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Planning for Multilateral Tax Controversy in the Post-BEPS World

1. Introduction

All multinational groups (MNEs) are, should or will be addressing their existing international tax planning structures with respect to a new world that is rapidly changing in apparently dramatic ways. The process may be supervised at the level of the board of directors, reflecting the seriousness of elements on the horizon.[1]

The changes on the horizon are prefaced with the word *apparently*. The authors use this term because the changes are only new in the sense of potentially being required on a global basis. Over the past 30 or so years, a similar process has occurred in certain countries on an examination and dispute resolution basis. MNEs have provided complete information in such contexts, and the disputes between treaty countries have been resolved via treaty-based mutual agreement procedure (competent authority) proceedings which are indeed non-transparent (i.e. in the dark for the rest of the world) or before the courts in instances where there is no applicable treaty (judicial decisions are open for review, but tend to be far different than treaty-based solutions).

Knowledge gained from these prior periods may be instructive in terms of the way forward with the developments in place or on their way.

2. Background

Two years ago, it would have been rare that the global tax and transfer pricing strategies of MNEs would find their way onto the front pages of financial centre newspapers and magazines. This has become a new normal,[2] with criticism of such taxpayers growing in volume and intensity.

In 2012, the European Commission unveiled plans to "crack down on tax havens and aggressive tax planning by companies" as one means of helping EU states recover from their economic downturns.[3] Similarly, the G7 and G20 asked the OECD to review applicable rules to reduce the ability of MNEs to shift profits (i.e. base erosion).[4] In the United States, Treasury officials sang a consistent tune, advising that any broad tax reform must focus on the base erosion fight.[5] These comments largely relate to the concerns of OECD member countries.

At the same time, there has been controversy with non-OECD countries (whether designated as developed, developing, emerging or otherwise, source countries) concerning their own tax base defence. They have objected with increasingly strident voices to the essential structure of the OECD and the United Nations (UN) model income tax treaties (for reasons noted below). Non-governmental organizations and other groups have also been active members of the base erosion choir.

While rhetoric pillories the planning models of MNEs, at least two elements are consistently lost in the attacks. First, the planning paradigms utilized by MNEs are largely the result of treaty models, transfer pricing guidelines and domestic laws developed almost a century ago. Second, countries themselves commonly seek to expand their economies by offering financial incentives, special tax regimes and related policy environments (available regimes) to generate economic activity and growth within their borders (economic foundation), which may be perceived by other countries as eroding their own tax bases.[6]

In February 2013, the OECD launched a project to study base erosion and profit shifting (BEPS), including focus on transfer pricing, tax administration cooperation, substantive law and treaty mechanisms (the BEPS project).[7]

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1. *See* K.A. Bell, *BEPS Project Will Lead Boardrooms to Scrutinize Tax Planning, [US Treasury Official Robert] Stack Predicts*, 24 BNA Transfer Pricing Rep. 11 (14 May 2015).
2. *See* e.g. J. Drucker, *OECD Enables Companies to Avoid $100 Billion in Taxes*, bloomberg.net (18 Mar. 2013); J. Gapper, *Politicians Should Stop Posturing on Corporate Tax*, Fin. Times (31 Jan. 2013); B. Quinn & J. Ball, *UK's Top Companies Condemned for Prolific Use of Tax Havens*, The Guardian (15 May 2013); S. Thurm & K. Linebaugh, *More U.S. Profits Parked Abroad, Saving Taxes*, Wall St. J. (10 Mar. 2013); *The Missing $20 Trillion*, The Economist (16 Feb. 2013), at 13; *Silicon Valley vs. Corporate Taxes*, www.law.com/corporatecounsel (18 Mar. 2013); *Wake Up and Smell the Coffee*, The Economist (15 Dec. 2012), at 66; *Google Doubles Revenues Switched to Bermuda*, Fin. Times (13 Dec. 2012), at 18; V. Houlder & J. Pickard, *Pressure to End Digital "Tax Bonanza"*, Fin. Times (3 Jan. 2014).
3. J. Kirwin, *European Commission to Launch Plan Against Tax Havens, Corporate Tax Loopholes*, BNA Daily Tax Rep. (6 Dec. 2012), at I-2; J. Kirwin, *European Commission Calls for Larger Crackdown on Harmful Business Taxation*, BNA Daily Tax Rep. (7 Dec. 2012), at I-2. *See also* C. Lowell, M. Burge, R. Hammer & M. Levey, *International Transfer Pricing: OECD Guidelines* (Warren Gorham Lamont/Thomson Reuters 2015), para. 2.06(2).
4. *See* K.A. Bell, *G-20 Asks OECD to Review Rules with Goal of Curbing Profit Shifting*, BNA Daily Tax Rep. (11 Dec. 2012), at I-1; K.A. Bell, *OECD Committed to Holistic, Fundamental Review of Broken Tax System, Transfer Pricing Chief Says*, 21 BNA Transfer Pricing Rep. (21 Feb. 2013), at 1023.
5. *See* D.W. Gregory, K.A. Bell & A.M. Parker, *Public Outrage Over 'Profit Shifting' Puts Transfer Pricing Center Stage as BRIC Countries Command More Influence*, 21 BNA Transfer Pricing Rep. (10 Jan. 2013), at 851.
6. These elements are addressed with respect to the "State aid" processes presently underway in the European Union at sec. 5.4.
7. *See* OECD, *Addressing Base Erosion and Profit Shifting* (OECD Publishing 2013), International Organizations' Documentation IBFD. A cynic might note that this appears to be a retooling of the "harmful tax competition" initiative of the 1990s, discussed at sec. 5.3.6.4., which produced a broader range of information sharing arrangements (*see* Lowell, Martin & Levey, *supra* n. 3, paras. 2.06(2) and 12.02), as well as the business restructuring provisions added to the *OECD Guidelines* in 2010. *See* Lowell, Martin & Levey, *supra* n. 3, para. 12.02(2)(d).

In the interim, there has been a veritable flood of discussion drafts and commentary flowing from the OECD, as well as enactment by certain countries of their own tax base protection regimes.[8]

The net result of these elements is an ever-increasing level of tension in the world of international taxation, with an unfortunate deluge of disputes, aging inventories of competent authority cases and domestic resolution processes that are overwhelmed with cases in volume and complexity for which they are ill equipped to achieve efficient resolution. This is an unfortunate situation from the perspective of all parties in the international tax community.

While these developments present a challenging horizon for international tax planners, the issues to be addressed have been present in other circumstances over the years. Experience in those periods provides perspective on how MNEs can thoughtfully evaluate extant planning regimes and appropriate paths forward.

This article reviews the realities on the horizon and suggests means by which MNEs can prepare for the arrival thereof by reference to experience over the years.

3. Illustrative Example: Supply Chain Rationalization

Globalization is a fact of life for any MNE that must compete with global rivals often enjoying low effective tax rates (due to country of residence, incentives or otherwise). The essential challenge posed by globalization is the need to relentlessly squeeze cost out of the supply chain to maximize competitive position. The effective tax rate is one element of cost – often a material element. Accordingly, in virtually every group there is a continuous process of seeking to rationalize and drive cost efficiency from design, production, distribution, servicing, administrative and other functions. This often involves an increase or decrease in functions performed or risks borne in respective countries.

As MNEs are concerned about minimizing the tax cost of their operations, tax authorities in each country impacted by such rationalization processes are equally vigilant to defend their domestic tax base. Accordingly, a tax authority will scrutinize transactions to determine whether functions – including underlying risks – of its domestic companies are restructured in a manner that is not consistent with the arm's length transfer pricing standard or other applicable criteria.

The considerations to be addressed in future planning can seem like abstractions until placed into context with an illustration. Consider the following example.

Example

AlphaCo is the Country *X* parent of a group of companies engaged in the development, production, distribution and servicing of Unique Products. Under the traditional supply chain process, Unique Products were produced entirely in the Country *X* factories of AlphaCo, and then sold to affiliates around the world for distribution and servicing. The competitive situation for Unique Products is intense, with AlphaCo having many global competitors. Because Country *X* is a high-cost and high-tax country, AlphaCo has sought to move as many functions as possible to lower cost countries. The first step in this process many years ago was the formation of a wholly owned subsidiary, SubCo, which would build a production facility in Country *Y* to produce parts for Unique Products.

The next step was the formation of a holding company, HoldCo, in Country *B*, which offers a low effective tax rate. HoldCo will perform all service/administrative functions for the global business outside the United States. HoldCo will acquire production facilities in Country *C* through a new subsidiary from an unrelated party and renovate them to perform final assembly of Unique Products for its non-US territory.

As it is about to implement the HoldCo plan, AlphaCo has requested advice on (i) the international tax considerations that it needs to take into account and (ii) an agenda for implementing its evolving a strategy in a manner to successfully navigate those considerations.

The current supply chain of Unique Products is as follows, with a comparison to AlphaCo's competitors, which have already undertaken material steps to decentralize their processes to drive costs out of their systems:

Function	Performed in	Effective tax rate (%)	Problem/ Opportunity
AlphaCo			
Current			
Design	X	42	High op. costs
Procurement/ logistics	X	42	High op. costs
Parts production	Y	25	Op. costs +
Final production	X	42	High op. costs
Sale to distributors	X	42	High op. costs
Distribution	Local	25	High op. costs
Central services	X	42	High op. costs
Overall:		34	High op. costs, increasing *Unit cost: 100*
Competitors			
Overall:		22	*Low op. and tax costs* *Unit Cost: 60*
Competitive Disadvantage:		12	*40*
AlphaCo			
Plan			
Design	X	42	High op. costs
Procurement/ logistics	B	10	Fair op. costs
Parts production	Y	25	Low op. costs
Final production	C	10	Op. costs +

8. *See* sec. 5.6.

Function	Performed in	Effective tax rate (%)	Problem/ Opportunity
Sale to distributors	B	10	Fair op. costs
Distribution	Local countries	15 (avg.)	*B* is the principal
Central Services	B	10	Fair op. costs
Overall:		26	*Lower op. costs and effective tax rate; more to do*

To implement the plan, the following evolution of functions or risks is contemplated (functional evolutions):
– procurement: move from Country *X* to Country *B*;
– parts production: move from Country *X* to Country *Y*;
– final assembly: move from Country *X* to Country *C*;
– sales: move from Country *X* to Country *B*;
– distribution: local country controlled distributors converted to cost-plus "commissionaires" (move to Country *B* principal); and
– central services: move from Country *X* to Country *B*.

This example frames critical elements of today's evolving world of international taxation. In the process of addressing the questions framed by AlphaCo, it will be necessary to explain the evolutions that are occurring, and then contemplate the means of addressing those points in the most efficient manner possible – with all of the uncertainties that seem to exist for such global supply chain restructuring.

4. Origins of Current MNE Planning Regimes

As a point of beginning, the planning paradigms that are the subject of so much controversy today are a reflection of the historical evolution of today's model treaties and transfer pricing policies. The model treaty process evolved from the immediate post-World War I era in which the International Chamber of Commerce commenced a process. Its approach sought to balance the interests of all countries with regard to the allocation of income from cross-border operations. The essential model assumed was that of a corporation located in one country (the residence country) with operations in another country (the source country). In the event the countries could not agree on the allocation of income, the International Chamber of Commerce proposed a solution intended to balance the interests of residence and source countries via, essentially, a formulary split of the tax revenue (e.g. a 50/50 split of the "profit").[9]

The International Chamber of Commerce recommendations were not adopted. Instead, the League of Nations assumed responsibility for the process. The League's focus was to provide a basis to eliminate international double taxation. It proceeded in a manner that had the result of enshrining the prevailing mercantilist paradigm for the benefit of the capital exporting countries (victors of the war with war debt to be repaid). The result was to maximize the allocation of residual profit to the residence country, with the source country having the right to tax only local activities. In the 1920s, the paradigm was described as "imperial" and "colony" countries. For these purposes, an interim holding company was treated as a residence-country company entitled to residual profit (it then being assumed that all countries would adopt similar tax laws). This paradigm persisted into the post-World War II OECD and UN Model Conventions.

Transfer pricing principles evolved to facilitate the allocation of income to residence countries. This occurred via establishing so-called one-sided methodologies, with two-sided methodologies being the least favoured. The term "one-sided" refers to methodologies that test the financial results of related-party transactions by focusing on one party to the transactions and the financial results of that party (such as the resale price, cost-plus and comparable profits/transactional net margin methods), as opposed to "two-sided" (profit split) analysis that focuses on all parties to the transactions and their combined income.

In the context of the Example in section 3., structuring global business so that residual income is earned in a residence country company – even if it is an interim holding company resident in a low-tax jurisdiction – would be consistent with extant treaty and transfer pricing policies. In other words, the perceived base erosion that has become such a popular political issue in today's world was an intended result a century ago.[10]

However, the historical model is plainly under scrutiny for that precise reason (i.e. base erosion).

5. Considerations for Planning

5.1. Abandonment of the historic model

While the historic model has persisted for almost a century, it has largely been abandoned, even within residence countries. Critical events include the following:
– most residence countries, except the United States and a few others, have replaced tax regimes designed to attract global income to the residence country in favour of source-based regimes (such as a territorial tax);
– most countries have adopted tax-efficient regimes (such as the UK patent box)[11] plainly designed to attract inbound investment and economic activity at the expense of similar objectives in other countries (i.e. depleting the tax base of other countries);
– the rise of the source countries has brought increasing pressure to bear on the OECD, which needs their

9. In these early discussions, the bedrock principle was that where a company does business in more than one country (i) the profits should be taxed in each country in proportion to the profit realized therein; (ii) if the countries cannot agree, the allocation would be presumed to be proportional to sales (turnover); provided that (iii) in no case should such proportions exceed the total fixed by the "competent authority in the country of domicile" (residence). *See Programme of the Congress and Draft Resolutions*, International Chamber of Commerce Second Congress Rome (March 18-25, 1923), Brochure 23, at 34-35 (the 1923 International Chamber of Commerce Proceedings). *See generally* B. Wells & C. Lowell, *Income Tax Treaty Policy in the 21st Century: Residence vs. Source*, 5 Columbia Tax J. 1 (2014); Lowell, Martin & Levey, *supra* n. 3, para. 12.02(1)(a).

10. *See generally* B. Wells & C. Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 Tax L. Rev. (2012), at 535, 551-561.
11. *See* sec. 5.6.

membership or cooperation. Concessions are apparent in the inclusion of "soft" intangibles in the 2012 updating of the intangibles guidelines, reflecting policies of source countries;[12]
- the digital economy provides a different model of economic activity and base for competition (between countries and MNEs); and
- countries taking leading roles in the BEPS project have enacted their own tax base protection mechanisms (such as the new UK diverted profits tax).[13]

And so on.

The reality that the historic model is fading away is a consideration that will need to be taken into account in evaluating the proposed strategy of AlphaCo in the Example (the historic model rejection consideration).

5.2. Reaction of source countries

One of the vital international taxation debates of current times concerns this balance between residence and source. A debate has been brewing between source countries on the one hand, and the OECD on the other, with MNEs (the payers of tax to finance the budgets of all countries) in the middle. Some source countries have rejected the OECD/UN model concepts. Others have generally expressed support, although enforcement practices suggest a different reality.

The essential issue is that source countries increasingly insist on taxing income based on their perception of the source of underlying economic activity, not on the residence of the parent company (or intervening holding company). As a result, MNEs often experience the following attitude of tax authorities in source countries: "If you want to do business in this country, you will pay tax on our terms. If you do not like our terms, do not come to this country; others will take your place".

While several of the major source countries are participants in the BEPS project, through their G7 and G20 membership, they have been outspoken critics of the existing treaty models and transfer pricing guidelines for many years. Interestingly, many of these countries have endorsed the BEPS Project[14] perhaps because the apparent trend in the manner by which source countries address international tax matters seems to coincide with what can be anticipated from that process (as will be discussed below), including:

- preferring two-sided to one-sided transfer pricing testing to assure that source-country functional activities are appropriately taken into account in allocating residual income;
- expansion of the definition of "intangibles" to include a broad range of local market synergies;
- assertions that permanent establishment limitations in current model treaties unduly restrict a source country's ability to tax all income from what that country argues is pertinent economic activity; and
- assertions that in order to backstop transfer pricing and domestic tax enforcement, tax base protection requires exit taxes, general anti-avoidance principles and extra-territorial reach (the *Vodafone* issue in India).[15]

The essence of the source-country refrain is that the existing model treaties encourage the very behaviour that the BEPS project seeks to prevent, as noted above and as reflected in the AlphaCo plan in the Example. Nonetheless, the BEPS Action Plan makes clear that it is "not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income", which means that MNEs should expect source countries to continue pursuing their own respective agendas, inevitably leading to ever-increasing rounds of tax disputes.

In the context of the Example, this is plainly a consideration to be taken into account (the source country consideration).

5.3. BEPS

In launching the BEPS project, the OECD noted that the "integrity of the corporate income tax" was at stake.[16] The initial report framed the following base erosion issues to be addressed:
- international mismatches in entity and instrument characterization, including hybrid mismatch arrangements and arbitrage;
- application of treaty concepts to profits derived from the delivery of digital goods and services;
- tax treatment of related-party debt financing, captive insurance and other intra-group financial transactions;
- transfer pricing, in particular in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents;
- effectiveness of anti-avoidance measures, in particular general anti-avoidance rules (GAARs), CFC regimes, thin capitalization rules and rules to prevent tax treaty abuse; and
- the availability of harmful preferential regimes.

12. Lowell, Martin & Levey, *supra* n. 3, para. 5.01(2).
13. *See* sec. 5.6.
14. *Former Chinese Official Says BRICS Influencing OECD's Base Erosion Project*, 21 BNA Transfer Pricing Rep. (4 Apr. 2013), at 1138 (former China SAT official indicating different interest of developed and developing countries with respect to tax base protection, including scepticism whether the OECD can accommodate the needs of source countries); K.A. Bell, *Saint-Amans: China, India Participating in BEPS Project on Par with OECD Members*, 22 BNA Transfer Pricing Rep. (19 Sept. 2013), at 690; K.A. Bell, *India Supports Significant People Functions Approach of BEPS Plan, Practitioners Say*, 22 BNA Transfer Pricing Rep. (25 July 2013), at 362; *Asia-Pacific Nations Announce Joint Task Force to Tackle BEPS*, BNA Daily Tax Rep. (2 Dec. 2014), at I-1.
15. Lowell, Martin & Levy, *supra* n. 3, para. 14.26(1).
16. OECD, *Addressing Base Erosion and Profit Shifting*, *supra* n. 7. *See generally* R. Mitchell, *As BEPS Report Released, Saint-Amans Says G-20 Push Could Speed OECD Work*, BNA Daily Tax Rep. (13 Feb. 2013), at I-2. A related focus of commentators has been on what is often referred to as "double non-taxation" or homeless income. *See generally* M.C. Durst, *Fixing Double Nontaxation Under the Transfer Pricing Guidelines*, Tax Notes (7 May 2012), at 785, at 785.

Fifteen "action" items were identified, some of which could be grouped together as involving transfer pricing.[17] The current status of those most likely to have a material impact on MNE planning strategies are discussed below.

5.3.1. *Country-by-country documentation*

A material goal of the BEPS project is transparency with respect to the allocation of functional activities within an MNE group, such as the proposed AlphaCo plan in the Example. The initial discussion draft was released in September 2014, describing consensus on the need for three elements of transfer pricing documentation, namely:
– a master file of standardized information about the group as a whole;
– a local or country file with data of transactions of the local group company; and
– a country-by-country report containing details of the global allocation of the group's income and taxes by jurisdiction, together with information intended to identify the location of economic activity within group.

The master and country file requirements are similar to those in the European Union.[18] While these elements are reasonable in approach, they are not coordinated with the third country-by-country element.

The initial country-by-country draft would certainly have aggravated compliance burdens and examination problems on all sides, crying out for practicality to be introduced.[19] There also seemed to be a clear slant toward soliciting information needed for a formulary apportionment methodology, notwithstanding an OECD proclamation to the contrary. Whether countries could actually cope with the potential avalanche of information to be forthcoming from such reports framed an interesting question of tax administration.

In February 2015, an updated discussion draft was released responding to inputs from the business community.[20] It addressed several matters relating to implementation, including the following:

– *Timing*. The first country-by-country reports should be for taxable years beginning after 1 January 2016, with one year to prepare the documentation, so that the initial reports would be due 31 December 2017 (the country-by-country filing consideration). The filing requirement normally falls on the ultimate parent entity with the tax authority of its place of residence. If the ultimate parent is not obligated to file, its country does not have an exchange of information agreement in place or there has been a systematic failure under such an agreement, then the MNE group may appoint a surrogate parent entity to do the filing in its country of tax residence. If the group does not appoint a surrogate, then each member of the MNE group may be required to file the country-by-country report locally.

– *Reporting companies*. All MNE groups above a threshold of EUR 750 million in annual revenue would need to file the country-by-country reports. It was believed that this threshold should exclude 85-90% of MNE groups, although it would encompass about 90% of corporate revenues. Other exemptions would include only industries that already have appropriate reporting obligations, such as international transportation.

– *Conditions for countries to be able to gain access to the information*. To obtain access to the information, countries would need to commit to confidentiality, application of reporting for groups in specific countries and appropriate utilization of the reports. Such commitment would include not simply making examination adjustments on a "formula based on the data from the country-by-country report", i.e. formulary apportionment methodologies.

– *Automatic exchange*. Countries should automatically exchange the country-by-country reports with other countries in which the MNE operates and which fulfil the conditions noted above. If a country fails to share due to not requiring the country-by-country reports, if there is no competent authority agreement for the exchange of the reports, if there is a failure to make such exchanges, or otherwise, a "secondary mechanism" could be accepted – such as local filing in the other countries or exchanging the reports with the next tier parent country.

It was also recognized that countries would require guidance on implementation.[21] Such a package was issued in June 2015, including model legislation, a multilateral competent authority agreement, a questionnaire for confidentiality and data safeguards, and competent authority agreements based on a treaty or tax information exchange agreement.

– *Monitoring and dispute resolution*. It was recognized that the country-by-country reports would expand the risk assessment capability and consequent likelihood of proposed adjustments of country tax

17. Lowell, Martin & Levey, *supra* n. 3, para. 2.08(2)(d).
18. K. Boatman, D. Liu & I. Novos, *Staying Ahead of the Curve: What Companies Should Consider in Preparing BEPS Master File*, 23 BNA Transfer Pricing Rep. (13 Nov. 2014), at 951.
19. M. Burow, *OECD Underestimated CbC Reporting Burden, Practitioners Say*, 2014 Tax Notes Today 233-7 (4 Dec. 2014).
20. OECD, *Action 13: Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 6 Feb. 2015); A. Athanasiou, *OECD Releases Implementation Guidance for CbC Reporting*, 77 Tax Notes Intl (16 Feb. 2015), at 561.
21. *See* e.g. S.S. Johnston, *OECD Publishes 'Game-Changer' CbC Reporting Implementation Package*, 2015 Worldwide Tax Daily 110-3; M. Herzfeld, *Implementing CbC Reporting (or Not) in the United States*, 2015 Worldwide Tax Daily (27 Feb. 2015), at 35-2 (suggesting that the United States may already have reporting requirements relating to the country-by-country data). Interestingly, there is recent experience with such local legislative/regulatory implementation projects in the context of the US financial reporting process known as "FATCA". *See also* M. Sapirie, *Lessons from U.S. FATCA for CbC Reporting*, 78 Tax Notes Intl. (6 Apr. 2015), at 15; C. Lowell & M. Martin, *U.S. International Taxation Practice & Procedure*, para. 7.05(1)(f) (Thomson Reuters 2015) (the US implementing regulations were 500 pages in length, implemented with bilateral information exchange agreements).

authorities, inevitably generating incremental transfer pricing controversy. Accordingly, the need for effective dispute resolution was recognized.

– *Capacity building*. It was also recognized that it would be necessary to implement a concentrated effort to build capacity to appropriately utilize the data in countries.[22] In this regard, strong voices suggested that unless all countries deem the country-by-country reporting to be relevant, it may not be successful.[23]

While the country-by-country reporting process is one of the most advanced BEPS projects from the standpoint of broad acceptance, implementation is yet to be determined. If it is not accepted by a broad range of source countries,[24] it is unlikely to gain serious traction (which would then be a problem for all other BEPS action items). Some countries have unilaterally imposed requirements that are stricter than country-by-country reporting, as others question whether it is possible to achieve all of the conditions noted above.[25]

The country-by-country checklist of data to be submitted has the feel of a collage of information requests used by tax authorities to conduct examinations of MNE groups where there are material cross-border flows and these examinations concern the overall transfer pricing strategy of the group (the country-by-country data consideration). These types of intense examinations have been a fact of life now for at least 25 years in a variety of countries. The nature of the examinations and the means of resolving any disputes have also evolved over this period.[26]

5.3.2. Automatic exchange of information and mandatory disclosure

A second element of the process of assuring transparency for governments is disclosure requirements. One aspect is continued focus on taxpayer disclosure to government via transfer pricing documentation. A second aspect is automatic exchange of certain tax information between governments.[27] The information subject to such a requirement continues to evolve, although the concept seems embedded.[28]

A third form of disclosure relates to so-called mandatory disclosure of certain tax avoidance schemes. The desire of governments is to have advance warning of schemes being promoted. In this sense, the process is similar to the UK legislation on disclosure of tax avoidance schemes and the so-called "uncertain tax position" filing requirements in the United States for financial accounting,[29] tax reporting[30] and financial institution reporting of cross-border investment flows.[31] A similar approach was once considered as part of the so-called harmful tax competition initiative of the OECD, which began as a hurricane on the horizon and ended as a slight breeze when it came ashore.[32]

The discussion draft would require promoters or taxpayers, subject to penalties, to disclose "international tax schemes" to their home jurisdiction, which would include a scheme that:
- incorporates a cross-border outcome;
- has economic or material tax consequences for a domestic taxpayer; and
- includes a domestic taxpayer as a party.

Not surprisingly, the reaction of the business community included suggestions that such "schemes" could potentially include every planning paradigm considered by an MNE group.[33] In any planning context, tax consequences are certainly taken into account, including means of minimizing the tax burden in the competitive world that exists for all business entities. It is also apparent that the requirements under this item would overlap with country-by-country reporting and potentially others.[34]

5.3.3. Transfer pricing, special measures and profit splits

An important and evolving issue is whether the arm's length standard will remain the bedrock of transfer pricing principles, or whether there will be a movement toward "special measures" to address specific tax base concerns.[35] OECD officials have been quoted as "agnostic" about the arm's length standard,[36] suggesting that the critical element is attacking base erosion, not preserving a transfer pricing

22. D.W. Gregory, *O'Donnell Fears Misuse of CBC Data, Calls for More Training of Auditors Globally*, 23 BNA Transfer Pricing Rep. 20 (19 Feb. 2015), at 1287.
23. R. Mitchell, *[UN Secretariat Michael] Lennard says CBC Reporting Key Test of BEPS Outcomes for Developing Countries*, BNA Daily Tax Rep. (2 Apr. 2015), at I-3.
24. *Lennard says CBC Reporting Key Test of BEPS Outcomes for Developing Countries*, *supra* n. 23.
25. M. Herzfeld, *Making Bets on CbC Reporting*, 78 Tax Notes Intl (18 May 2015) at 595.
26. *See* sec. 5.1.
27. Disclosure could include rulings and grants of preferential rates for IP income, although normal transfer pricing agreements (such as APAs) would not be covered. The popular patent box regimes would likely be subject to such mandatory exchange. *See* R. Mitchell, *Tax Administrators Vow Global Cooperation on BEPS, Automatic Information Exchange*, 23 BNA Transfer Pricing Rep. (30 Oct. 2014), at 836 (reporting on an October 2014 meeting of the Forum on Tax Administration, including the need for additional governmental resources to process such information).
28. M. Herzfeld, *Where BEPS May Hit First*, 76 Tax Notes Intl (6 Oct. 2014), at 22.
29. Financial Accounting Standards Board ASC 740-10 (FIN 48). *See generally* C. Hanna, M. Martin, M. Donohue, C. Lowell & P. Yong, *Corporate Income Tax Accounting* (Thomson Reuters 2015), para. 3.05(2).
30. Hanna et al., *supra* n. 29, para. 3.11.
31. US: Foreign Account Tax Compliance Act of 2010 (FATCA). *See generally* Lowell & Martin, *supra* n. 21, para. 7.05(1)(f).
32. *See* sec. 5.3.6.4.
33. K.A. Bell, *Business Delegates Tell OECD Consultation Mandatory Disclosure Draft Is Unworkable*, 24 BNA Transfer Pricing Rep. (14 May 2015), at 34.
34. R. Mitchell, *Mandatory Disclosure Rules May Duplicate Country-by-Country Reporting Requirements*, 24 BNA Transfer Pricing Rep. 38 (14 May 2015).
35. R. Mitchell, *OECD'sMarlies de Ruiter: Interaction of Treaty Rules, Special Measures Must Not Cause Double Tax*, 22 BNA Transfer Pricing Rep. (17 Apr. 2014), at 1509; *OECD Discussions on Special Measures Still in 'Very Early Stages', Marlies de Ruiter Says*, 22 BNA Transfer Pricing Rep. (17 Apr. 2014), at 1511. In a G20 tax conference in Tokyo in May 2014, a senior tax official of a major MNE suggested that a global minimum tax of approximately 15% would resolve many problems (subject to advance pricing agreement-type negotiation on a case-by-case basis). This might not be realistically possible, but it frames an interesting point, similar to the positions of source countries.
36. D.W. Gregory, *Going 'Past' Arm's-Length Standard is Recognizing 'Economic Reality,' Official Says*, BNA Daily Tax Rep. (23 July 2013), at I-2; M. Hoy, *OECD Official: Arm's Length Alternatives to be Aimed at Artificial Structures*, BNA Daily Tax Rep. (28 Aug. 2013), at I-2.

standard that is viewed in some quarters as contributing to the BEPS problem to start with.

The discussion draft in this area was released on 19 December 2014,[37] proposing significant modification of traditional principles.[38] The overall intention is to focus on the value-drivers of business activities in a more effective manner than the existing OECD Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), even if departing dramatically from traditional principles. Notably, the discussion draft introduces the concept of moral hazard as a risk for transfer pricing purposes (a moral hazard is said to shape third-party contractual arrangements; such that risk should be allocated in proportion to functional activity).[39]

Special measures. The discussion draft suggests that in the case of transfers of "hard to value intangibles", special measures could be required.[40] The special measures suggested would include price adjustment mechanisms and greater use of profit split methodologies. Such measures should not apply where the MNE provides:
– full details of its ex ante projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (e.g. probability-weighted), and the comprehensiveness of its consideration of reasonably foreseeable events and other risks; and
– satisfactory evidence that any significant difference between the financial projections and actual outcomes is due to unforeseeable or extraordinary developments or events occurring after the determination of the price that could not have been anticipated by the associated enterprises at the time of the transaction.

There is also a suggestion that the taxpayer should document options realistically available at the time of the transfer in question, and with mandatory disclosure as noted above. These requirements would, at the very least, add to the documentation burden for transactions. The element of "alternative options available" will inevitably have a different appearance in hindsight than at the time transactions are planned and undertaken, so that the danger of conflict seems to be inevitably expanded (the special measures consideration). If such approaches are to be required, then there will need to be guidance on materiality to narrow the scope of the process. In any event, it would seem that all such data should be provided in the new rules on transfer pricing documentation, as discussed above.

In the absence of an effective dispute resolution process, it is apparent that such measures would continue the explosion of transfer pricing adjustments and double taxation threats for MNEs.[41] In addition, such "special measures" could raise serious questions as to whether assessments are subject to treaty MAP provisions or eligible for domestic foreign tax credit for MNEs based in traditional worldwide tax countries.

The special measures provisions stand as mute testimony to the anxiety of all parties in the international tax world.[42] Oddly enough, in all of the focus and writing on these issues, it is only rarely that anyone notes that existing arm's length methodologies have long accommodated means of addressing such issues, as will be noted below.[43] Indeed, this has been the common means of resolving major cases, directly or indirectly, in the APA/competent authority context for generations, even in situations where no treaty is applicable.

Profit splits. A related element of the transfer pricing focus of the BEPS project is whether the traditional use of one-sided transfer pricing methodologies should be replaced in certain circumstances by testing both or all parties on a combined income basis via profit split methodologies (so-called two-sided methods). The OECD discussion draft asks questions and requests responses, as opposed to offering substantive guidance, reflecting the non-consensus nature of the issue.

The reaction of the business community has generally been critical of any expanded use of profit split methods. The essence of the comments have included:
– potential departure from the arm's length method;
– substitution of one ambiguity (comparables) for another (value drivers);
– prevention of consistency of global methodologies for MNEs;
– expansion of the range of disputes; and
– utilization of the residual profit split is preferable to other two-sided approaches, in that it initially focuses on activities for which one-sided methods are appropriate.

As will be developed below, the utilization of profit split methodologies has, for many years, been the common means of resolving serious disputes in competent authority and advance pricing agreement (APA) contexts, as well as in some famous litigated cases. Over the years, certain countries have utilized profit split methodologies

37. OECD, *Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines (Including Risk, Characterization, and Special Measures)* (19 Dec. 2014). *See also* K.A. Bell, *OECD's Draft on Risk Clarifies 'Proper' Transfer Pricing Analysis, Marlies de Ruiter*, 23 BNA Transfer Pricing Rep. (22 Jan. 2015), at 1211; *Marlies de Ruiter, Hickman Say OECD Draft on Risk Requires Arm's Length Principle to 'Work Harder'*, 23 BNA Transfer Pricing Rep. (22 Jan. 2015), at 1219.
38. Thoughtful commentators have suggested that the problem with the arm's length standard is the failure to apply it in an appropriate manner. *See* B.E. Lebowitz, *The Arm's-Length Standard as a 'Special Measure' Under BEPS*, 77 Tax Notes Intl (16 Feb. 2015), at 607.
39. P. Breslin, *Coin Flips, Rational Decisions and Risk: Support for OECD Draft Guidance on Chapter 1*, 23 BNA Transfer Pricing Rep. 20 (19 Feb. 2015), at 1322; K. Singh, W.J. Murphy & C. Saliba, *The Role of Moral Hazard Under the Arm's Length Principle*, BNA Daily Tax Rep. (10 Mar. 2015), at J-1.
40. In this context, it is often suggested that the US commensurate-with-income rules under transfer pricing law could be a model. *See* Lowell, Martin & Levy, *supra* n. 3, paras. 5.04(3) and 5.05(4)(e) (similar to the exit tax formulations, *see* Lowell, Martin & Levey, *supra* n. 3 para. 12.02(2)(d)(v)).
41. K.A. Bell, *Taxpayers React to Transfer Pricing Discussion Drafts, Bemoan Draft on Risk*, 23 BNA Transfer Pricing Rep. (19 Feb. 2015), at 1307 (summarizing BIAC and other comments); F. Vincent & P. Luquet, *Risk, Characterization – and a Tsunami of Double Tax Cases*, 23 BNA Transfer Pricing Rep. (19 Mar. 2015), at 1474.
42. A.M. Parker, *IRS Official Says Special Measures in OECD Draft Like 'Religion,' Not Law*, BNA Daily Tax Rep. (14 Jan. 2015), at G-8.
43. *See* sec. 5.1.

as a standard means of demanding information and then making assessments as they gained experience with the transfer pricing examination and dispute resolution processes.

The approaches and methodologies of such resolutions in a competent authority or APA context, of course, are not public, so the learning derived from such resolutions is within the range of experience of the MNEs in question and their advisory teams. The critical element in this context is that there is long experience in the practical utilization of profit split methodologies. Indeed, it is a common process with many MNEs to undertake profit split confirmations of their global transfer pricing methodologies in at least certain contexts in order to confirm the one-sided results utilized in annual documentation. Such confirmation is also a practical means of preparing for a tax authority challenge.

In any event, it seems inevitable that there will be an increased use of profit splits (the profit-split consideration),[44] as will be developed below.[45]

5.3.4. *Dispute resolution*

It is apparent that disputes in the international tax world are expanding at an alarming rate as a result of the considerations noted above. It is in the interest of all parties to develop an effective and respected dispute resolution process. The initial OECD discussion draft in this area recognized the need for improvement, but merely listed some thirty-plus "options" that could be considered, including mediation and arbitration. The reaction of the business community was highly critical of the failure to make positive recommendations to develop a globally efficient process to address the inevitable increase in disputes that will be generated from the BEPS project.[46] In response, the OECD advised that it would develop more explicit proposals.[47]

5.3.5. *Multilateral instrument*

A critical element of the BEPS project will be actual implementation of its final proposals. There are some 3,000 treaties following the OECD or UN Models, such that bilateral amendment would be a long and tedious process. Accordingly, a potential solution could be to adopt as many proposals as possible, such as dispute resolution,[48] via a multilateral instrument that would amend all treaties between signatory countries. Such an approach has been used in non-tax treaty contexts, such as international investment agreements.

The discussion draft on the development of a multilateral instrument was released in September 2014. The OECD expressed optimism about such an evolution,[49] although there is ample room for scepticism as to the reality and practicality of such a step.[50] It would need to be negotiated through a process that includes OECD member and non-member countries, MNEs and other interested parties. A two-year time frame was originally anticipated, with the aim to have the instrument open for signature by the end of 2016.

5.3.6. *Challenges of the BEPS project*

In evaluating the BEPS project and the way forward, there are a variety of elements that all parties need to consider (the BEPS challenge considerations).

5.3.6.1. *Limits of OECD authority*

The fundamental threshold problem for an initiative such as the BEPS project is that it must ultimately rely on domestic implementation on a country-by-country basis.[51] The OECD itself has no mandate to change the law, even with the broad public endorsement of the G7 and G20. Accordingly, any actual change in treaty, transfer pricing or other policies will depend on interested sovereign states.

As there will inevitably be variation in how states adopt the ultimate proposals from the OECD, there will never be a perfectly coordinated, supra-national action on BEPS. In practical terms, this means that directions declared will be starting points to address perceived base erosion activities from the idiosyncratic perspective of each country.

It is to be hoped that consensus will be reached, as unilateral action by many countries would exacerbate existing controversy and eventual competent authority problems for all parties.[52] The difficulties of sovereign country action is, perhaps, best illustrated by the current situation of the United Kingdom's newly introduced patent box and diverted profits tax,[53] which plainly reflect tax base defence tactics. It simply cannot have been enacted without due thought or consideration having already been given to the public and prominent work of the OECD in the BEPS project, in which the United Kingdom is a leader.[54] The OECD cannot force the United Kingdom to abandon those regimes and, given their relatively recent appear-

44. J.M. Kadet, *Expansion of the Profit Split Method: The Wave of the Future*, 77 Tax Notes Intl. (30 Mar. 2015), at 1183.
45. *See* sec. 5.
46. D.W. Gregory, *Comments on OECD's Action 14 Draft Fault 'Tepid' Language, Ask for Arbitration*, 23 BNA Transfer Pricing Rep. (22 Jan. 2015), at 1215; K.A. Bell, *Business Community Pleads with OECD to Endorse Binding, Mandatory Arbitration*, BNA Daily Tax Rep. (26 Jan. 2015), at I-3.
47. K.A. Parillo, *OECD Will Add 'Muscle' to Next BEPS Dispute Resolution Draft*, 2015 Worldwide Tax Daily (13 Feb. 2015), at 30-1.
48. D.W. Gregory, *U.S. Exploring Multilateral Instrument to Expand Arbitration Network, Rolfes Says*, BNA Daily Tax Rep. (18 Mar. 2015), at G-4.
49. K.A. Bell, *Multilateral Instrument Updating Bilateral Tax Treaties Is Feasible, Saint-Amans Says*, 23 BNA Transfer Pricing Rep. (12 June 2014), at 284.
50. C. Mapp, *The Feasibility of Developing a Multilateral Instrument*, 74 Tax Notes Intl (23 June 2014), at 1086; R. Eicke, *BEPS Multilateral Instrument: Practical Solution or Elusive Pipe Dream?*, 76 Tax Notes Intl. (10 Nov. 2014), at 527.
51. *See* e.g. K.A. Bell, *BEPS Project Needs to Consider EU Law Prohibitions, Official Says*, 22 BNA Transfer Pricing Rep. (11 July 2013), at 305.
52. R. Mitchell, *Unilateral BEPS Actions Could Lead to Double Taxation, Business Tells OECD*, 22 BNA Transfer Pricing Rep. (17 Oct. 2013), at 755.
53. *See* sec. 5.6.
54. K.A. Bell & A. Bennett, *Government Officials Say U.S. Won't Wait for BEPS Action Plan*, BNA Daily Tax Rep. (10 Dec. 2013), at G-7. Similarly, Ireland has undertaken steps to moderate some of the complaints from other countries concerning its tax regime, which was perceived to facilitate "stateless" companies. *See* D. Paletta & K. Linebaugh, *Dublin Takes Aim at Firms by Tightening Tax Rules*, Wall St. J. (16 Oct. 2013), at 1; D.D. Stewart, *Ireland Targets 'Stateless' Companies in 2014 Budget*, 72 Tax Notes Intl. 3 (16 Oct. 2013), at 212.

ance on the statute books, it seems highly unlikely that the United Kingdom would voluntarily remove them.

In other words, perfect alignment on international issues of such complexity and significance is not feasible due to national sovereignty. There can never be a truly global solution. Principles are easier to agree on in broad terms at an international policy level than they are to implement on the ground. On the other hand, there has been recent cooperation by governments across a broad spectrum of domestic systems and points of view in other areas of international tax compliance.[55]

5.3.6.2. Reaction of source countries

While several source countries are members of the G7, G20 and OECD, it will remain to be seen whether they, or the broad membership of the UN, will embrace critical elements of the BEPS project. If not, the reality is likely to be simply an expansion of international tax disputes, which, frankly, is not in the interests of any party.

5.3.6.3. Coordination with other initiatives

The European Union has undertaken its own course of action. On 12 June 2013, the European Union released its own action plan to "strengthen the fight against tax fraud and tax evasion" (the EU Action Plan).[56] It contains 34 action points, which span a spectrum similar to the BEPS project. The European Union suggests:

> Member States are encouraged to include a clause in Double Tax Conventions (DTCs) concluded with other EU Member States and with third countries to resolve a specifically identified type of double non-taxation. The Commission also recommends the use of a common general anti-abuse rule. This would help to ensure coherence and effectiveness in an area where Member State practice varies considerably.[57]

In some ways, the EU process is even more assertive than elements of the BEPS project. If both the EU and OECD action plans continue, there will need to be coordination at some point.

There are also other OECD initiatives underway that could have an impact on any ultimate BEPS proposals. For example, the first item on the BEPS Action Plan concerns the digital economy, which the OECD attempted to address in the 2010 update of the Model Treaty, (although that update probably created more problems than solutions).[58]

5.3.6.4. Prior OECD initiatives

A related practical reality is that the BEPS project is not the first time that the OECD has undertaken broad-based efforts to address perceived tax base erosion issues. In May 1996, OECD Ministers called on the OECD to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases".[59] The heads of state of the then group of eight (G8 at the time) countries endorsed this request, urging the OECD "to vigorously pursue its work in this field, aimed at establishing a multilateral approach under which countries would operate individually and collectively to limit the extent of these practices".[60]

While the project started off in a similar manner as the BEPS project, internal dissension among OECD member countries derailed the process, so that the net result after several years of the harmful tax competition initiative was a broad-based expansion of information exchange agreements.[61]

Frankly, this same process may be underway in the case of the BEPS project, as political and legislative officials in some member countries are questioning whether the project is in their national interests.[62]

5.3.6.5. Transition

Finally, even if consensus can be developed for elements of the BEPS project, an additional issue that will need to be considered is how transition from the status quo to any specific action ultimately undertaken by one or more countries will be addressed. The BEPS Action Plan seems to discourage this reality, as it calls in several places for concerted and coordinated action. The likelihood that some states will want to move faster and more comprehensively than others has already been seen to be inevitable.[63] If such splintering of positions by countries taking unilateral actions in the exercise of their sovereign authority continues, there will be an explosive increase in competent authority proceedings, aggravating the risk of double or multiple taxation for MNEs and bottlenecks for tax administrations.[64] The situation in the United Kingdom provides an excellent example of this phenomenon,[65] although the issue is indeed global.[66]

55. For example there has been broad international cooperation with the US initiative addressing reporting of investment income, framed by the US Foreign Account Tax Compliance Act (FATCA). Lowell & Martin, *supra* n. 21, para. 7.05(1)(f); D.W. Gregory, *Collaboration on FATCA Sets Stage for Work on BEPS, Corwin Suggests*, BNA Daily Tax Rep. (1 Mar. 2013), at G-5.
56. EU: Communication from the Commission to the European Parliament and the Council: An Action Plan to Strengthen the Fight against Tax Fraud and Tax Evasion, 6 Dec. 2012, COM (2012) 722 final. *See also* J. Kirwin, *Hybrid Loans, Letterbox Companies Targets of Proposal on EU Parent-Subsidiary Law*, 22 BNA Transfer Pricing Rep. 15 (28 Nov. 2013), at 911; *European Commission May Probe Tax Breaks to Multinationals in Ireland, Luxembourg*, BNA Daily Tax Rep. (13 Sept. 2013), at I-4.
57. Section 8.
58. Lowell, Martin & Levey, *supra* n. 3, para. 9.08(1)(d).
59. Foreward: *Harmful Tax Competition: An Emerging Global Issue*, OECD 1998.
60. *G7 Finance Ministers Report*, 28 June 1996.
61. Lowell, Martin & Levey, *supra* n. 3, para. 2.06(2).
62. L.A. Sheppard & S.S. Johnston, *U.S. 'Extremely Disappointed' in DPT and BEPS Output, [US Treasury Official Robert] Stack Says*, Tax Notes Today. (11 June 2015), at 112-1; R. Mitchell, *Stack: BEPS Plan's Focus on U.S. Firms Has Undermined U.S. Political Support*, 23 BNA Transfer Pricing Rep. (30 Apr. 2015), at 1609; A. Bennett, *BEPS Proposals Face Hurdles in Congress as Other Countries Act*, BNA Daily Tax Rep. (12 Jan. 2015), at G-3.
63. *See* sec. 5.6.
64. D.W. Gregory, *BEPS Effort Will Ramp Up Pressure on Competent Authorities, Danilack Says*, 22 BNA Transfer Pricing Rep. (28 Nov. 2013), at 901.
65. *See also* M. Herzfeld, *Political Developments in BEPS and the EU*, 76 Tax Notes Intl. (24 Nov. 2014), at 653.
66. K.A. Bell, *Countries Taking Legislative Action to Adopt BEPS Proposals on Hybrids, Practitioner Says*, 23 BNA Transfer Pricing Rep. (30 Oct. 2014), at 834.

There will also be anxiety in both tax administrations and MNEs about any suggested changes to domestic or treaty law as to whether the measures will be administrable, on the one hand, or able to be reasonably complied with on the other.[67]

5.4. State aid

As the BEPS and the EU action plans have progressed, the European Union also commenced a process of reviewing the ruling and related regimes of Member States. The principal focus is on whether certain Member States have provided illegal tax subsidies to induce MNEs to locate activities in their countries. If such enticements were not available to other similarly situated MNEs,[68] the consequence under applicable EU law could lead to a conclusion that those MNEs had received State aid.[69] In such an event, the country in question would be obligated to recover such aid from those MNEs (which could be for a period as long as ten years) with compounded interest.[70]

Needless to say, such a process could be a financial disaster for an MNE. Not only would it have to repay the "aid", with compounded interest for up to ten years prior to the opening of an investigation (i.e. expiration of pertinent statutes of limitations for income tax purposes may not prevent recovery of such unlawful State aid), but may not be able to obtain a deduction, treaty relief (via competent authority or otherwise) or foreign tax credit for the payment.[71] In addition, the MNE may face tax liabilities in other countries which pursue transfer pricing or other examinations to protect their own tax bases from the State aid.[72]

A cautionary element of the State aid process for MNEs is that such rulings or other governmental grants were initially obtained pursuant to the laws or policies of the granting country after discussion and full disclosure of the planned activities of the MNE. Having been transparent with the issuing Member State, when EU politics change years later, the MNE is subject to potentially crippling punishment for dutifully following the laws of the particular Member State (the State aid consideration).

As with the EU Action Plan, there will be need for coordination of these investigations with ultimate BEPS project deliverables, including dispute resolution.

5.5. Exit and restructuring taxes

Another reality in the landscape of the current international taxation world – especially when it comes to considering restructuring of functions and risks in an MNE group, as in the Example – is the danger of incurring an exit tax in the country from which a function or risk is removed. In this regard, a critical element in evaluating any type of business restructuring, is valuation of the functions or activities deemed to be removed from a jurisdiction.[73] The principles, in this regard, are similar to those evolving in the area of intangible transfers.

Exit taxes generally seek to tax unrealized gains the moment an MNE's seat, functions or assets leave the country (shifted assets). Such movements are common given the international mobility of capital and the tendency of global business models to evolve in the face of competitive pressures.

From the perspective of a country from which the shifting takes place, existing laws often impose taxation on the shifted assets measured by the amount of gain that would have been realized if the assets had been sold on the market. In effect, the MNE realizes so-called phantom income. Nonetheless, it is increasingly common for countries to expand existing laws to address such asset transfers as a means of protecting their tax base. In addition, states may recapture previously allowed deductions or deferrals from the MNE. Some states also impose a tax in lieu of the levy of dividend withholding taxes.[74]

Exit taxes have a number of adverse effects on MNEs, including:

- increasing the complexity of restructuring and adapting to changing economic conditions in a globalized world. Taxation of phantom income may be a barrier to such movement, causing economic loss to the MNE and the tax base of the country imposing the exit tax;
- diminishing the liquidity and net equity of the MNE's operations in the country as a result of the tax on unrealized gains or the obligation to provide adequate security;
- adding layers of complexity and compliance/administration burdens for both MNEs and tax authorities;
- increasing the incidence of double taxation. Often, the country to which assets are transferred will impose tax on subsequent income or gain without credit for the exit taxes in the other state. Even if the new state provides some form of recognition, excessive taxation

67. *BEPS Could Lead to 'International Chaos' If Not Managed Well, IRS Official Cautions*, 23 BNA Transfer Pricing Rep. (1 May 2014), at 3; D.W. Gregory, *Treasury Pushing for 'Administrable' Documentation Rules Under BEPS*, BNA Daily Tax Rep. (15 Jan. 2014), at I-1.
68. T. Fairless, *U.S. Firms Probed on Taxes*, Wall Street J. (12 June 2014), at B1; *A Bit Too Cosy*, The Economist (4 Oct. 2014), at 71; *European Commission Commissioner Says Apple Tax Probe is Priority*, BNA Daily Tax Rep. (3 Oct. 2014), at I-2 (focusing on Ireland and Luxembourg).
69. *See* Treaty on the Functioning of the European Union (TFEU), art. 107, EU Law IBFD. There are five cumulative conditions, namely (i) economic advantage, (ii) selectivity, (iii) granted by state, (iv) distortion of competition and (v) effect on trade between Member States. Only the European Union can approve State aid measures. Tax rulings can constitute State aid.
70. The procedures to be followed in such investigations involve several steps, namely (i) initiation, (ii) preliminary investigation, (iii) in-depth investigation, (iv) final decision, (v) appeal to the EU Court of Justice by a party and (vi) role of the beneficiary (MNE).
71. T. Fairless, *Ireland Let Apple Engineer Its Tax Bill, EU Probe Finds*, Wall Street J. (1 Oct. 2014), at B4; W. Hoke, *EU Orders Spain to Recover Illegal State Aid*, Worldwide Tax Daily 200-1 (2014) (the illegal State aid consisted of allowing MNEs to take deductions for goodwill arising from an acquisition of indirect shareholdings in non-resident holding companies).
72. S. Schechner, *Google Faces a Fight in France Over Its Tax Bill*, Wall Street J. (9 Oct. 2014), at 1 (including detailed charts of the mechanisms allegedly used by the MNE).
73. P. Penelle, *The Economics of Business Restructuring and Exit Charges*, 23 BNA Transfer Pricing Rep. 3 (29 May 2014), at 238.
74. Lowell, Martin & Levey, *supra* n. 3 sec. 12.02(2)(e).

may remain if the states do not apply the same valuation principles. Taxation rights need to be synchronized; and
- burdening all tax authorities, as well as MNEs, as MNEs can be expected to seek relief from double taxation under applicable treaties. The authors' experience is that such cases are difficult, contentious and time consuming on all sides. In this regard, it is not apparent whether exit taxation would be viewed at the competent authority level as a domestic issue not eligible for double taxation relief, or as a transfer pricing issue that would be entitled to treaty protection.

The assertion of exit tax on cross-border transfers of functions and risks in these contexts appears to be incompatible with the arm's length principle and will lead to double taxation of the same profits. When risks and functions are terminated and/or moved from one country to another (via supply chain rationalization or other forms of functional realignment), it is appropriate to examine the changes from the perspective of both normal transfer pricing as well as the "exit" provisions of chapter 9 of the OECD Guidelines. This is true even when the functions appear to be routine.[75] Such analysis would appropriately be included in the documentation of at least the party from which the functions or risks are removed or transferred.

The issue is particularly apparent in the European Union, where it would be necessary to reconcile exit taxation with the European Community law concerning businesses that operate within the Union, such as the EU law providing for non-discrimination and free movement of capital.[76] In short, the role of exit taxation in this context is of vital importance to ensure the absence of double or multiple taxation (the exit tax consideration).[77]

Where exit taxes are enacted, they should include at least the following protections for both countries and MNEs:
- *avoidance of double taxation*. Exit taxes lead to double taxation if neither domestic law nor applicable treaties provide a mechanism to prevent its existence. Such protections should be an element of any taxes enacted. There should also be recognition of the need to coordinate with the other country, even absent a treaty. In planning for potentially shifted assets, the MNE will also want to address these double taxation issues on its own via negotiation with the prior or future country, or both. This could be by negotiating an advance agreement to provide a corresponding deduction or depreciation in the future country or otherwise;
- *valuation to follow the arm's length principle*. Where exit taxes are imposed, the tax should be determined in a manner consistent with the arm's length value of the shifted assets consistent with the OECD Guidelines. These principles include the importation of valuation models into the Guidelines;
- *treaty dispute resolution*. Where controversies arise, disputes should be resolved via applicable treaty mechanisms for the benefit of MNEs and the respective countries; and
- *guarantees or other means of coordinating tax on future income with realization of such income*. Where exit taxes are appropriate, an MNE should have a means of providing an adequate guarantee or assurance of paying the tax due as the income, upon which the unrealized gain is determined, is actually earned.

Business restructuring has been the subject of significant controversy between the OECD and the MNE community since its inception in 2005. This is understandable, as these transactions are typically viewed by tax administrations as giving rise to tax base defence issues (it is seldom that a tax administration is heard to complain of profits moved into its tax base) and by MNEs as a means of cost reduction needed to remain competitive in their industry. For the most part, chapter IX of the OECD Guidelines reflects an even-handed application of the OECD Guidelines to the phenomenon of business restructurings that result in the transfer of functions, assets, or risks from one jurisdiction to another. There seem to be exceptions with regard to the following:
- the party in question must have personnel who have the authority to, and effectively do, perform control functions concerning the risk;
- attention must be given to options (alternative forms of transactions) that could realistically have been available to achieve the objectives of the parties other than the transactions selected (as is also true under the BEPS discussion draft relating to special measures); and
- the OECD Guidelines implement even-handedness by imposing on the taxpayer an obligation to document the critical elements of its restructurings with respect to each party to the transactions in question.

In short, chapter IX frames the issues that will need to be addressed by tax administrations and MNEs in the context of restructurings undertaken for business and other reasons, with respect to which the OECD is realistic in accepting that tax minimization is a legitimate element of cost reduction in a competitive world – subject, of course,

75. FR: Tribunal Administratif (Paris), 11 May 2011, *Nestlé Finance France*, Ref. 0902095 (exit tax required with respect to intra-group cash-pooling arrangement relocated from France to Switzerland); X.S. Jaime, *French Administrative Court Supports Need for Exit Payment Following Cross-Border Transfer of Intragroup Routine Function*, 20 BNA Transfer Pricing Rep. (5 Apr. 2012), at 1237.
76. A. Louwinger & A. Fortuin, *Dutch Exit Tax Rules Restrict Freedom of Establishment, ECJ Says*, 2013 World Tax Daily (6 Feb. 2013), at 25-1 (discussing NL: ECJ, 31 Jan. 2013, *Commission v. Netherlands*, Case C-301/11, ECJ Case Law IBFD).
77. *See generally* Dhawate & Bajwa, *Exit Charges: Evidence from Third-Party Automotive and Industrial Supply Agreements*, 19 BNA Transfer Pricing Rep. S-3 (20 May 2010) (an analysis of termination provisions in unrelated-party agreements); N. de Boynes, *Exit Taxation in the EU After* DMC, 75 Tax Notes Intl. 4 (28 Jul. 2014), at 305 (reviewing EU case law involving the imposition and timing of tax on the transfer of assets); S. Zucchetti & R. Petrelli, *Exit Tax: Optional Deferral*, 21 Intl. Transfer Pricing J. 3 (2014), Journals IBFD (review of Italian exit tax on migration out of Italy, as well as EU developments). In 2011, the Dutch exit tax was held by the European Court of Justice to be disproportionate under EU principles relating to freedom of establishment. *SeeDutch Exit Tax Is Disproportionate, ECJ Holds*, World Tax Daily (29 Nov. 2011), at 230-22 (discussing NL: ECJ, 29 Nov. 2011, Case C-371/10, *National Grid Indus BV v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, ECJ Case Law IBFD (transfer of place of effective management from Netherlands to United Kingdom)). *See also* FR: CE, 31 Mar. 2010, Case 304715, *Ste Zimmer Limited* (a buy-sell distributor was converted to a commissionaire for a UK principal; French tax authority finding of a PE was rejected).

to arm's length principles for transactions that are involved in the restructuring.

5.6. Unilateral measures: UK diverted profits tax

While the United Kingdom has been a leader in the BEPS project, it has also distinguished itself by seeking to erode the tax base of other countries via the patent box regime. It has also undertaken to implement its own base protection strategies in a manner that goes beyond the thrust of the BEPS project.[78]

In the fall of 2014, it introduced a diverted profits tax targeted to deter and counteract the diversion of profits from the United Kingdom by MNE groups that (i) seek to avoid creating a UK permanent establishment or (ii) use arrangements or entities lacking economic substance to exploit tax mismatches through intra-group expenditure or diversion of income in circumstances where it is reasonable to assume that, in the absence of a tax benefit, the expenditure would not have been incurred or the income would have been within charge to UK corporation tax. The diverted profits tax applies to diverted profits arising on or after 1 April 2015. The normal rate of diverted profits tax is 25% of the diverted profit plus any true-up interest (in the oil sector, the rate is 55% plus interest). Credits are available in certain contexts.[79]

UK officials proclaim that the diverted profits tax is "consistent with the objective of the BEPS project".[80] It was introduced "to protect ourselves against highly contrived arrangements to avoid UK tax. Its objective is to ensure profits are taxed in the UK when the economic activities that give rise to them take place here".[81] These are arrangements where an MNE "goes to extraordinary lengths to avoid paying tax in the UK".[82] Such a mismatch would occur when a group pays less than 80% of the tax that would have been due in the United Kingdom in the absence of those arrangements, and the tax benefits must outweigh any other commercial purpose.

The ultimate charge levied under the diverted profits tax will normally be calculated by the application of the transfer pricing principles, and adjusted to take account of taxes paid in other jurisdictions. This ensures that there is no double taxation. In other words, it is declared that the diverted profits tax is not an attempt to tax profits that have been taxed elsewhere.

The diverted profits tax is intended to promote full disclosure and early engagement with HMRC.[83] It is a strong incentive for groups to provide timely information about high-risk transfer pricing transactions. There are many elements of the diverted profits tax that are problematic which will need to be addressed by MNEs as global planning regimes evolve, as discussed below (the diverted profits tax consideration).

6. Planning in Light of the Considerations

Epochal change in treaty, transfer pricing and related areas of international taxation are plainly on the horizon. Whether or not there is sufficient political will to push through even some of the BEPS Actions, the other developments (the considerations) are plainly underway. Accordingly, MNEs need to proactively engage with the new world dawning. This will require vigilance to assess the impact of the considerations on their respective effective tax rate planning, as well as thoughtful developments that will address the considerations and incrementally enhance the effective tax rate planning in a cost competitive world. For each MNE, there are at least two questions to be addressed:

– What do the considerations mean to the particular MNE's effective tax rate planning?

– How can this particular MNE incrementally evolve to enhance its effective tax rate planning in its cost competitive industry?

The answer to both questions will be driven by the relevance of the respective considerations. In summary form, the considerations include the following:

– *historic model rejection*: extant treaty, transfer pricing and related policies are being thoroughly reconsidered;
– *source evolution*: many countries are redefining tax principles appropriate to their own context (regardless of direction from global organizations);
– *country-by-country data*: there are likely to be fully transparent data available to all or many tax authorities;
– *special measures*: alternative options available or considered at the time of the transactions in question should be explained;
– *profit split*: it will be increasingly common for examination proposals to be based on profit splits applied to the country-by-country data;
– *BEPS challenge*: accommodation of the BEPS Actions implemented, whether by unilateral or multilateral action;
– *State aid*: obtaining relief from one government may be an element (not the driver) of future planning;
– *exit tax*: moving functions or risks from one country to another may trigger an additional layer of tax, which may or may not be creditable or deductible elsewhere; and

78. S. Picciotto, *The UK's Diverted Profits Tax: Admission of Defeat or Pre-Emptive Strike?*, 77 Tax Notes Intl. 3 (19 Jan. 2015), at 239.
79. UK: *Diverted Profits Tax Guidance* (HMRC 2015) (which contains detailed explanations of respective elements). Following consultation, HMRC made a variety of changes to the initial diverted profits tax legislation (revising HMRC notification requirements and expanded the "avoided PE" rule, which are explained in "Summary of Amendments Following the Technical Consultation (HMRC 2015). *See also* K.A. Parillo, *UK Diverted Profits Tax Legislation Both Narrowed and Broadened*, World Tax Daily (25 Mar. 2015), at 57-2.
80. *Financial Times*, 17 June 2015.
81. *Financial Secretary to the Treasury speech at 'Britain, Europe and tax competition' conference, organised by the European Tax Policy Forum and Institute for Fiscal Studies.* 1 June 2015.
82. *UK Financial Secretary Addresses Business Taxation Plans*, World Tax Daily (1 Jun. 2015), at 105-21 (remarks of Financial Secretary David Gauke).
83. In this sense, diverted profits tax may end up serving a similar function to the US "uncertain tax position" disclosure requirements. Lowell, Martin & Levy, *supra* n. 3, para. 10.07(6).

– *unilateral regime*: specific countries may adopt sui generis policies (such as the UK diverted profits tax) that pose the same kinds of problems as the exit tax and other considerations.

In the aggregate, these considerations reflect a situation in which international tax rules need to be thoughtfully overhauled to address needs of countries and MNEs in the current world, not a patchwork process (as is happening with the laundry list of considerations) of the century-old regime. In this regard, the OECD has made it perfectly clear that it is unwilling to revisit the residence-source model of the 1920s.[84]

In any event, the considerations reflect the tax world confronting all MNEs. The issue for many will be designing a means of addressing the questions noted above.

Interestingly, many MNE groups have, over the years, experienced many of these same considerations in other contexts. There is valuable learning to be derived from that experience.

6.1. Experience with similar considerations

The OECD Guidelines evolved in the late 1970s. At that point, there were only a few countries that were aggressively examining transfer pricing. The United States was certainly in that group. It made many material assessments against prominent MNE groups.

For example, there was a series of assessments in Japanese automobile cases in the early 1980s. Those cases were resolved in competent authority proceedings. The reaction of the Japanese Ministry of Finance and National Tax Administration (Japanese tax authorities) was to develop its own transfer pricing rules and regimes, which were introduced as part of the 1986 fiscal year tax reform and became effective for tax years beginning after 31 March 1986.[85] Thereafter, the Japanese tax authorities commenced an aggressive examination process, having learned from the automobile cases that development of their own expertise in this area was a critical element in defending the interests of their MNEs and tax base. As material examinations progressed, the normal process often included the following elements:

– information requests seeking data for global elements of transactional patterns relating to Japan. For example, in the case of a Japanese affiliate of AlphaCo in the Example, the Japanese tax authorities would request global data;
– in the early days, MNEs and their advisors often resisted the data requests on the grounds that, in essence, data beyond the borders of Japan were not relevant to transfer pricing issues in Japan (almost inevitably involving a one-sided method);
– the examination team would be persistent. The relationship often became antagonistic;
– if a stand-off continued, the Japanese tax authorities' examination team utilized pertinent provisions of Japanese law. In the case of non-cooperative taxpayers (failing to submit necessary information or doing so with significant delay), the Regional Taxation Bureau was authorized to determine taxable income based on an estimation using comparable data in its possession.[86] This provision authorized the use of so-called secret comparables, which were utilized to derive presumed gross sales and profit ratios from the comparables having size and business similar to the taxpayer, and ultimately an arm's length price from the perspective of the Japanese tax authorities;[87]
– where secret comparables were utilized, the contentiousness of the examination would, not surprisingly, continue on an adversarial trajectory.[88] In theory, such secret information would be disclosed in competent authority proceedings, although this was also a difficult and often drawn-out process;[89]
– when the disputes crystallized, the Japanese domestic appeals and judicial processes at that time were generally not viewed as favourably disposed to MNE appeals of transfer pricing matters, although some disallowances of adjustments did occur;[90]
– on the other hand, cases were successfully resolved in examination as well as in competent authority (and often related APA procedures) processes notwithstanding these elements of the practice of the Japanese tax authorities. Some MNEs were comfortable disclosing the global data requested, often organizing it in a manner to facilitate profit split presentation, which was plainly presented to the Japanese tax authorities and other country tax authorities seeking to defend the taxpayer's position and find common, bilateral ground for resolution.[91] There would then be a detailed examination of the profit data concerning the respective functions and risks of the global parties. In situations where the examination had become adversarial before the data were provided, the process was, not surprisingly, more difficult to get back on a cooperative footing, but such results were certainly achieved with good faith on both sides; and
– as the Japanese tax authorities gained experience with these processes, they began to deviate from their

84. *See* sec. 5.2.
85. JP: Special Taxation Measures Law art. 66-5. *See generally* Y. Gomi, *Guide to Japanese Taxes 1992-1993* (Zaikei Shoho Sha 1992), at para. 6-200.
86. Art. 66-4-6 and 7 (at the time),Special Taxation Measures Law.
87. Art. 66-4-9 (at the time), Special Taxation Measures Law.
88. Criticisms of the policies of the Japanese tax authorities were plainly and publicly framed. *SeeU.S. Practitioners Critique Japanese Competent Authority Process*, World Tax Daily 79-4 (24 Apr. 2001).
89. *NTA Will Disclose Secret Information to Competent Authority, Official Confirms*, 10 BNA Transfer Pricing Rep. (8 Aug. 2001), at 256.
90. T. Aritake, *Japanese Court Finds Reinsurance Contract With Irish Subsidiary Legitimate*, BNA Daily Tax Rep. (8 Dec. 2008), at I-1 (Japanese court disallows transfer pricing adjustments in a case involving a domestic reinsurance company and its Irish subsidiary, in a rare order to the regional tax authority to withdraw its tax deficiency).
91. Such a process is described in P.L. Briger, Y. Gomi, C.H. Lowell, J.-M. Tirard, K. Someya, T. Ueda & B. Gangemi, *Criticisms of the Japanese National Tax Administration Agency's Performance in Competent Authority Matters: A Different Experience*, 23 Tax Notes Intl. 5 (30 July 2001), at 621. Interestingly, provision of the complete global information requested by the Japanese tax authorities was often similar in nature of what is now included in the BEPS country-by-country templates; *see* sec. 5.3.1. (as will be developed below).

insistence on profit split analysis. For a period, they developed a so-called hybrid method that reflected an effort to blend two- and one-sided methodologies.[92] In some cases, this produced an apparently convoluted transfer pricing method, especially in ongoing APAs. On the other hand, the process was understood and manageable on both sides of bilateral arrangements. Ultimately, the Japanese tax authorities gained confidence and accepted one-sided methodologies,[93] and agreed to binding arbitration in certain treaties.[94]

This experience in Japan is similar in nature to the evolution of transfer pricing processes in other countries. For present purposes, the point is that the considerations discussed above may seem new and confrontational, but they actually represent evolutions of processes that have been underway in other contexts for many years. Experience from those periods may be helpful in framing MNE policies in the future.

6.2. A planning agenda for AlphaCo in the Example

In the Example, AlphaCo requested advice on:
- the considerations that it needs to take into account as it plans for implementation of its planned utilization of HoldCo and its local country affiliates; and
- an agenda for implementing its evolving strategy in a manner designed to successfully navigate those considerations.

The first question is answered with the laundry list of considerations. The response to the request for an agenda can be gleaned from the experience noted above in dealing with, for example, the evolution of transfer pricing dispute processes in Japan twenty-plus years ago (and other countries in the interim).

In this time of epochal change, it is inevitable that the present treaty and transfer pricing principles will evolve. As new rules are developed (relating to, for example, intangibles, PE definitions and the digital economy), they will offer opportunity for thoughtful companies to evaluate how the rules can be used to defend and expand effective tax rate planning strategies.[95] As always, the race will go to the nimble. With forward-thinking creativity, many MNEs may actually be able to seize the considerations as an opportunity. This is a function of a critical factor that the BEPS project fails to fully engage with, namely that business will continue to operate in a world where there is no single coordinated taxation regime; each country has sovereign taxation rights; and tax policy making will be a fundamental ingredient of competition among countries for attracting inward investment (as it is between MNE groups).[96]

For groups like AlphaCo in the Example, the key focus will be to assess their existing effective tax rate planning in terms of the considerations, and then chart the way forward. In the case of AlphaCo, the specific question will be whether and how to proceed with its HoldCo and local affiliate plan.

6.2.1. Attorney-client privilege

A first step in such a process is to determine whether it should be undertaken within the protections of the attorney-client privilege or similar protections in non-common law legal systems.[97] As with each of the items to be addressed, there are pros and cons that can be developed in the context of specific situations.

6.2.2. Identify critical planning elements

The next step could be to revisit the MNE's effective tax rate planning to identify which of the building blocks upon which that planning is based are subject to one or more of the considerations (the critical planning elements).

6.2.3. Modelling

A third step could be to model the potential impact of the considerations on the critical planning elements (based on the working assumption that each of the considerations evolves as presently anticipated). This could involve the elements set forth below.

- Establish a simplified spreadsheet version of the effective tax rate planning.
- Evaluate the likely impact of each evolving element of the considerations. In the AlphaCo context of the Example, these could include as follows:
  - *Source evolution*. Determine in which of the affiliate countries are the tax authorities are adopting aggressive policies.
  - *Country-by-country data*. The template will make global income and tax allocations transparent, so plan accordingly and develop the data that could be required.
  - *Special measures*. Are any of the function/risk evolutions likely to be targets of special measure considerations? If so, proceed as noted below with respect to profit splits.
  - *Profit split*. As noted above with respect to Japan and other country experience, utilize existing profit split models of AlphaCo to assess the

92. T. Nakamura, *Hybrid Method in Komatsu APA Shows Importance of Using Consolidated Results in Profitability-Based Method*, 5 BNA Transfer Pricing Rep. (12 Mar. 1997), at 723; Schwinn, *Japan's NTA Using 'Formulary' Profit Split in Hybrid-Method Bilateral APAs, Practitioners Say*, 6 BNA Transfer Pricing Rep. (17 July 1997), at 175. *See alsoNTA, IRS Continue to Use Hybrid Method in Bilateral APA Negotiations, Sources Say*, 6 BNA Transfer Pricing Rep. (16 July 1997), at 186; T. Aritake, *U.S.-Japan Hybrid Method for APAs Seen Boosting Settlements, Practitioners Say*, BNA Daily Tax Rep. (23 Aug. 1996), at G-1.
93. *Japan Abolishes Priority of Methods, Writes Profit-Based Methods Into Law*, 20 BNA Transfer Pricing Rep. (14 July 2011), at 251.
94. Y. Nagano, *Revised Japan-U.S. Tax Treaty Includes Mandatory Binding Arbitration Procedure*, BNA Daily Tax Rep. (13 June 2013), at I-4.
95. L.A. Sheppard, Rosbif *Rules: What Should the OECD Do About Base Erosion?*, Tax Notes 174-1 (9 Sept. 2013), at 1055 (reviewing a variety of elements of the initial BEPS Action Plan and suggesting that "taxpayers will find new tricks when old ones are shut down", in the context of tax arbitrage).
96. Of course, this process is plainly underway in the context of what the authors have described as unilateral country action. *See* sec. 5.6.
97. *See generally* Lowell & Martin, *supra* n. 21, Chapter 8.

defendability of the effective tax rate planning in view of the considerations. If AlphaCo does not have such a model, begin developing a format that can be utilized in any situation. The authors' experience is that such internal profit split analysis is a helpful means of confirming one-sided analysis used for transfer pricing documentation purposes (and which need not be disclosed in the documentation, although it is available in the event of question or challenge by one, both or many sides of a transactional pattern).

– *BEPS challenge*. Evaluate each of the BEPS Action items. For example if the AlphaCo plan will involve material digital activity, it will be important to take into account the likely direction of those policies on a local and global basis. This may be consistent with the special measures (such as formulary apportionment applicable to digital commerce, which can be taken into account easily enough) and profit split elements noted above.

– *State aid*. If there are existing or potential special regimes available to HoldCo or otherwise, take the EU State aid developments into account. For example determine whether some type of special financial reserve would be appropriate.

– *Exit tax*. The AlphaCo – HoldCo plan could involve a variety of functional evolutions from AlphaCo to HoldCo or its local affiliates. As each element is evaluated, consider whether there are exit or similar tax considerations to be taken into account. Moving functions or risks from one country to another may trigger an additional layer of tax, which may or may not be creditable or deductible elsewhere.

– A frequent element of such analyses is to have a valuation undertaken of specific functional evolutions. In this regard, it is often critical to address financial valuation, financial accounting and transfer pricing issues at the same time in order to avoid creating a situation where a tax authority could use the group's own valuation against it.[98] The overall approaches should be consistent, with the inevitable differences/divergences noted, valued and substantiated.[99] Coordination of the analyses will inevitably be more efficient, and will certainly anticipate the questions that may be pertinent. If the projects are undertaken separately, and without such coordination there is likely to be significant room for dispute as to the meaning of the respective analyses.

– *Unilateral regime*. If countries important to the AlphaCo-HoldCo plan have adopted sui generis policies (such as the UK diverted profits tax), such regimes need to be addressed in a consistent manner.

– Segregate the elements into those that are and are not material to the effective tax rate planning.

– For those that are material, begin a process of evaluating steps that could be taken, consistent with overall business plans, to mitigate adverse consequences of such elements if they should, ultimately, become reality. In essence, these approaches are contingent plans.

For example, in the case of the potential functional movements from AlphaCo to HoldCo in the Example, it may be appropriate to make only incremental changes, leaving existing functions that could have intangible value in place to be evolved over time as new technologies or functionality is developed in HoldCo, as noted further below.

There will also be issues to be addressed in each country in the case of functional movements, including the following. In each country from which functions or risks are moved, there will likely be questions from the relevant tax authorities concerning whether the transfer of function/risk has been achieved on arm's length terms. In preparation for these questions, and to comply with transferor country tax return filing obligations, as well as transfer pricing documentation requirements, attention will need to be given to the following:

– valuation of the assets, functions, risks or liabilities transferred, which will depend in part on the form of the restructuring transaction (e.g. sale, licence, assignment, contribution). The valuations may be significant for tax and book purposes;
– arm's length consideration to be received by the transferor entity, or the entity that loses the function/risk in question. The focus of tax authorities on these issues has been heightened by the recent OECD business restructuring additions to the Commentary on the OECD Model and the OECD Guidelines;
– preparation of transfer pricing documentation reflecting the pre-restructuring and post-restructuring arrangements;
– preparation for tax authority examination, such as creating mock document requests and queries to ensure that necessary documentation has been prepared contemporaneously with the transaction (versus after the examination has begun); and

98. For example, if a valuation is prepared with a material element of goodwill, a tax authority in the country from which a function is moved may take the position that, for transfer pricing or exit tax purposes, the goodwill is an intangible. *See* Hanna et al., *supra* n. 29, paras. 2.24 and 9.24.
99. S. Schnorberger, *The Seven Deadly Sins of Post-Acquisition IP Transfers*, 23 BNA Transfer Pricing Rep. (22 Jan. 2015), at 1230 (indeed, "failing to coordinate purchase price and tax valuations" is identified as one of the seven deadly sins of post-acquisition IP transfers).

- identify tax treaties and exchange of information agreements between these countries and ensure that the right to appeal to the competent authority is preserved. If there are no such arrangements, ensure that the statute of limitations is open for the affected tax year(s) in all taxing jurisdictions involved.

In the country that takes over the functions and risks, there will be similar questions:
- valuation: same as noted above;
- arm's length consideration to be paid by the transferee entity: as noted above. The tax authorities in the transferee's country will be concerned about the amount of payment, specifically whether it is in excess of arm's length terms;
- preparation of transfer pricing documentation reflecting the post-restructuring arrangements; and
- preservation of rights to appeal to the competent authority and ensuring that statutes of limitations are aligned for all affected tax years in all tax jurisdictions involved.

- Take these plans into account as business decisions need to be made.
- Transitional considerations.
- Home country tax authority coordination. In the evolving world, relationship with the home country tax authority will be even more critical than it is today. The authors' experience is that a close working relationship – whether reflected in APAs or other unilateral or bilateral agreements – can be critical to minimize exposure to double or multiple taxation, especially in the uncertainties of the world that are on the horizon.

In practice, the authors' experience is that modelling these matters is a relatively straightforward process. For example, it is regularly undertaken with respect to resolving substantive tax or transfer pricing disputes (either administratively or in competent authority, APA, or litigation contexts) in which likely outcomes are evaluated to develop similar contingency plans or business plan adaptations.

6.2.4. Planning opportunities

A fourth step will be to consider steps to either take advantage of opportunities to strengthen, or minimize any adverse impact on the critical planning elements.

As is true in any type of material change, legacy structures may need to be revisited, especially where anticipated tax benefits are accruing annually and the existing planning will be affected by that evolution. A specific approach could be along the following lines: In the Example, the final assembly of Unique Products may have evolved over many years as available technology allowed for incremental efficiencies. Assume that the present process is Final Assembly 5.0. This process could be viewed as an intangible of AlphaCo. The valuation – accounting – transfer pricing process noted above should be undertaken. If it turns out that there is risk of an intangible transfer, develop alternative plans. For example, it may be appropriate for HoldCo to license Final Assembly 5.0, enter a cost-sharing agreement or simply wait until it can develop a final assembly process on its own using resources uniquely available to it in Country *B*.

7. Conclusion

MNEs are entering an exciting and challenging time. The G7, G20 and OECD, as well as source countries, have made it clear that they seek a fundamental rewrite of the principles of international taxation laid down almost a century ago. The ultimate materiality of the BEPS project and the other considerations noted above will evolve in due course.

Given that the current opportunities for international tax planning are, and always have been, largely a consequence of rules developed by countries for their own purposes (rather than anything MNEs have created on their accord), it is possible that little may actually come about if countries ultimately decide to protect their own tax base at the expense of other countries, as has occurred in the past (such as the OECD harmful tax competition process).

While these developments are evolving rapidly on a global basis, it is a process that has been experienced often on a country-by-country basis in the past. Learning from those times should provide a beacon for charting the way forward for MNE groups to cope with the current range of considerations. Controversy dockets at all levels are likely to continue to escalate in terms of sheer numbers as well as swelling inventory, so it is to be hoped that global processes will also evolve to provide means of meaningful relief for both countries and MNE groups.

Oddly enough, it appears that the intense focus of the BEPS project, in conjunction with the other considerations, seems to be driving planning and acquisition strategies toward the world that existed long ago, of utilizing non-treaty protected corporate structures as a means of minimizing the imposition of transfer pricing, exit or other taxes on the movement of intangibles or other assets in the process of evolutions required to address competitive and other challenges of global business reality. This is probably not an outcome anticipated in the launch of the BEPS project or other considerations.