Managing transfer pricing audits in the BEPS environment: Industry’s perspective

Mickey Culpepper, Purvez Captain, David J. Canale

Tax executives institute tax school

February 17, 2016
Agenda

► Update on LB&I restructuring and transfer pricing enforcement
► BEPS and OECD developments affecting transfer pricing
► IRS Audit Experience
► Global tax controversy management
► Appendices
  ► Notice 2015-54
  ► Proposed 367(d) and Temporary 482 regulations
Update on LB&I restructuring and transfer pricing enforcement
New transfer pricing executive team effective Feb. 7

- Sharon Porter, Director Treaty and Transfer Pricing
  - Cheryl Teifer, Director of Field Operations Transfer Pricing Practice
  - Hareesh Dhawale, Director APMA
  - Deborah Palacheck, Director Treaty Administration (includes TAIT and EOI)
- John Hinding, Director Cross Border Activities
LB&I proposed restructuring – Three key changes

1. LB&I will eliminate domestic/international distinction
2. LB&I will restructure into nine practice areas

► **Subject-matter areas**
   1. Pass-through entities
   2. Enterprise activities
      ► Includes financial products and institutions, corporate issues and credits, and penalties
   3. Treaty and transfer pricing
   4. Withholding (Form 1042, FACTA) and international individual compliance
   5. Cross-border activities
      ► International activities other than transfer pricing and withholding areas

► **Geographic compliance areas**
   1. Northeast (New York)
   2. East (Downers Grove, Illinois)
   3. Central (Houston)
   4. West (Oakland, California)
3. LB&I moving to centralized issue selection based on risk

- A shift to a centralized issue development process or “campaign” that focuses on how to identify and address compliance risks.
  - Campaign-related actions would include development of training materials, technical positions, and audit aids, among other tools.
  - Develop “treatments” or enforcement work streams – e.g., soft letters, exams, public guidance, other)
- New process integrates recent Information Document Request changes and new claim filing policy
- LB&I will generally be moving away from the Coordinated Industry Case (CIC) approach
- Any potentials changes to the compliance assurance process (CAP) have yet to be determined
Treaty and Transfer Pricing Operations (TTPO)
Role of TTPO

► All transfer pricing enforcement personnel under one roof
  ► APMA, TPP, IPNs, TAIT, JITSIC, Field Economists
    ► IEs part of cross-border activities to start, but will work with TTPO
  ► Sharon Porter, currently with IBC, named first TTPO Director
  ► TPP and APMA will generally remain as is
    ► APMA will reorganize to create three Associate Director positions, each responsible for specific branches and country coordination
    ► Appointments: Donna McComber (DC); Peter Rock (SF), Nancy Wiltshire (DC)
► TTPO will have “primary” jurisdiction over TP issues
  ► Will develop all TP-related campaigns and treatments
  ► Will coordinate with other practice areas, particularly the four regions
  ► Level of involvement in audits will increase, but continue to vary
► Implications for taxpayers of centralized enforcement
  ► Unlikely to see major changes in current strategies and issue focus
  ► Effect of top-down issue identification on exams and elevation
Role of TTPO

- Three current core strategies:
  - Better case selection, development, and presentation
    - “Take back the audit process”
    - TPP audit road map – new rules of engagement required
  - Information Document Request (IDR) directives
  - Updated APA and MAP revenue procedures (see Appendices 1 and 2)
  - Section 6038 regulations (i.e., country-by-country reporting)
  - Revise technical rules to support “rational” economic outcomes
    - Section 721 partnership notice
    - Section 367(d) and 482 regulations
  - Win in litigation to rebalance perceived hazards
    - Retain preference for audit resolution, but…
    - Tougher tactics at IRS Appeals
    - Designated summons and use of outside counsel (e.g., Microsoft)
    - Designated cases (e.g., Amazon, Coca Cola, Microsoft)
Role of TTPO
Perceived TP risks?

- If focus on issues, which TP issues viewed as most risky?
  - IP transfers
    - Income method at least as corroborating method
  - Restructurings (e.g., supply chain/procurement companies)
  - High-value services (e.g., oil and gas industry)
  - Financial transactions within non-financial institutions (e.g., loans, preferred interests, guarantees)
  - US distribution
    - Balancing foreign-initiated adjustments
  - ROA/ROI as PLI
    - Not just for manufacturing
    - $ investment?
BEPS and OECD developments affecting transfer pricing
BEPS project
Final reports

- Final BEPS reports issued by OECD on October 5, 2015:
- Recommendations for domestic law and treaty provisions in variety of forms:
  - There are also analytical reports on the overarching actions.
  - Some measures may have (almost) immediate effect in a number of countries.

<table>
<thead>
<tr>
<th>Immediate impact</th>
<th>Treaty-based action</th>
<th>Legislative action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Action 8 – TP for intangibles</td>
<td>Action 2 – Hybrid mismatch arrangements</td>
<td>Action 2 – Hybrid mismatch arrangements</td>
</tr>
<tr>
<td>Action 9 – TP for risks and capital</td>
<td>Action 6 – Treaty abuse</td>
<td>Action 3 – Controlled foreign corporation (CFC) rules</td>
</tr>
<tr>
<td>Action 10 – TP for other high-risk transactions</td>
<td>Action 7 – Permanent establishment status</td>
<td>Action 4 – Interest deductions and other financial payments</td>
</tr>
<tr>
<td>Action 13 – TP documentation and CbC reporting</td>
<td>Action 14 – Dispute resolution</td>
<td>Action 5 – Harmful tax practices</td>
</tr>
<tr>
<td></td>
<td>Action 15 – Multilateral instrument</td>
<td></td>
</tr>
</tbody>
</table>

Analytical reports

- Action 1 – Digital economy
- Action 11 – Economic analysis of BEPS
- Action 15 – Multilateral instrument
Implications of BEPS project on TTPO

- Major themes: increased transparency, subjectivity, uncertainty, controversy
- US generally lukewarm on BEPS project, but can expect:
  - Marginally more aggressive technical enforcement, e.g.:
    - Recent transfer pricing-related notices and regulations
    - Cash box arrangements
    - Contractual risk allocations vs. valuations of risk
  - Cooperation on transparency
    - Country-by-country reporting
    - Information exchange
  - Mostly defensive posturing
    - Perception that BEPS project targeted US companies
    - Expectation of aggressive and/or inconsistent foreign-initiated adjustments
    - Focus on making mutual agreement process (MAP) more effective
Implications of BEPS project on taxpayers

- Increased need for:
  - Coordinated intercompany business models
    - Not limited to tax function
    - Global policies helpful, but, at a minimum, must know and be able to explain local exceptions
    - Assess use of alternative dispute resolution processes (e.g., APAs, MAP, treaty arbitration vs. domestic procedures)
  - Consistent messaging to tax authorities
    - Facts, analyses, and conclusions
  - Constant internal communication
    - Who’s in charge?
    - Internal and external resources
US Treasury and IRS issue proposed regulations on CbC

- Proposed regulations include a template modeled on the OECD recommendations, however, there are some differences.
- US persons that are the ultimate parent entity of a MNE group with annual revenue of $850m or more for the immediately preceding annual accounting period would be required to file CbC.
- Proposed to apply to tax years of ultimate parent entities of US MNE groups that begin on or after the date the Proposed Regulations are finalized and that include annual accounting periods of all foreign constituent entities and tax years of all domestic constituent entities beginning on or after that date.
- Information reported will be treated as return information under IRC Section 6103, with the attendant confidentiality provisions and exchange-of-information conditions associated with tax return information.
IRS Audit Experience
IRS audit administrative tactics

- IRS is using Administrative tools to strengthen its case and improve its ultimate position, while disregarding the intended purpose of the given process.
- Fast-Track
  - Came back with revised economist report and larger adjustment in NOPA.
- IDR requests foreign TP doc and tax returns under §6038A
- IDR requests a confirmation of a “statement of facts.”
  - Intended to get insight into your position/counter-arguments.
  - Knowing disregard of the responded facts in their write-up.
- Imposing penalties to require taxpayer to submit a reasonable cause statement.
  - Try to argue the statement constitutes waiver of privilege.
- Requiring closing agreement in MAP eligible cases
Current Environment/Trends – Global Tax Exams of Baker Hughes

- Tax assessments from tax examinations are increasing in both volume and amounts in controversy due to acute need by governments to raise revenue – especially oil revenue dependent countries like Brazil/Canada/Mexico
- Nations are emboldened to conduct more invasive and aggressive tax examinations as a result of the current tax morality debate and the Base Erosion and Profit Shifting (“BEPS”) project, global initiative of G20-OECD – (i.e., Australia, China, Indonesia, Mexico, and Germany)
- Governments are adopting “unilateral measures” and asserting positions that diverge from historic international tax norms based on BEPS project released discussion of tax reform recommendations
Income tax audits/appeals by region for Baker Hughes resource requirements greatest in NA, LA and EARC tax exams
Proactive steps implemented by Baker Hughes – Tax group

- Adopted Global Approach to Tax Risk and Controversy Management
- Global Tax Examination Policies and Management Strategies Implemented with Centralized Coordination of Cross Border Tax Exam Responses
- Engaged a Global Tax Controversy Legal Service Provider for Controversy Issues
- Adopted Global Alternative Dispute Resolution (“ADR”) Mechanisms as Part of Tax Examination Management (Enhanced Relationship Audits, APAs, Tax Rulings, MAP cases)
Template for TP responses on cross border tax exams

► Introduction to Company
  ► Region/Geomarket organization
► Product Line Explanation
  ► Emphasize provision of services and products bundled to client
► Industry Review
► Local Entity under review
  ► Simplified legal entity chart
  ► Simplified org chart
  ► Summary of financials/operations
  ► Local industry review (if appropriate)
► I/C Transactions
  ► Use of consistent global TP policy
  ► Simplified transaction flow diagrams
Global tax controversy management
Leading practices for effective global tax controversy management

- Evaluate global resources, processes and systems for tax risk management
- Manage your ongoing and potential controversies at a strategic level
- Include global tax risk as a corporate governance issue
- Stay connected with global legislative, regulatory and tax administration changes

Adopt a global approach to tax risk and controversy management
# Proactive tax controversy management – and ways to get it right

<table>
<thead>
<tr>
<th>Adopt a global approach to tax controversy</th>
<th>Evaluate global systems/processes</th>
<th>Manage controversies</th>
</tr>
</thead>
<tbody>
<tr>
<td>► Implementing effective tax risk strategies can reduce tax audit risk.</td>
<td>► Creating an internal environment of openness and transparency leads to earlier identification of risk issues.</td>
<td>► Establishing global policies and procedures facilitates management oversight of global controversies.</td>
</tr>
<tr>
<td></td>
<td>► Resolving a dispute in one country can have implications across the entire tax agenda.</td>
<td>► Recognizing issues early provides opportunities for tax audit strategy and resolution.</td>
</tr>
<tr>
<td></td>
<td>► Integrating tax with business planning can facilitate the proactive management of controversy.</td>
<td>► Implementing a globally coordinated approach enhances the ability to manage and prioritize global controversy risk.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>► Assessing the multijurisdictional impact of a tax issue early can provide opportunities for resolution across multiple jurisdictions.</td>
</tr>
</tbody>
</table>
What should you do now to improve your tax controversy risk management?

<table>
<thead>
<tr>
<th>Big picture: company framework</th>
<th>Pre-controversy</th>
<th>Current-controversy</th>
<th>Post-adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Review your company’s existing tax controversy risk management framework and make improvements:</td>
<td>Consider conducting a tax risk assessment/mock audit</td>
<td>Audit defense strategy</td>
<td>Know your rights and options (pros/cons)</td>
</tr>
<tr>
<td>▶ Understand and improve global systems capabilities to implement tax controversy strategy to centralize monitoring, management and communications</td>
<td>▶ High-level or light version (e.g., single country or issue)</td>
<td>With information sharing among tax authorities, consider implications for others in the group, especially in the supply chain</td>
<td>▶ Domestic appeals</td>
</tr>
<tr>
<td>▶ Establish global policies and procedures for controversy management</td>
<td>▶ Deep or full version (multiple country, various hot issues)</td>
<td>Understand all of the goals and objectives of tax authority as well as your company</td>
<td>▶ Mutual agreement procedure/accelerated competent authority procedure</td>
</tr>
<tr>
<td>▶ Coordinate responses to various tax authority inquiries around the world from the center</td>
<td>▶ What happens if need to escalate?</td>
<td>Know when to escalate:</td>
<td>▶ Advance pricing agreement</td>
</tr>
<tr>
<td>▶ Establish cross-functional business support of tax strategy</td>
<td>Mock audit results work product</td>
<td>▶ Within tax authority</td>
<td>▶ Litigation</td>
</tr>
<tr>
<td>▶ Ensure tax is integrated with business planning</td>
<td>▶ Tax Risk Heat Map:</td>
<td>▶ When to bring in advisors – back office consult or with tax authority</td>
<td>▶ Pre-payment versus interest tolling</td>
</tr>
<tr>
<td></td>
<td>▶ Issues</td>
<td></td>
<td>▶ US foreign tax credit (FTC) impact of decision</td>
</tr>
<tr>
<td></td>
<td>▶ Countries</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Appendices
Foreign IP partnership

Issues with traditional IP structures:
- USP may pay high residual US tax on royalty income
- Transfer of IP rights to CFC may be inefficient
- Taxable transfer to CFC may be irreversible and legislative proposals may change relevant considerations

IP partnership may address problems:
- Contribution to partnership may be tax-free under section 721, subject to Notice 2015-54
- Special allocations from partnership may increase effective tax rate attached to USP income share
- Foreign partnership may serve as supply chain principal
Notice 2015-54 (8/5/15)

- Notice 2015-54 states that Treasury will issue regulations covering US partners’ transfers of appreciated property to controlled foreign partnerships with a related foreign partner
- **General rule**: Immediate gain recognition
- **Exception**: Taxpayers may defer gain recognition if they use the remedial method for property contributed by the US partner
- The Notice further states that US transfers including IP will be subject to the periodic adjustment (CWI) rules of Reg. Sec. 1.482-7(i)(6)
Simplified example

- USP is in an excess FTC position
- IP would produce an annual net royalty of $100x subject to no foreign withholding tax
- US contributes IP with an FMV of $1,000x and a 10-year life to Foreign Partnership
  - USP will receive annual remedial allocations of $100x
- USP’s distributive share of partnership income before remedial allocations would be $100x
- USP’s distributive share carries FTCs at a 20% rate
- CFC’s contributed property produces no remedial allocations
### Simplified example

<table>
<thead>
<tr>
<th></th>
<th>IP license</th>
<th>Pre-notice partnership</th>
<th>Post-notice partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income</td>
<td>100</td>
<td>100</td>
<td>200</td>
</tr>
<tr>
<td>Tentative US tax</td>
<td>35</td>
<td>35</td>
<td>70</td>
</tr>
<tr>
<td>FTC</td>
<td>0</td>
<td>25</td>
<td>50</td>
</tr>
<tr>
<td>Net US tax</td>
<td>35</td>
<td>10</td>
<td>20</td>
</tr>
</tbody>
</table>
Proposed 367(d) and temporary 482 regulations
Relevant section 367 and 936 provisions

- **367(a)(1)** – Provides that if a US person transfers property to a foreign corporation in a section 332, 351, 354, 356, or 361 exchange, the foreign corporation is not treated as a corporation for purposes of recognizing gain (i.e., gain is generally recognized by the US transferor).

- **367(a)(3)** – Provides that, except as provided in the regulations, section 367(a)(1) does not apply if the property transferred to the foreign corporation is used by the foreign corporation in the active conduct of a trade or business outside the US. The exception does not apply to intangible property described in 936(h)(3)(B).

- **367(d)** – If a US person transfers property described under section 936(h)(3)(B) to a foreign corporation in a section 351 or 361 exchange, section 367(a)(1) does not apply but the US person must generally recognize deemed royalty income going forward under section 482 principles; however, the current temp. regulations under 367(d) exclude foreign goodwill and going concern value from the deemed royalty rule.

- **936(h)(3)(B)** – does not specifically describe goodwill or going concern value but has a catch-all provision that describes “any similar items”.
Under the proposed regulations, upon an outbound transfer of foreign goodwill or going concern value, a US transferor will be subject to either current gain recognition under section 367(a)(1) or the tax treatment provided under section 367(d) [deemed royalty]"
Paradigm transactions

**Branch Incorporation**
- SHs
- USCO
- Branch
- F Newco

Transfer of FGGCV in 351 exchange

**Outbound reorganization**
- SHs
- USCO
- US Sub
- Branch
- F Newco

Transfer of FGGCV in 361 exchange

F Newco Stock
Reg – 139483-13 proposed regulations under § 367

► Notice of Proposed Rulemaking issued 14 September 2015 (corr. 4 November 2015)
  ► Proposed regulations are to be retroactively effective to 14 September 2015
  ► Should be seen as part of larger project dealing with transfer of US IP offshore using special purpose IRC provisions to arguably avoid cost sharing regulations of Treas. Reg. §1.482-7 or general 482 principles

► Subchapter K
  ► Notice 2015-54 is notice of new regulations that will deal with transfer of IP through partnerships among related parties and apply principles of § 1.482-7 to determine value of transferred IP

► Section 482
  ► TD 9738 adopts Temporary Regulations that amend Treas. Reg. § 1.482-1 (coordination rule with § 936) and also are proposed regulations under Reg. 139483-13
  ► Emphasis on valuing transactions in the aggregate, accounting for all value transferred, even if governed by different code sections
Unusual procedural aspects

- Regulations proposed pursuant to Reg. 139483-13 are to be retroactively effective to 14 September 2015
- Regulations to be adopted pursuant to Notice 2015-54 (application of Treas. Reg. § 1.482-7 to controlled transactions involving partnerships) are retroactively effective to 15 August 2015
- Temporary regulations under § 482 generally adopted in a three step process except here.
  - Typically, Proposed Regulations → Temporary Regulations → Final Regulations.
  - In this case, Temporary Regulations → Final Regulations

Implication is that IRS views these regulations as dealing with transactions that are making use of loopholes that should be closed immediately

- Section 367(a) requires US transferor of property to recognize gain (but no loss) for transactions described in §§ 332, 351, 354, 356 or 361
  - Property transferred to foreign corporation for active conduct of a trade or business is exempt.
  - Exemption applies to all property not excluded in regulation
- Proposed regulations significantly limits this exemption by providing it applies only to “eligible” property
  - Tangible property
  - Working interests in oil and gas property
  - Certain financial assets
  - Cannot be “ineligible property”
    - Inventory and like property
    - Accounts receivable, installment obligations and like property
    - Foreign currency and like property
    - Certain leased tangible property
Reg – 139483-13 issues addressed by Prop. Reg. (2)

- Section 367(d) requires recognition of gain upon the outbound transfer of property
  - Identified as intangible property under § 936(h)(3)(B)
  - In transactions described in §§ 332, 351, 354, 356 or 361.
- Regulations currently provide § 367(d) does not apply to transfers of foreign goodwill and going concern value (FGGCV)
  - However, this exclusion is eliminated from proposed regulations
  - One could still argue FGGCV are not listed in § 936(h)(3)(B) so § 367(d) should not apply
- Narrowing of exemption under § 367(a) means FGGCV not specifically excluded from application of § 367(a)
- Proposed regulations give taxpayer option of applying either § 367(a) or § 367(d) to transfers of FGGCV
Reg – 139483-13 implications for clients

- Proposed regulations take position inconsistent with position taken by many taxpayers
- Creates possibility for further controversy, particularly because of the proposed retroactive date of 14 September 2015
  - Implications of *Altera* opinion?
- Raises complex issues in time of drastic reduction in number of IRS employees dealing with compliance
- Leaves open many technical issues
Bio

David J. Canale Principal
Americas Leader, Transfer Pricing Controversy Services

Tel +1 202 327 7653
Fax +1 866 216 9039
Email david.canale@ey.com

David J. Canale is EY’s Americas Leader, Transfer Pricing Controversy Services. He has over 20 years of experience in transfer pricing. Dave advises both US and foreign-based multinational companies on transfer pricing controversy and risk management, planning and structuring. He assists clients with transfer pricing policies, controversy resolution (including audit dispute resolution), Advance Pricing Agreements (APA), Mutual Agreement Procedures (MAP) and monitoring tax treaties and competent authority. Dave works with companies in a variety of industry sectors, including pharmaceutical, medical device, electronics, computer, telecommunications, energy, transportation, entertainment, automotive, heavy manufacturing, food and beverage, consumer goods, apparel, publishing and information services, retail and chemical.

Prior to joining EY, Dave served with the Internal Revenue Service’s APA Program in the Office of Associate Chief Counsel (International). He was acting branch chief for the program and served as program coordinator for all bilateral APAs with Canada. He also developed strategies and coordinated with the US competent authority regarding negotiations with various treaty partners. Dave’s combined IRS and private practice APA and MAP experience includes well over 200 cases, comprising files with Japan, Canada, Mexico, UK, Germany, France, The Netherlands, Switzerland, Belgium, Australia, China, India, Korea and Indonesia.
Bio

► Bill Macey
► Telephone: +1 713 750 1283

► Bill Macey is a Principal in Ernst & Young LLP’s Southwest Region Transfer Pricing and Economics practice in Houston.

► Prior to joining Ernst & Young LLP, Bill worked with the Public Utility Commission in the Electric Division in Austin, Texas, from 2001-2002. There, he assisted with the introduction of economic competition into the retail electricity market, managed the regulatory approval process for electricity aggregators and participated in various rule-making committees.

► Bill has over thirteen years of experience providing transfer pricing services and has worked on a wide range of projects including advance pricing agreements, global transfer pricing documentation, economic modeling, valuation of intangible assets, headquarter services studies, and general economic consulting. Bill’s focus is on the energy industry and his clients include super-major and independent oil and gas, oilfield service, and exploration and production drilling companies.
Bio

Mickey G. Culpepper
Director – Global Tax Planning, Risk & Governance
BAKER HUGHES INCORPORATED

► Mickey Garland Culpepper has been with Baker Hughes Incorporated (“BHI”) in various tax leadership positions over the past 40 years. He currently is the Director - Global Tax Planning, Risk & Governance for BHI with oversight of 200+ income tax examinations and related controversies.

► Prior to joining BHI, Mickey was a tax consultant with KPMG in Shreveport, Louisiana. He graduated from University of Louisiana - Monroe in 1973 with bachelors in accounting, is a Certified Public Accountant, member of AICPA, and Tax Executive Institute (“TEI”).

► Mickey has negotiated resolution of tax examinations in a dozen or more countries, responded “no” to multiple requests for bribes to resolve tax assessments, worked directly with U.S. Competent Authority on double taxation issues, and obtained a U.S./Canadian APA covering 12+ years. Also, Mickey defended BHI and its tax employees from civil tax fraud allegations filed by a Tax Whistleblower, and successfully moved BHI’s U.S. tax examinations into the IRS Compliance Assurance Process (“CAP”).
About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of
Ernst & Young Global Limited operating in the US.

© 2016 Ernst & Young LLP.
All Rights Reserved.
1602-1821132
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.

ey.com