MAYER • BROWN

Legal Update
February 28, 2014

Significant Progress Made on the OECD's BEPS Action Plan

This Legal Update is the second in a series that Mayer Brown Tax lawyers are publishing on key developments at the national and international levels related to the Organisation for Economic Co-Operation and Development's ("OECD") *Action Plan on Base Erosion and Profit Shifting* (the "BEPS Action Plan"). At the core of the BEPS Action Plan is the perceived problem of "double non-taxation" and the intense political pressure from the G-20 and its member states for the OECD to take decisive and internationally coordinated action.

As we described in our first Legal Update on this topic, dated July 30, 2013, the BEPS Action Plan sets forth 15 proposals for specific actions ("action items") that the OECD intends to complete during the next two years. These action items contemplate potentially significant changes to the international tax system in areas such as transfer pricing, the permanent establishment threshold, and hybrid entities and instruments, as well as overhauls of international tax administration in areas such as exchange of information and the mutual agreement procedure ("MAP").

Since the time of our first Legal Update, the OECD has made significant progress toward meeting several of its BEPS Action Plan objectives, particularly in the areas of transfer pricing for intangibles and transfer pricing documentation. Meanwhile, amid intense political pressure for immediate action, countries throughout the world have been making their own international tax reform proposals at an accelerated pace. Many of these unilateral proposals address the same issues as the BEPS Action Plan, but do so at the domestic level in a manner that is seemingly inconsistent with the BEPS Action Plan's strong admonition about the need for multilateral coordination of any changes to the international tax system.

In this Legal Update, we provide summaries of some of the key steps taken by the OECD in making progress toward its BEPS Action Plan objectives, as well as a few of the important developments at the domestic level in Europe and the United States related to the issues addressed by the BEPS Action Plan.

- OECD
  - OECD/BIAC Business Dialogue
  - Transfer Pricing Documentation and Country-by-Country Reporting
  - OECD Publishes Comments Received on the Tax Challenges of the Digital Economy
  - Revised Intangibles Discussion Draft
- UK/Europe
  - European Commission Challenge to UK Patent Box Regime
  - Ireland Proposes Solution to "Stateless" Income
  - New Rules for Tax Treatment of Regulatory Capital in the UK Enter Into Force
- US
  - Baucus Discussion Draft

OECD/BIAC Business Dialogue

On October 1, 2013, the OECD held a business dialogue with the Business and Industry Advisory Committee to the OECD ("BIAC") to discuss the BEPS Action Plan. While all 15 items were discussed to some extent, the key themes of these discussions were as follows.

Disclosure: The OECD considers strengthened documentation rules and country-by-country ("cbc") reporting to be significant parts of the BEPS Action Plan.

Here, the discussions focused on the need to develop a template for cbc reporting of basic information regarding income, activities and taxes. On October 3, these discussions were followed by the release of a Memorandum on Transfer Pricing Documentation and Country-by-Country Reporting[1] that listed a number of suggestions regarding the type of information to be communicated to the tax authorities and the manner in which the information should be reported. The OECD's efforts and subsequent developments in this area are discussed later in this update (*see* Transfer Pricing Documentation and Country-by-Country Reporting).

Hybrids and Interest Deductibility: Since the beginning of the discussions around BEPS, various countries have taken unilateral measures with respect to hybrids and interest deductibility. These measures have tended to exacerbate the various inconsistencies among the domestic tax systems.

At this dialogue, both the OECD and the business representatives recognized that these inconsistencies had to be addressed. Business representatives advocated for clarity and certainty in the rules that are to be developed. Moreover, growing concerns were expressed regarding hybrid structures "promoted" by governments and, with respect to interest, the need to distinguish between banking and non-banking interest. According to a timetable released by the OECD on February 20, 2014,[2] a Discussion Draft on Hybrid Mismatch Arrangements is scheduled to be released on April 4, 2014 with a public comment period that will be open until May 4, 2014. A public consultation on the Discussion Draft is scheduled to be held on May 15-16, 2014.

Additional discussions regarding the treatment of hybrid structures are taking place in the European Union. The European Commission released a proposal in late November to amend Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries in different member states (the "Parent-Subsidiary Directive").[3] The proposed amendment aims at tackling hybrid loan arrangements and introduces further anti-abuse provisions. If and when the amendment to the Parent-Subsidiary Directive is implemented, it would have a significant effect on many existing structures.

Digital Economy: Governments (notably France) are increasingly arguing that the current international tax rules are no longer adequate to address new business models, while businesses are generally of the view that it is difficult to draw a line between digital and non-digital activities. Businesses are particularly concerned by the current trend to modify the permanent establishment standard. Both the OECD and the EU Commission are currently investigating better ways to tax the digital economy. In the EU, a recently established expert group is due to deliver a report to the EU Commission on this topic in early 2014. Note: recent developments relating to this topic are discussed later in this update (*see* OECD Publishes Comments Received on the Tax Challenges of the Digital Economy).

Observations: The OECD's discussions with business regarding the BEPS Action Plan have been dynamic and are progressing steadily. The OECD work regarding disclosure and documentation requirements (action item 13) is expected to progress at a fast pace, as it is not directly connected to the other action items. Regarding the other action items, it remains to

be seen whether countries (and the European Union) will take part in a collective process or instead develop their own unilateral responses. The latter approach would create non-harmonized rules, inconsistency and increase the potential for double taxation.

Transfer Pricing Documentation and Country-by-Country Reporting

The OECD has been making significant progress towards meeting its objective of BEPS Action Plan item 13 of providing enhanced rules for transfer pricing documentation, including rules for the so-called "country-by-country" reporting, or reporting of the "global allocation of the income, economic activity and taxes paid among countries according to a common template." The OECD plans to complete action 13 by publishing a revised Chapter V of the OECD Transfer Pricing Guidelines by September 2014, and as interim steps in this process, released a White Paper on Transfer Pricing Documentation in July 2013, followed by a Discussion Draft in January 2014.

The White Paper: On July 30, 2013, the OECD released a White Paper on Transfer Pricing Documentation for public consultation within the framework of BEPS Action Plan item 13. The White Paper endorsed a so-called "Coordinated Documentation Approach"; a two-tier structure consisting of a "Master File" and a "Country File." The OECD is of the opinion that this two-tier approach, also developed by the EU Joint Transfer Pricing Forum ("EU JTPF"), has significant potential for simplifying transfer pricing documentation requirements.

The White Paper's key message relates to the need for companies to provide "big picture" information in order for tax authorities to perform an efficient risk assessment. At the same time, the OECD stresses that the core of transfer pricing documentation must continue to be the taxpayer's description of the transfer pricing methods and the analysis that it uses to demonstrate compliance with the arm's length principle.

Comments and Consultation on the White Paper: Comments on the White Paper were due at the end of September 2013 and were released thereafter. A common theme in many of the comment letters is the rising concern that the approach considered in the White Paper would lead to an increased compliance burden rather than simplification. The information that would be required for the Master File and Country File goes beyond what is necessary for transfer pricing documentation purposes under current rules. Concerns were also expressed regarding the confidentiality of the data that would be required to be transmitted to the tax authorities.

Business organizations further suggested that it would be desirable to align the work done on transfer pricing documentation with the previously published Draft Handbook on Transfer Pricing Risk Assessment (OECD draft issued on April 30, 2013). That Draft had suggested that taxpayers whose behavior indicates low risks should have a reduced compliance burden.

Shortly after the close of the comment period, the OECD held a dialogue with BIAC regarding documentation and other BEPS Action Plan-related items and released a Memorandum on Transfer Pricing Documentation and Country-by-Country Reporting in early October.[4] This dialogue was followed by a public consultation held on November 12-13, 2013.

Discussion Draft: As noted above, the OECD released a Discussion Draft on Transfer Pricing Documentation and Country-by-Country Reporting (the "Discussion Draft") on January 30, 2014, which, among other proposed guidance, sets forth a proposed template for cbc reporting. The OECD released this Discussion Draft despite the lack of consensus regarding the policy objectives and deliverables that remained for this BEPS Action Plan item following the November consultation. As noted in the

introduction, the Discussion Draft does not necessarily reflect the consensus views of either the OECD's Committee on Fiscal Affairs or Working Party N°6.

The Discussion Draft has three stated objectives: to provide the tax administration with the information necessary to conduct a transfer pricing risk assessment, to ensure that taxpayers are giving appropriate consideration to transfer pricing requirements and to provide tax administration with the information they require to conduct a thorough audit. It adopts the two-tiered approach contemplated in the White Paper by proposing that multinational enterprises ("MNEs") prepare both a Master File (the "blueprint" of the MNE) in English and a Local File (for the local transactions of the associated enterprises) in the local language.

The most controversial aspect of the Discussion Draft is the proposed cbc Model Template, which would require disclosure of information such as number of employees, tangible assets, local sales and taxes paid by each entity in the MNE group. The Discussion Draft left open for comment whether the cbc reporting on the Model Template would be required to be included in the Master File or if it would be a separate document. The Model Template raises a number of significant concerns for MNEs, including the confidentiality of the highly sensitive information that the template would require to be reported, the potential that local tax authorities could use the information to apply formulary apportionment (despite the intent of the Discussion Draft to reinforce the arm's length standard), and the compliance burdens that it would impose. The Discussion Draft suggests that less extensive documentation requirements for small and medium-sized enterprises ("SMEs") may be appropriate to reduce their compliance burden, but provides little in the way of specifics and indicates that even SMEs should be subject to cbc reporting on the Model Template.

The Discussion Draft also leaves open the question of the relationship of cbc reporting to transfer pricing administration. While the goal of the Discussion Draft is to propose a replacement for the text of existing Chapter V of the Transfer Pricing Guidelines, the OECD's original objective of developing a common template for cbc reporting to tax authorities was not limited in its purpose to transfer pricing administration. As noted in the introduction to the Discussion Draft, "the OECD will be giving further consideration to whether information relevant to other aspects of tax administration and the BEPS Action Plan should also be included in the common template."

Comments on the Discussion Draft were due on February 23, 2014, and a public consultation is scheduled for May 19, 2014 with a view toward finalizing the Discussion Draft thereafter.

Outlook and Next Steps: While, not long ago, the momentum behind cbc reporting might have seemed unstoppable, the most recent sentiment among tax administrators in key OECD countries now suggests that its adoption (at least in the form contemplated in the Discussion Draft) is far from certain. For example, IRS Director of Transfer Pricing Operations Samuel Maruca recently intimated that the IRS believes it does not need cbc reporting because its existing reporting rules are adequate, though he did acknowledge that cbc reporting might benefit certain other countries.[5] As of the date of this Legal Update, the comments on the Discussion Draft that were due on February 23 have not yet been publicly released by the OECD, but it can be expected that the comments of taxpayers, their advisors and business groups will echo common concerns about administrative burdens, confidentiality and the potential for misuse (for example, use of the data for formulary apportionment). In light of these concerns, as well as the possible waning support of certain governments, conditions seem potentially ripe for a compromise approach that will better balance governments' interests in risk

assessment and transparency with the concerns of business. The May 19, 2014, public consultation will, therefore, be of critical importance and developments between now and then should be closely watched.

EU and Country-level Initiatives: Other policy initiatives in the area of documentation are concurrently being developed by the EU JTPF and at the domestic level in a number of countries. At the country level, the general trend is toward increased compliance burdens on taxpayers. Examples are the effective implementation of stricter transfer pricing documentation rules in Russia (especially taking into account the phasing of the in-scope transactions) and recent changes in France (with reporting requirements in addition to the traditional transfer pricing documentation requirements).

OECD Publishes Comments Received on the Tax Challenges of the Digital Economy

Following a November 22, 2013 request for input on the tax challenges of the digital economy (which are to be addressed under action item 1 of the BEPS Action Plan), the OECD has published comments received from a range of stakeholders in a number of countries (available here). Specific issues raised included:

- Whether there even is a "digital economy" or whether this notion really concerns the general effects of digital technologies on existing business models;
- Whether digital businesses are sufficiently different from non-digital businesses such that the OECD and the international tax community should support an approach enabling countries to tax them differently;
- The observation that base erosion affects all sectors, and that digital tools simply facilitate/accelerate this—the digital sector is not affected more than others;
- Whether the definition of permanent establishment should be amended to include a server/website;
- Whether amendments to the threshold for a permanent establishment create the possibility for multiple countries to claim permanent establishment arising from a single activity and therefore require some form of multilateral mutual agreement facility to be developed;
- The difficulty of predicting the direction in which the digital economy will move and the challenge of designing a tax system that will continue to be fit for purposes of the digital economy; and
- In the event that the debate concludes that digital businesses should be taxed differently, when does a business become a "digital business," and what position can or should be taken in relation to those countries that decide they should levy tax on a different basis?

On January 20, 2014, Pascal Saint-Amans, the Director of the OECD's Centre for Tax Policy and Administration, announced that the OECD task force on the digital economy had concluded that designing special tax rules for Internet companies would not be viable in light of the growing use of digital technology in every industry. The intention going forward is, therefore, to devise a single set of international tax rules that will apply to all multinationals, rather than devising a specific regime for purely digital companies, with the new rules being designed to address most of the tax planning enabled by the digital economy. According to a new timetable released by the OECD on February 20, 2014,[6] a Discussion Draft on the Tax Challenges of the Digital Economy is expected to be released on March 24, 2014, with a public comment period that will be open until April 14, 2014. A public consultation on this Discussion Draft is scheduled for May 19, 2014.

The OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

The OECD released its revised Discussion Draft on Transfer Pricing Aspects of Intangibles (the "Revised Discussion Draft") on July 30, 2013, less than two weeks after the OECD released the BEPS Action Plan. The Revised Discussion Draft follows earlier discussion drafts on the same topic that the OECD released in June and September 2012. Those discussion drafts were released as part of the OECD's longstanding project to revise Chapter VI of the OECD Transfer Pricing Guidelines on intangibles, which was first announced in 2010. While the OECD's intangibles project predates the BEPS Action Plan by a number of years, this preexisting project to revise Chapter VI has now been fully subsumed into BEPS; specifically, as item 8 of the BEPS Action Plan.

Since being subsumed into the BEPS project, the OECD's intangibles project has been moving at an accelerated pace. Item 8 of the BEPS Action Plan contemplates publication of revisions to Chapter VI of the OECD Transfer Pricing Guidelines (i.e., finalization of the proposed revisions contained in the Revised Discussion Draft) by September 2014.[7] As key steps in the process toward finalization, public comments on the Revised Discussion Draft were due on October 1, 2013, and the OECD held a public consultation on November 12-13, 2013. At a January 23, 2014 webcast entitled "BEPS Action Plan: Update on 2014 Deliverables," Marlies de Ruiter, Head of the Tax Treaty, Transfer Pricing and Financial Transactions Division of the OECD's Centre for Tax Policy and Administration ("CTPA"), stated that the OECD's work in this area will be finalized during the Working Party N°6 meetings scheduled for March and May 2014.[8]

While the Revised Discussion Draft discusses a number of issues relating to transfer pricing of intangible property, including the definition of intangible property, location savings, synergies, and pricing methods, in large part the public debate has focused on the provisions that address the allocation of income from the exploitation of intangible property among the members of a related party group. More specifically, the Revised Discussion Draft, like the OECD's prior discussion drafts on this topic, places more emphasis on functions performed and "control" over risk, and places less emphasis on IP ownership, funding and contractual terms, in determining which group member is entitled to the intangibles-related income. In particular, the Revised Discussion Draft, building on the earlier Discussion Drafts released in 2012, would effectively make certain "important functions" (i.e., those involving "control" over research and marketing programs, budgets or strategic decision-making), the key factors with "special significance" in this determination.[9]

While elevating the importance of "important functions," the Revised Discussion Draft diminishes the role of capital by proposing to restrict the return that a related party should expect from bearing a "funding risk," such as under a cost sharing or contract R&D arrangement. Specifically, paragraph 84 provides that "[b]earing a funding risk, without the assumption of any further risk, and without any control over the use of the contributed funds or the conduct of the funded activity, generally would entitle the funder to a *risk-adjusted rate of anticipated return on its capital invested* but not more."[10] While the Revised Discussion Draft provides no guidance on how to determine such a "risk-adjusted rate of anticipated return," other paragraphs of the Revised Discussion Draft intimate that the "risk-adjusted rate of return" should be modest. For example, paragraph 80 provides that "[w]here the legal owner outsources most or all such *important functions* to other group members, the entitlement of the legal owner to retain *any material portion of the return attributable* to the intangibles after compensating other group members is highly doubtful."[11]

To the extent that the Revised Discussion Draft contemplates denying related parties any "material portion" of the total intangibles-related profits for placing their capital at risk in research and development, it contradicts the actual market evidence that the returns for placing capital at risk are often quite substantial.[12] A number of business groups pointed this out during the comment period,[13] and it is still to be determined what action, if any, the OECD will take in response to this point.

As controversial as the Revised Discussion Draft's function-centric view of transfer pricing may be, the Draft also contemplates (in a footnote) an even more controversial view held by some OECD member countries that would prefer to disregard or recharacterize at least certain transactions involving the funding of hard-to-value intangibles in the related-party context.[14] This alternative view is alluded to in item 8 of the BEPS Action Plan, which contemplates (among other revisions to Chapter VI) "developing transfer pricing rules *or special measures* for transfers of hard-to-value intangibles." The OECD recently confirmed during its January 23, 2014 webcast that, while "replacing the arm's length principle is not the solution," "[s]pecial measures may be necessary."[15]

Furthermore, even after the OECD publishes a final revised Chapter VI of the OECD Transfer Pricing Guidelines, it will not necessarily be the OECD's last word on these issues. The Action Plan includes two additional transfer pricing-related action items, one on "risks and capital" (action item 9) and a second on "other high risk transactions" (action item 10), that are expected to result in additional changes to the OECD Transfer Pricing Guidelines by September 2015. The content of the OECD's pending guidance on these other two items is yet to be seen, but it will likely involve even greater scrutiny of related-party transactions involving intangibles. Item 10, on "other high risk transactions," is particularly concerning because it is expected to include rules that "clarify the circumstances in which transactions can be recharacterised."

While the content of the final revisions to Chapter VI of the OECD Transfer Pricing Guidelines and output of the other transfer pricing-related BEPS Action Plan items remains uncertain, the changes will almost certainly encourage tax administrators around the world to scrutinize related-party transactions involving intangible property even more closely. This is true regardless of whether the OECD adopts the function-centric transfer pricing principles of the Revised Discussion Draft and/or takes a turn in the direction of the view held by some OECD member countries that certain transactions should be disregarded or recharacterized. In either case, the future for multinational enterprises is likely to involve increased compliance burdens, controversy and the potential for double taxation.

European Commission Challenge to UK Patent Box Regime

According to the OECD, BEPS can occur as a result of aggressive government competition for a share of the tax base, including the introduction of favorable tax regimes targeted at activities such as intellectual property. This is one of the issues being addressed as part of action item 5 of the BEPS Action Plan. An example of such a preferential regime is the UK patent box, which was introduced on April 1, 2013, and is to be phased in over five years in such a way as to ultimately permit income arising from patents and other qualifying intellectual property to be taxed at the favorable corporation tax rate of 10 percent.

The European Commission recently announced that it considered the UK patent box to violate the EU Code of Conduct on business taxation (the "Code"), despite the fact that similar preferential tax regimes for intellectual property introduced by several other EU member states have either not been challenged or have been assessed and judged compliant with the Code. A

meeting of EU member states on October 22, 2013 failed to reach agreement on whether the UK patent box violated the Code and the matter was referred to the December meeting of the Economic and Financial Affairs Council ("ECOFIN"), where it was debated in the context of intellectual property incentives more generally. Again, no decision was reached, but EU finance ministers called upon the Code group to conduct an analysis of patent box schemes in EU member states, including those that had previously been assessed and judged compliant with the Code, by the end of 2014. It was expressly stated that this analysis should be conducted against the background of international developments, including the OECD's BEPS initiative.

Ireland Proposes Solution to "Stateless" Income

One of the perceived problems that the BEPS project seeks to address (as part of action items 2 and 6 of the BEPS Action Plan) is "double non-taxation" or "stateless" income. An example of a structure perceived to give rise to such stateless income is the so-called "double Irish" structure, in which a company incorporated in Ireland is managed and controlled in an offshore jurisdiction with no corporate income tax, or where tax residence is based upon incorporation rather than management and control (as in Ireland), resulting in the company not being subject to tax either in Ireland or in the offshore jurisdiction.

Ireland announced plans to address this "loophole" in s38 Finance (No. 2) Bill 2013, which seeks to amend the company residence rules contained in s23A Taxes Consolidation Act 1997 to ensure that an Irish-incorporated company can no longer achieve stateless status as a result of a mismatch between Ireland's company residence rules and those of a treaty-partner country.

The amendment provides that, where an Irish-incorporated company that is managed and controlled in a treaty-partner country would not otherwise be regarded as tax resident in any territory because (i) the company would not be tax resident in Ireland because it is not managed and controlled there and (ii) the company would not be tax resident in the treaty-partner country because it is not incorporated there, then the company will be regarded as tax resident in Ireland.

This amendment has effect from October 24, 2013 (the date the draft legislation was published) for companies incorporated on or after that date, and from January 1, 2015 for companies incorporated before October 24, 2013.

It is worth noting that this amendment will not affect the tax residence status of Irish companies managed and controlled in non-treaty-partner jurisdictions, e.g., the Cayman Islands.

New Rules for Tax Treatment of Regulatory Capital in the UK Enter Into Force

One of the issues considered by the BEPS Action Plan (action items 2 and 4) is the debt/equity boundary and interest deductibility. The UK recently published the Taxation of Regulatory Capital Securities Regulations 2013 (the "Regulations"), which entered into force on January 1, 2014, to provide certainty of tax treatment of securities issued to meet new EU regulatory requirements under the Capital Requirements Directive IV and the Capital Requirements Regulation (the "CRR"). The Regulations provide that additional tier 1 securities ("AT1") and tier 2 securities ("T2") will be treated as debt for UK tax purposes.

As background, the CRR (which applies from January 1, 2014) requires AT1 and T2 to have a number of features intended to aid loss absorbency in the event of a financial crisis, which (absent the Regulations) had the result of making the UK tax treatment of these securities uncertain.

Because AT1 and T2 replace regulatory capital securities treated as debt for UK tax purposes and share features with debt-type instruments, it

was decided that AT1 and T2 should also be treated as debt for UK tax purposes (subject to certain specific rules for these types of securities). The Regulations therefore provide that payments (other than repayments of principal) made to the holders of such securities are not distributions for UK tax purposes but are chargeable as interest, thus making them tax deductible for the issuer.

The Regulations are the result of regulatory changes that have been in the pipeline since long before the BEPS project was initiated. However, given that interest deductibility is a key area of interest for BEPS, it will be interesting to see whether the outcomes of the BEPS project will drive any changes in this area.

Baucus Discussion Draft

On November 19, 2013, US Senate Finance Committee Chairman Max Baucus released a Chairman's Staff Discussion Draft of Provisions to Reform International Taxation (the "Baucus Discussion Draft").[16] Described as "drawing extensively from" previous international tax reform proposals,[17] the Baucus Discussion Draft aims to reduce base erosion and incentives for US-based businesses to move abroad, while at the same time improving the ability of US-based multinationals to compete against foreign-based multinational businesses. The intention of the draft is that the proposed reforms to broaden the corporate tax base would be accompanied by a reduction in the corporate tax rate. [18]

The Baucus Discussion Draft follows other recent proposals for international tax reform in the United States, including those proposed by the Obama administration and by House Ways and Means Committee Chairman David Camp. Moreover, Chairman Camp has just released a new discussion draft on tax reform.

While these other proposals were similar in their general approach (for example, all would attempt to broaden the corporate tax base in part by overhauling and expanding the CFC rules under Subpart F), the changes proposed by the Baucus Discussion Draft are the most comprehensive and sweeping in scope. Moreover, the Baucus Discussion Draft is particularly significant because its proposals would attempt to address, on a strictly domestic basis, many of the same international tax issues that the OECD is addressing in the context of its BEPS Action Plan. There is significant overlap between the Baucus Discussion Draft and BEPS Action Plan items 2 (Hybrid Mismatch Arrangements),3 (Strengthening CFC Rules), 4 (Limit Base Erosion via Interest Deductions and Other Financial Payments) and 8-10 (Transfer Pricing).

The most extensive reform proposed by the Baucus Discussion Draft is the replacement of the current deferral system with one of two alternative statutory schemes ("Option Y" or "Option Z"). According to the Baucus Discussion Draft, both options would have the effect of replacing deferral with a system under which all income of foreign subsidiaries of US companies would either be taxed currently (at a certain minimum rate) or be permanently exempt. Both options would result in subjecting a greater portion of CFC income to US taxation on a current basis. Comments have been solicited on the advantages and disadvantages of each option.

Option Y would couple a 100-percent dividends received deduction with a broadening of Subpart F, primarily by the addition of two new categories of Subpart F income ("United States-related income" and "low-taxed income"). Hybrid dividends (payments that are treated as dividends for US tax purposes but for which the CFC making the payment receives a deduction or other tax benefit under the laws of another country) would generally not be eligible for the 100-percent dividends received deduction. United States-related income would include the CFC's "imported property income" and its "United States services income." Imported property income would include income derived in connection with the (i) manufacturing,

producing, growing or extracting imported property, (ii) the sale, exchange or other disposition of imported property or (iii) the lease, rental or licensing of imported property. For this purpose, "imported property" means property imported (or reasonably expected to be imported) into the United States by the CFC or a related person. United States services income would include income derived in connection with services (including certain financial services) provided with respect to persons or property located in the United States.

The second new category of income under Option Y, low-taxed income, would generally include any income subject to a foreign income tax of less than a certain percentage of the maximum US corporate tax rate. The example given in the Baucus Discussion Draft is 80 percent. Under the proposal, and using the 80 percent example, such low-taxed income is included in US taxable income subject to a 20 percent deduction and allowance of foreign tax credits for foreign taxes actually paid. As a result, low-taxed income would be subject to tax at 80 percent of the US corporate tax rate.

Option Z would expand Subpart F to include all CFC income, while providing an exemption for a portion of a new category of Subpart F income, "active foreign market income." Active foreign market income would include "income attributable to economically significant activities of a qualified trade or business derived in connection with property sold or exchanged for use outside the United States or services performed outside the United States with respect to persons or property located outside the United States."[19] Only a certain percentage (the example given was 60 percent) of active foreign market income would be taxed at 100 percent of the full US tax rate. The other 40 percent of such active foreign market income would be exempt from US taxation. The remaining income of the CFC (all other income plus 60 percent of active foreign market income) would be taxed at the full US tax rate.

Both Option Y and Option Z would modify the foreign tax credit limitations and disallow certain interest expense deductions. Under Option Y, the foreign tax credit limitation would be applied separately for six different categories of income: (i) passive income; (ii) United States-related income; (iii) low-taxed income; (iv) foreign branch income; (v) insurance income; and (vi) all other income. Option Z would apply the foreign tax credit limitation separately to three different categories of income: (i) Subpart F income from active foreign market income (excluding the percentage of such income which was not subject to US taxation); (ii) passive income; and (iii) all other income.

Under both options, interest expense deductions would be disallowed to the extent that the interest expense is apportioned to a CFC's income that is exempt from US taxation (such as non-subpart F income or income that is not effectively connected with a US trade or business in Option Y, or the excludable portion of the CFC's active foreign market income in Option Z). Under Option Z, deductions for other expenses would also generally be disallowed to the extent that they are definitely allocable to that excludable portion.

Some of the other provisions in the Baucus Discussion Draft include:

- A retroactive, one-time tax on previously deferred CFC income. The example given in the Baucus Discussion Draft is a 20 percent tax payable over an eight-year period. A foreign tax credit would be available, but only with respect to the taxable portion of the included income (20 percent in the example).
- Essentially repealing the check-the-box rules with respect to wholly owned subsidiaries of CFCs by requiring them to be treated as corporations.
- Allowing the expiration of the section 954(c)(6) look-through rule (which provides that dividends, interest, rent and royalties received by a CFC from a related CFC are not

treated as subpart F income to the extent that such items are properly allocable to income of the payor CFC that is not Subpart F income).

- Accelerating the apportionment of interest expenses on a worldwide basis.
- Amending the definition of intangible property in section 936(h)(3)(B) (which also applies for purposes of sections 367(d) and 482) to include workforce in place, goodwill and going concern value, and providing that the previously undefined residual category of "any similar item" shall mean "any other item the value of which is not attributable to tangible property or the services of an individual."[20]
- Clarifying that, for purposes of sections 367(d) and 482, the IRS has the authority to require: (i) valuation on an aggregate basis where it achieves a more reliable result and (ii) valuation on the basis of realistic alternatives.
- Treating the gain or loss of a foreign person from the sale or exchange of an interest in a partnership that is engaged in trade or business within the United States as effectively connected to the US trade or business in proportion to the portion of the partnership's gain on a hypothetical sale that would be effectively connected.
- Disallowing deductions for any related party payments arising in a "base erosion arrangement," defined as "any transaction or series of transactions, or other arrangement, that reduces the amount of foreign income tax paid or accrued and that involves (1) a hybrid transaction or instrument, (2) a hybrid entity, (3) an exemption arrangement, or (4) a conduit financing arrangement."[21]

Because the Baucus Discussion Draft is a unilateral response to perceived weaknesses in the US international tax system, there is legitimate concern that its proposals, combined with the unilateral actions of other countries to similarly get ahead of the BEPS curve, could lead to more uncertainty, to inconsistencies from country to country and to the potential for unprecedented double taxation. This would seemingly contradict the BEPS Action Plan's strong admonition about the paramount need for multilateral coordination and consensus.

In relation to the Baucus Discussion Draft, US officials have continued to assert that the United States will not wait for the outcome of the OECD's BEPS project to enact proposals to reform US international tax laws.[22] At the same time, the United States considers itself "a leader in the BEPS process" and is concerned by the risk that other countries "will take unilateral actions to combat BEPS."[23] While the United States is committed to goals such as fighting base erosion and addressing the issues caused by hybrid entities and arrangements, the United States remains more skeptical of BEPS action items 1 (address the challenges of the digital economy) and 7 (prevent the artificial avoidance of permanent establishment status), expressing the concern that they "target" US multinationals and threaten the US tax base.[24]

The tax reform draft plan released by Chairman Camp on February 26, 2014 (the "Camp Draft Plan") is similarly intended to broaden the corporate tax base and prevent base erosion. However, the Camp Draft Plan would take a different approach than the Baucus Discussion Draft, by proposing an essentially territorial tax system through a 95 percent dividends received deduction. However, like the Baucus Discussion Draft, the Camp Draft Plan would expand Subpart F income, by creating a new category of Subpart F income (foreign base company intangible income), and would similarly impose a one-time retroactive tax on previously untaxed foreign earnings (albeit at a lower rate).[25] Unlike the Baucus Discussion Draft, which does not commit to any particular corporate tax rate, the Camp Draft Plan would lower the corporate tax rate to 25 percent.

Despite the wide news coverage of the Baucus Discussion Draft and now also the Camp Draft Plan, the likelihood that either draft will be enacted into law in its entirety is probably quite

low. Moreover, Senator Baucus recently resigned from the Senate to serve as the US Ambassador to China, and the impact that the Senator's departure will have on the future of the Discussion Draft's proposals is uncertain. Nevertheless, the Baucus Discussion Draft is significant because of its extremely broad scope, and because certain aspects of it could be proposed on a stand-alone basis in future US tax reform discussion drafts or legislation.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

BRUSSELS

Charles-Albert Helleputte
+32 2 551 5982
chelleputte@mayerbrown.com

Astrid Pieron
+32 2 551 5968
apieron@mayerbrown.com

Dina Scornos
+32 2 551 5949
dscornos@mayerbrown.com

CHICAGO

Thomas L. Kittle-Kamp
+1 312 701 7028
tkittlekamp@mayerbrown.com

Lee Morlock
+1 312 701 8832
lmorlock@mayerbrown.com

Scott M. Stewart
+1 312 701 7821
sstewart@mayerbrown.com

HOUSTON

Shawn R. O'Brien
+1 713 238 2848
sobrien@mayerbrown.com

LONDON

Sandy Bhogal
+44 20 3130 3645
sbhogal@mayerbrown.com

Kitty Swanson
+44 20 3130 3431
kswanson@mayerbrown.com

NEW YORK

Lewis Greenwald
+1 212 506 2437
lgreenwald@mayerbrown.com

Brian W. Kittle
+1 212 506 2187
bkittle@mayerbrown.com

WASHINGTON DC

Suzanne Cartwright
+1 202 263 3239
scartwright@mayerbrown.com

Jason M. Osborn
+1 202 263 3386
josborn@mayerbrown.com

Charlie Triplett
+1 202 263 3262
ctriplett@mayerbrown.com

Endnotes

1. This memorandum is available at: http://www.oecd.org/ctp/transfer-pricing/memorandum-transfer-pricing-documentation-and-country-by-country-reporting.pdf.
2. *See* BEPS/G20 Project: Calendar for planned stakeholders' input 2013-2014 (20 Feb. 2014), *available at* http://www.oecd.org/ctp/calendar-planned-stakeholders-input-2013-2014.pdf.
3. *See* Proposal for a COUNCIL DIRECTIVE amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (25 Nov. 2013), *available at* http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/legislation_proposed/com(2013)814_en.pdf.

[4] This memorandum is available at: http://www.oecd.org/ctp/transfer-pricing/memorandum-transfer-pricing-documentation-and-country-by-country-reporting.pdf.

[5] *See* Parker, "Maruca: Country-by-Country Rules Won't Help U.S.; Current Rules Adequate," 22 Transfer Pricing Rept. 1251 (Feb. 12, 2014).

[6] *See* BEPS/G20 Project: Calendar for planned stakeholders' input 2013-2014, *supra* note 1.

[7] Action item 8 also contemplates that revisions to Chapter VIII of the OECD Transfer Pricing Guidelines on Cost Contribution Arrangements will be published by September 2015.

[8] *See* OECD Live Webcast, BEPS Action Plan: Update on 2014 Deliverables at Slide 25 (23 Jan. 2014), *slides available at* http://www.oecd.org/tax/OECD-BEPS-Webcast-23Jan.pdf; *recorded webcast available at* http://www.oecd.org/tax/beps-webcasts.htm.

[9] Revised Discussion Draft, ¶79.

[10] Revised Discussion Draft, ¶84 (emphasis added).

[11] Revised Discussion Draft, ¶80 (emphasis added).

[12] *See* Greenwald, Osborn & Khripounova, "Cost Sharing Regulations Seek to Limit the Expected Return on Investments in Intangible Property," 43 TM International Journal 3 (Jan. 2014).

[13] *See, e.g.*, United States Council for International Business, "Comments on the OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles" at 7 (Sept. 27, 2013), 2013 TNT 190-38; Tax Executives Inc., Comments regarding the OECD's Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (Oct. 1, 2013), 2013 TNT 191-36.

[14] *See, e.g.*, Revised Discussion Draft, Examples 13-14, n.5 ("Some country delegates believe that fact patterns like those reflected in Examples 13 and 14 could be appropriately addressed by disregarding or recharacterising transactions under paragraph 1.65 [of the OECD Transfer Pricing Guidelines] in some instances because such transactions would not normally occur between independent enterprises. The BEPS action plan calls for additional consideration to be given to the circumstances in which it is appropriate to disregard or recharacterise transactions. The analysis of these Examples will accordingly be discussed further in the context of the work on BEPS.").

[15] *See* OECD Live Webcast, *supra* note8, at Slide 21.

[16] A summary of the legislation, draft statutory language, and a JCT report released with the Baucus Discussion Draft are *available at* http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14.

[17] Summary of Staff Discussion Draft: International Business Tax Reform, Chairman Max Baucus, US Senate Committee on Finance (11/19/2013).

[18] No specific rate reduction has been suggested. The overall effect is intended to be revenue neutral in the long term. *Id.*

[19] Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft of Provisions to Reform International Business Taxation, JCX-15-13 (Nov. 15, 2013).

[20] *Id.*

[21] *Id.*

[22] *See* Bell, Kevin, and Bennett, Alison, "Government Officials Say U.S. Will Not Wait for BEPS Action Plan," 22 Transfer Pricing Report 992 (Dec. 12, 2013).

[23] *Id.*

[24] *Id.*

[25] Technical Explanation of the tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title IV — Participation Exemption System for the Taxation of Foreign Income, JCX-15-14 (February 26, 2014). The Camp Draft Plan also includes proposals denying deductions for the interest expense of U.S. shareholders which are members of worldwide affiliated groups with "excessive" U.S. indebtedness and limiting tax treaty benefits with respect to U.S. withholding tax imposed on deductible related-party payments. In contrast to the Baucus Discussion Draft, the Camp Draft Plan would not repeal the check-the-box rules, or allow the expiration of the section 954(c)(6) look-through rule.

Mayer Brown is a global legal services organization advising many of the world's largest companies, including a significant portion of the Fortune 100, FTSE 100, DAX and Hang Seng Index companies and more than half of the world's largest banks. Our legal services include banking and finance; corporate and securities; litigation and dispute resolution; antitrust and competition; US Supreme Court and appellate matters; employment and benefits; environmental; financial services regulatory & enforcement; government and global trade; intellectual property; real estate; tax; restructuring, bankruptcy and insolvency; and wealth management.

Please visit our web site for comprehensive contact information for all Mayer Brown offices. www.mayerbrown.com

IRS CIRCULAR 230 NOTICE. Any advice expressed herein as to tax matters was neither written nor intended by Mayer Brown LLP to be used and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed under US tax law. If any person uses or refers to any such tax advice in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to any taxpayer, then (i) the advice was written to support the promotion or marketing (by a person other than Mayer Brown LLP) of that transaction or matter, and (ii) such

taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

Mayer Brown is a global legal services provider comprising legal practices that are separate entities (the "Mayer Brown Practices"). The Mayer Brown Practices are: Mayer Brown LLP and Mayer Brown Europe – Brussels LLP, both limited liability partnerships established in Illinois USA; Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales (authorized and regulated by the Solicitors Regulation Authority and registered in England and Wales number OC 303359); Mayer Brown, a SELAS established in France; Mayer Brown JSM, a Hong Kong partnership and its associated entities in Asia; and Tauil & Chequer Advogados, a Brazilian law partnership with which Mayer Brown is associated. "Mayer Brown" and the Mayer Brown logo are the trademarks of the Mayer Brown Practices in their respective jurisdictions.

This Mayer Brown publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein.

© 2014 The Mayer Brown Practices. All rights reserved.