or parties "exercising the most control."

[13] While financial capacity appears to be a requirement equally as important as control, this article focuses on control of risk, since this putative requirement is more ambiguous and likely to be the subject of more disputes than financial capacity, which can be established relatively easily by adequately capitalizing the risk-taking entity.

[14] *Id*. at para. 1.65.

Further, the revised guidelines elaborate that for the control requirement to be met, the decision-making must be active and focused on specific risks, explaining that:

> Neither a mere formalizing of the outcome of decision-making in the form of, for example, meetings organized for formal approval of decisions that were made in other locations, minutes of a board meeting and signing of the documents relating to the decision, nor the setting of the policy environment relevant for the risk . . . , qualifies as the exercise of a decision-making function sufficient to demonstrate control over a risk.[15]

Moreover, the decision-makers must be appropriately qualified. While the revised guidelines stop short of setting specific requirements for the skills, experience, or managerial level of decision-makers, they do state that:

> Decision-makers should possess competence and experience in the area of the particular risk for which the decision is being made and possess an understanding of the impact of their decision on the business. They should also have access to the relevant information, either by gathering this information themselves or by exercising authority to specify and obtain the relevant information to support the decision-making process.[16]

E. 3 Levels of Returns for 3 Levels of Control

Reflecting the "control of risk" framework, Chapter VI of the revised guidelines ("Special Considerations for Intangibles") provides specific guidance on determining the appropriate arm's-length return from funding the development of intangibles, such as when a principal in a research and development services agreement reimburses the service provider for costs incurred. Although not directly stated, the revised guidelines effectively prescribe three different levels of returns that correspond to three different levels of control.

[15] *Id*. at para. 1.66.

[16] *Id*. at para. 1.66.

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1. Cash Boxes: Risk-Free Return

Applying the principles of Chapter I of the revised guidelines, related parties that provide funding of development without exercising any control over the financial risk of providing that funding (so-called cash boxes) are treated as not assuming any risk at all. Accordingly, those related parties would be limited to a return that reflects the use of money without any risk element — that is, a risk-free return.[17]

2. Smart Cash: Risk-Adjusted Return

The second category of related parties that provide funding are those that "exercise . . . control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk."[18] These related parties provide cash funding with monitoring and strings attached (so-called smart cash) and such a company can "generally only expect a risk-adjusted return on its funding," also referred to as "an appropriate risk-adjusted return."[19]

There is no specific guidance provided on how to determine an appropriate risk-adjusted return other than that the return must take into consideration the financing options realistically available to the party receiving the funds.[20] However, by definition, an appropriate risk-adjusted return is greater than a risk-free return, and if supported by the facts and circumstances, could presumably be a risky return akin to a return on equity.

3. High-Substance: Non-Routine Returns

Finally, while not explicitly stated, an implied third category includes those related parties that control risks beyond the financial risks of funding — for example, the operational risks of the business — or either perform or control functions involving the development, enhancement, maintenance, protection, and exploitation of intangibles (DEMPE functions).[21] Those entities presumably would not be limited to an appropriate risk-adjusted return on capital, but rather, could enjoy some or all of the non-routine returns actually attributable to the exploitation of the intangibles.[22]

F. DEMPE Functions: Why All the Hype?

Anecdotally, much of the taxpayer and practitioner attention to BEPS actions 8-10 has centered less on control of risk than on DEMPE functions, at least in the context of intangibles. This focus is understandable since Chapter VI of the revised guidelines refers to DEMPE functions as "one of the key considerations in determining arm's length conditions for controlled transaction."[23] The revised guidelines also state that a legal owner of intangibles (or other related party claiming the right to all residual profit) "must perform all of the functions, contribute all assets used and assume all risks related to the development, enhancement, maintenance, protection and exploitation of the intangible" to be entitled to retain all of the returns from the exploitation of that intangible.[24]

Does this emphasis on DEMPE functions mean that MNEs should rush to relocate all R&D functions to the locations to which they attribute the profits from their intangibles? Based on a closer reading of the revised guidelines, we would say not necessarily. The revised guidelines clarify that while DEMPE functions are a key consideration for transfer pricing purposes, self-performance of DEMPE functions by an entity using only its own employees is not necessarily required to reap DEMPE-related rewards. Outsourcing of DEMPE functions — for example, through an R&D services arrangement — is expressly permissible and sufficient to support attributing income from these functions to the intangibles owner or other principal, but *only if*

[17] *Id*. at paras. 1.103 and 6.59. Many passive, unrelated providers of equity capital to business ventures (for example, private equity funds) would be rather surprised to learn that at arm's length they would only be entitled to a risk-free return.

[18] *Id*. at para. 6.61.

[19] *Id*. at para. 6.62.

[20] *Id*.

[21] *See id.* at para. 6.50. *See also infra* Section I.F.

[22] *See, e.g.,* revised guidelines, *supra* note 1 at paras. 6.55-6.56, 6.59.

[23] *Id*. at para. 6.50.

[24] *Id*. at para. 6.51.

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the owner or other principal exercises control over the outsourced activities.[25] That said:

> if the legal owner *neither controls nor performs* the functions related to the development, enhancement, maintenance, protection or exploitation of the intangible, the legal owner would not be entitled to *any* ongoing benefit attributable to the outsourced functions.[26] [Emphasis added.]

The bottom line appears to be that relocating DEMPE functions to the location of the intangibles owner or other principal may help to support the attribution of profits to that entity, but vesting control over those functions (whether self-performed or outsourced) in that entity may help as much or more.

G. No Safe Harbor for Cost Contribution

Chapter VIII of the revised guidelines provides new guidance on both service and development cost contribution arrangements (CCAs) that is consistent with the general focus on control of risk. The revised guidelines debunk the notion that CCAs are safe harbors or otherwise subject to different, more favorable rules than other transactions involving intangibles, explaining that "there is no difference in the analytical framework for analyzing transfer prices for CCAs compared to analyzing other forms of contractual relations."[27] Thus, Chapter VIII of the revised guidelines explains that, consistent with chapters I and VI of the revised guidelines (but seemingly inconsistent with prior U.S. and (arguably) OECD guidance), a related party will not be treated as a participant in a CCA "if it does not exercise control over the specific risks it assumes under the CCA and does not have the financial capacity to assume these risks."[28]

II. BEPS Actions 8-10 and Section 482

Unlike many countries that directly adopted the OECD 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 and, importantly, without direct reference to the OECD guidelines.[29] That said, the United States has historically maintained that its section 482 regulations and the OECD guidelines are fully consistent.[30] U.S. Treasury officials have also endorsed the final BEPS actions 8-10 reports and stated that the reports are consistent with the arm's-length standard of the section 482 regulations and prior versions of the OECD guidelines.[31]

With this in mind, U.S. MNEs seeking to minimize their transfer pricing exposure in the post-BEPS actions 8-10 world should pay particular attention to Treas. reg. section 1.482-1(d)(3)(iii)(B), an old and (until recently) obscure rule that seemingly foreshadowed BEPS actions 8-10. The regulation begins by stating a general rule that "the allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction." The regulation proceeds to list three factors that may be relevant to evaluating economic substance and thus relevant to whether the contractual allocation of risk should be respected. To paraphrase, these three factors are:

- whether the pattern of the parties' conduct over time is consistent with the contractual allocation of risk;
- whether a given party has sufficient financial capacity to bear any losses that

[25]For this purpose, control has the same meaning as under Chapter I of the revised guidelines discussed above. *See id*. at paras. 6.51 and 6.53. Of course, in that case, the entity actually performing the DEMPE function on an outsourced basis would be entitled to arm's-length compensation for the services performed. *Id*. at para. 6.52.

[26]*Id*. at para. 6.54.

[27]*Id*. at para. 8.9.

[28]*Id*. at para. 8.15.

[29]IRS AM-2007-07 (Mar. 15, 2007). *See also* Osborn, Kittle, and Klein, *supra* note 4.

[30]IRS AM-2007-07 (Mar. 15, 2007). *See also* Osborn, Kittle, and Klein, *supra* note 4.

[31]*See* the testimony of Robert B. Stack, deputy assistant secretary (International Tax Affairs) U.S. Department of the Treasury, before the 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 US transfer pricing regulations under section 482."); and Ryan Finley, "Treasury Official Says BEPS Reports Import Concept of Control," *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 guidelines and section 482 regulations). *See also* Osborn, Kittle, and Klein, *supra* note 4.

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might result from the risks assumed under the agreement; and
- the extent to which each party exercises managerial or operational control over business activities that directly influence the amount of income or loss realized.

This regulation, promulgated in final form in 1994, is strikingly similar to the risk framework in the revised guidelines, given the emphasis on financial capacity and control when evaluating risk in a related-party transaction.

Nonetheless, while the regulation lists financial capacity as well as managerial and operational control as non-dispositive, relevant factors to be considered in an analysis of risk, the revised guidelines purport to elevate financial capacity and control to the status of hard-and-fast requirements. Thus, the revised guidelines allow considerably less deference to contracts and place an even greater premium on substance than the section 482 regulations, even though both frameworks look to related parties' contracts as the starting point for a transfer pricing analysis of risk. This is a key distinction between the BEPS guidance and U.S. domestic law that may be apparent to an appeals officer or a judge hearing a taxpayer challenge to a proposed IRS adjustment based on this regulation. Because of their differences, the regulations would appear to require amending to be consistent with the revised transfer pricing guidelines. However, in case the IRS argues that the revised guidelines' control of risk framework and Treas. reg. section 1.482-1(d)(3)(iii)(B)(2) are consistent — a position with which we would disagree — U.S. MNEs may wish to consider how they can structure (or restructure) their activities to prevent the IRS from asserting an unfavorable application of BEPS control of risk principles.

III. A Hypothetical Revisited

To illustrate how a U.S.-based MNE could reduce its BEPS actions 8-10 exposure, we return to the case of L Corp, a hypothetical used by our colleagues in a previous article.[32] L Corp is a U.S.-based MNE and producer of widgets that entered into a typical "Irish IP HoldCo Structure" and reduced its worldwide effective tax rate. L Corp licensed the non-U.S. rights in its preexisting IP to its Irish subsidiary (L Ireland) and, at the same time, entered into a cost-sharing arrangement (CSA) with L Ireland to share the costs and risks of developing future IP. Initially, L Ireland hired two administrative employees to oversee the manufacturing of products for non-U.S. markets by contract manufacturers. L Ireland also formed subsidiaries in various jurisdictions, including Germany and Japan (L Germany and L Japan) to act as commissionnaires in selling products on L Ireland's behalf (collectively L Group). (See figure.)

Because of BEPS exposure concerns, L Corp moved a portion of its U.S.-based R&D group to Ireland, increasing its headcount from two to 15 and causing a significant increase in L Ireland's tangible assets. L Corp also converted its German and Japanese commissionnaires to full-fledged buy/sell distributors. These proactive adjustments allowed L Corp to file a more robust CbC report showing a level of revenue, tax, employees, and assets in each of Ireland, Japan, and Germany that was less likely to attract the attention of a tax authority conducting a risk assessment of an L Group entity tax return.

IV. Reducing L's BEPS-Related Exposure

Let us assume that, notwithstanding the prior measures taken to improve the robustness of L Group's CbC report, L Corp remains concerned that it will be selected for an in-depth transfer pricing audit by the IRS or another tax authority. What additional steps could L Corp take to reduce its potential BEPS-related exposure in the event of an audit? The BEPS actions 8-10 control of risk framework, including the language of the revised guidelines, can serve as a useful guide in this effort.

A. Enhance L Ireland's Control of R&D Funding

As a very preliminary step, L Group may wish to consider ways to increase L Ireland's control over the financial risks of funding R&D under the CSA. While there are certainly other relevant considerations, it may be wise to address the financial risk of R&D first because of the harsh consequences contemplated by BEPS actions 8-10, which purport to limit an entity that does not

[32] *See* Pieron, Greenwald, and Giardelli, *supra* note 5.

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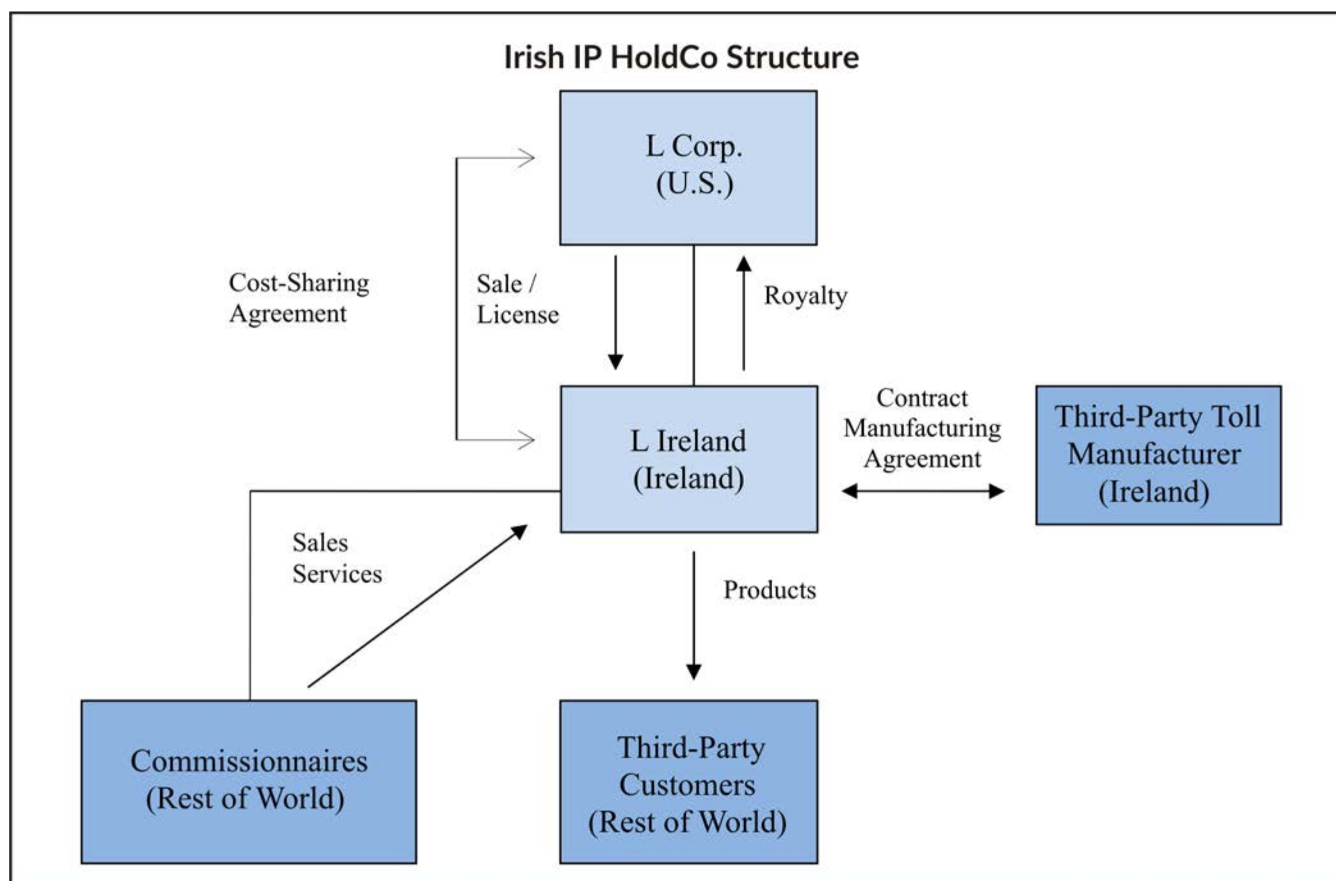

control the financial risk associated with its capital to a risk-free rate of return.[33]

To enhance L Ireland's control over the financial risk of R&D, L Corp and L Ireland could consider amending their CSA to provide L Ireland with bona fide decision-making authority regarding L Corp's R&D expenditures and the use of L Corp's R&D funds. For example, they could amend the CSA to require that L Corp submit quarterly R&D budgets for L Ireland's approval and require that expenses that exceed the approved budget by a set threshold (say, 10 percent) be subject to L Ireland's prior written approval. Further, the companies could consider amending the CSA to require L Corp to provide monthly (or quarterly) reports to L Ireland, which would provide L Ireland with the information it needs to monitor L Corp's ongoing R&D activities, such as statements of incurred costs and descriptions of material risks involving the R&D activity.

While amendments to the CSA requiring budgets and reports may be a good first step, a good second step may be to consider ways that the information contained in the budgets and reports can actually be used by L Ireland in making decisions regarding R&D funding and expenditures. For example, L Ireland could ensure that the proposed budgets and reports are subject to substantive discussion at board meetings before any approvals being granted. Board members may want to scrutinize and discuss these expenditures, propose meaningful changes to the budgets as appropriate, and

[33] Merely vesting L Ireland with control over the financial risk of R&D alone — even without doing anything more — should be sufficient under the revised guidelines to support the attribution of an appropriate risk-adjusted return to L Ireland on its R&D funding. Presumably, this could be a robust, equity-like return if supported by the facts and circumstances. Moreover, because an appropriate risk-adjusted return is an ex ante return, an entity controlling the financial risk of R&D should enjoy any unanticipated upside return (or, conversely, suffer any downside loss) on its investment in R&D. *See* revised guidelines, para. 1.100. Nevertheless, because what constitutes an appropriate risk-adjusted return is a highly subjective matter that may be challenged by a tax authority, L Corp may wish to consider (as discussed below) whether other business risks can be meaningfully controlled by L Ireland, rather than relying only on its control over the financial risks of R&D to support the attribution of profits to L Ireland.

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provide substantive feedback based on the information contained in periodic reports. L Ireland may also wish to consider minimum qualifications for its board members to ensure they have the competence and experience necessary to make decisions about R&D budgets and the disposition of R&D funds.

Further, to substantiate that L Ireland controls the risks of R&D funding (and any other risks), it is important that the L Ireland board's decisions and deliberations must be appropriately documented. To this end, appropriately detailed minutes memorializing the board's discussions, including any changes proposed to L Corp's R&D budget and deliberations before approval, could help provide L Group with audit-ready documentation that may prove invaluable in the event of an in-depth audit focused on control of risk issues.

B. Identify Other Economically Significant Risks

Ensuring that L Ireland exercises meaningful control over the financial risks of funding R&D under the CSA should substantially reduce the risk of a tax authority arguing that L Ireland's returns should be drastically limited. To further support the attribution of profits from the exploitation of intangibles to L Ireland, L Corp could conduct an in-depth analysis to identify all economically significant risks of its business outside of the United States. Because the revised guidelines define economically significant risks as, essentially, those risks with the biggest potential bottom-line effect on an MNE's profit or loss, an analysis identifying economically significant risks might mirror the analysis that publicly traded companies and other companies with SEC-registered securities must conduct for securities offerings and annual reports. Indeed, if L Corp is itself an SEC registrant, it may be able to leverage its legal department's risk factor analysis for this purpose since the analysis of economically significant risks contemplated by the revised guidelines is very similar to the analysis already mandated by the SEC.[34]

After identifying the economically significant risks, L Group can then consider ways how L Ireland can manage some of these risks both in theory and in practice.

C. Enhance L Ireland's Control of Those Risks

To enhance L Ireland's control over the economically significant risks of its business, L Group may then wish to consider ways to increase L Ireland's capability to make decisions to "take on, lay off, or decline" risk and to actually exercise this decision-making authority. To this end, and as noted above, careful consideration might be given to the composition of L Ireland's board. In accordance with the guidance in the revised guidelines, L Ireland might consider which individuals would have the best ability, based on their experience and background, to manage and mitigate the economically significant risks of the business, including R&D activities. In appropriate circumstances, L Group might consider including one or more of L Corp's top-level executives on L Ireland's board of directors, while carefully defining their roles to avoid making L Ireland subject to tax in the United States.

Further, L Group could hire appropriately high-level executives resident in Ireland who, in line with the revised guidelines, have "the capability to make decisions to take on, lay off, or decline" risks and who are authorized to actually perform day-to-day decision-making functions, within the parameters set by the board. An advantage to placing executives in Ireland, rather than simply relying on the board of directors, is that resident executives can make day-to-day decisions regarding risks that might not ordinarily warrant board-level discussion. This should help deflect any argument by a tax authority that L Ireland's board of directors is merely rubber-stamping decisions actually made in substance in the United States. To the extent that it is impractical to relocate executives with the capability to manage every economically significant risk to Ireland, L Group may wish to consider whether a high-level executive of L Corp resident in the U.S. can also be an employee of L

[34] *See* 17 CFR 229.503(c) (requiring that a prospectus contain "a discussion of the most significant factors that make the offering speculative or risky").

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Ireland without making L Ireland taxable in the U.S.[35]

L Group's analysis of its economically significant risks can be an invaluable tool for selecting directors and deciding which executives and functions are placed in Ireland. For example, if product safety risk is identified as economically significant, L Group may want to place a product safety expert in Ireland with the expertise and authority to make decisions about product design, safety features, and warnings. If risks involving the acceptance of the L brand outside the U.S. are economically significant, L Group may want to prioritize the placement of marketing and business development executives in Ireland.

D. Limit BEPS Exposure in Germany and Japan

Moderation is key when bolstering the substance of L Germany and L Japan. While L Group improved the robustness of its CbC report and reduced its permanent establishment-related exposure by converting L Germany and L Japan from commissionaires to buy-sell distributors and adding employees in those jurisdictions,[36] care should be taken to avoid creating unintended BEPS actions 8-10 exposures in Germany or Japan. As routine distributors, it would make sense if L Germany and L Japan assumed and controlled the risks typically borne by independent distributors, such as inventory risk, foreign exchange risk, and bad debt risk. However, it may be better if they did not bear or control risks related to local market strategy or other risks that may be economically significant in the local jurisdictions. To the extent L Germany and L Japan do perform marketing functions (for example, developing customer relations and the L brand in the local markets), BEPS actions 8-10 exposure could be mitigated by having L Germany and L Japan merely execute local marketing plans provided by L Ireland and ensuring they work within the parameters of marketing budgets controlled by L Ireland. ■

[35] Even if a high-level executive resident in the United States did create a permanent establishment in the U.S. under an income tax treaty or cause L Ireland to be engaged in the conduct of a U.S. trade or business under section 864, often that U.S. presence would not generate effectively connected income taxable under sections 864 and 865. This is because, under the applicable ECI rules, foreign-source income often cannot be ECI. Further, a senior executive's involvement in the day-to-day business may not be sufficient to cause the limited amounts of foreign-source income that *could* be ECI to *actually* be ECI in the hands of the foreign corporation. Careful attention to the section 864 ECI rules and the section 865 sourcing rules can minimize or eliminate the ECI risk in most situations.

[36] *See* Pieron, Greenwald, and Giardelli, *supra* note 5.

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