Global Awareness Training
for
International Tax Examiners

OECD

- This training on Global Awareness for International Tax Examiners was originally given by the U.S. Competent Authority at an OECD meeting to promote awareness of "global tax administration" goals
- Modifications have been made to make the training more U.S. tax centric without losing the broader global context
- The OECD (Organisation for Economic Co-operation and Development) mission is to promote policies that will improve the economic and social well-being of people around the world
- The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems

Training Objectives

- This training module is designed to raise the awareness of International Tax Examiners (ITEs) to important considerations associated with tax treaties and the global tax administration environment
- This module is designed for International Tax Examiners working on a case involving a country that has entered into a bilateral income tax treaty (also known as a "double tax convention" or "double tax agreement") with the U.S.
- This module is intended to provide general guidance to an ITE making a cross-border tax adjustment that might result in double taxation
- After completion, the ITE will have a better understanding of what is needed to sustain a cross-border tax adjustment under bilateral income tax treaties

Overview of Presentation

- Role of examiners in global tax administration
- Transfer pricing adjustments and treaty mechanisms to provide double taxation relief
- Tax treaties goals and how they operate
- Role of Competent Authority and the MAP Articles of treaties
- Transfer Pricing adjustments under Section 482 and OECD transfer pricing guidelines
- OECD BEPS Project and Action Plan
- Role of the ITE and Best Practices for ITEs

Basic Definitions

- For purposes of this module, an “International Tax Examiner” (ITE) is <u>any</u> tax examiner or tax auditor, however designated, in a position to reassess or adjust a tax position taken by a multinational enterprise where that cross border tax adjustment could result in “double taxation” of a multinational enterprise
- For purposes of this module, a “multinational enterprise” (MNE) is any entity or group of related entities engaged in business or investment activities in more than one country
- The transactions described in this module are between related or controlled parties residing in countries that are parties to a bilateral income tax treaty

Key Global Awareness Points

- This training module presents the following key global awareness points:
  - ITEs play an important role not only in the tax administration of their own country but also in a broader "global tax administration" established through relationships between and among countries that have entered into income tax treaties with one another
  - The primary goal of tax treaty partners is to secure the appropriate tax base for each jurisdiction and avoid double taxation, thereby minimizing conflict between tax administrations and promoting international trade and investment

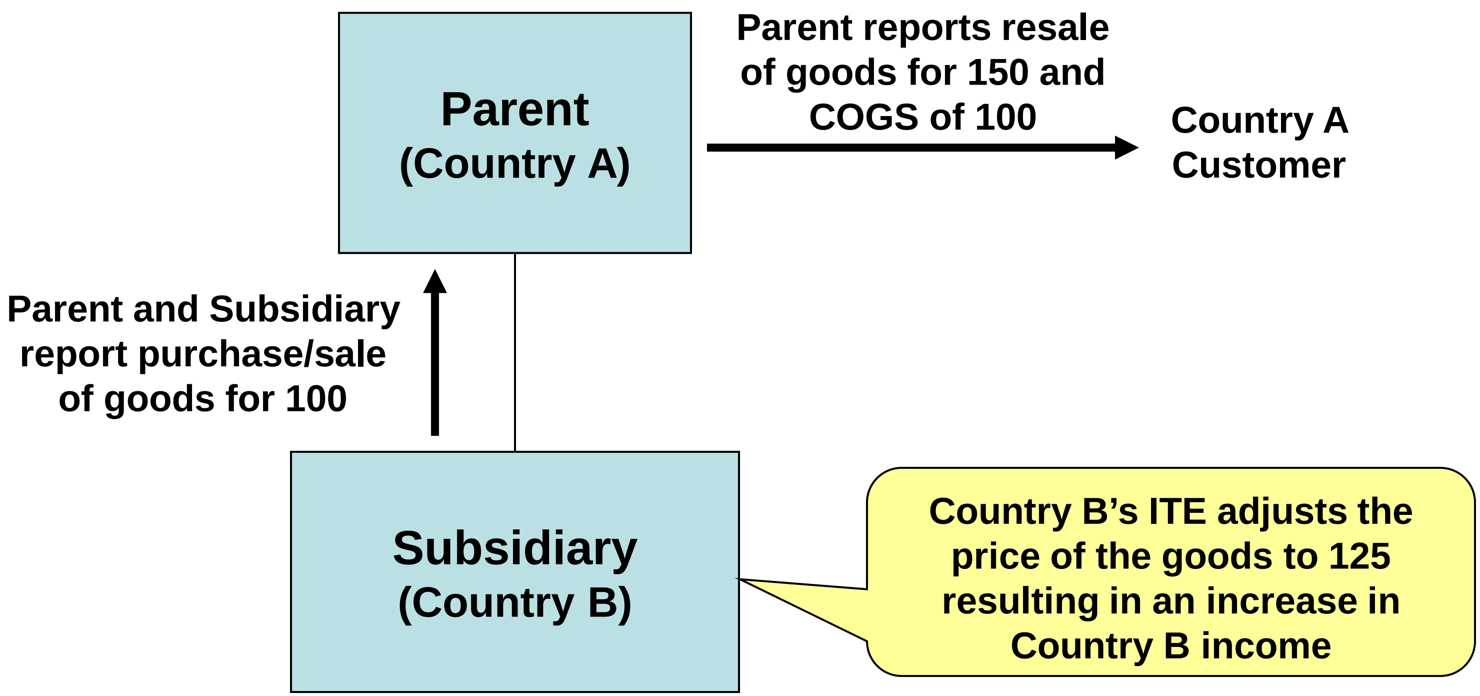
U.S. Adjustments and Double Taxation Relief

- A tax adjustment in the U.S. could result in potential double taxation of an MNE, and thus raise a potential conflict with a treaty partner, when the adjustment changes the taxation of an item of income or expense that the MNE has already reported in the treaty country
- Examples:
  - A tax adjustment results in an inclusion in the U.S. tax base of income already subjected to tax in another treaty country
  - A tax adjustment results in a disallowance of a deduction in the U.S. for a payment already subjected to tax in another treaty country
  - A tax adjustment results in the imposition of a withholding tax by the U.S. on a payment already taxed in another treaty country

Foreign Adjustments and Double Taxation

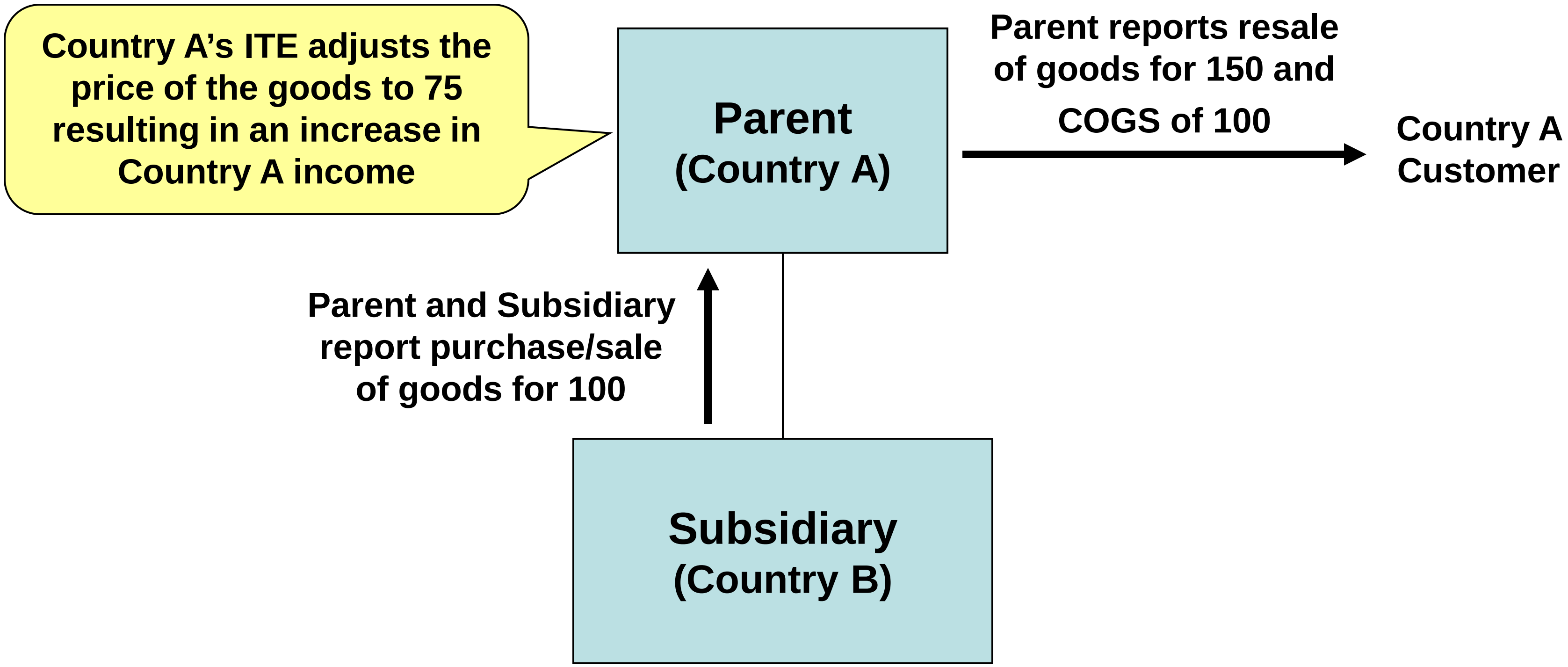
- Transfer pricing adjustments on U.S. MNEs in treaty countries can increase income or disallow deductions in the treaty country which can result in additional foreign tax on the U.S. MNE and/or its foreign affiliates
- The U.S. MNE taxpayer must exhaust all "effective and practical" remedies (including competent authority procedures provided under applicable tax treaties) to reduce, over time, its liability for the foreign tax
- Failure to exhaust all remedies, including invoking the competent authority process under the relevant treaty, can result in denial of the foreign tax credit (FTC) as a non-compulsory or voluntary payment
- ITEs should verify that remedies have been exhausted before allowing FTCs to be claimed

Double Tax Example 1



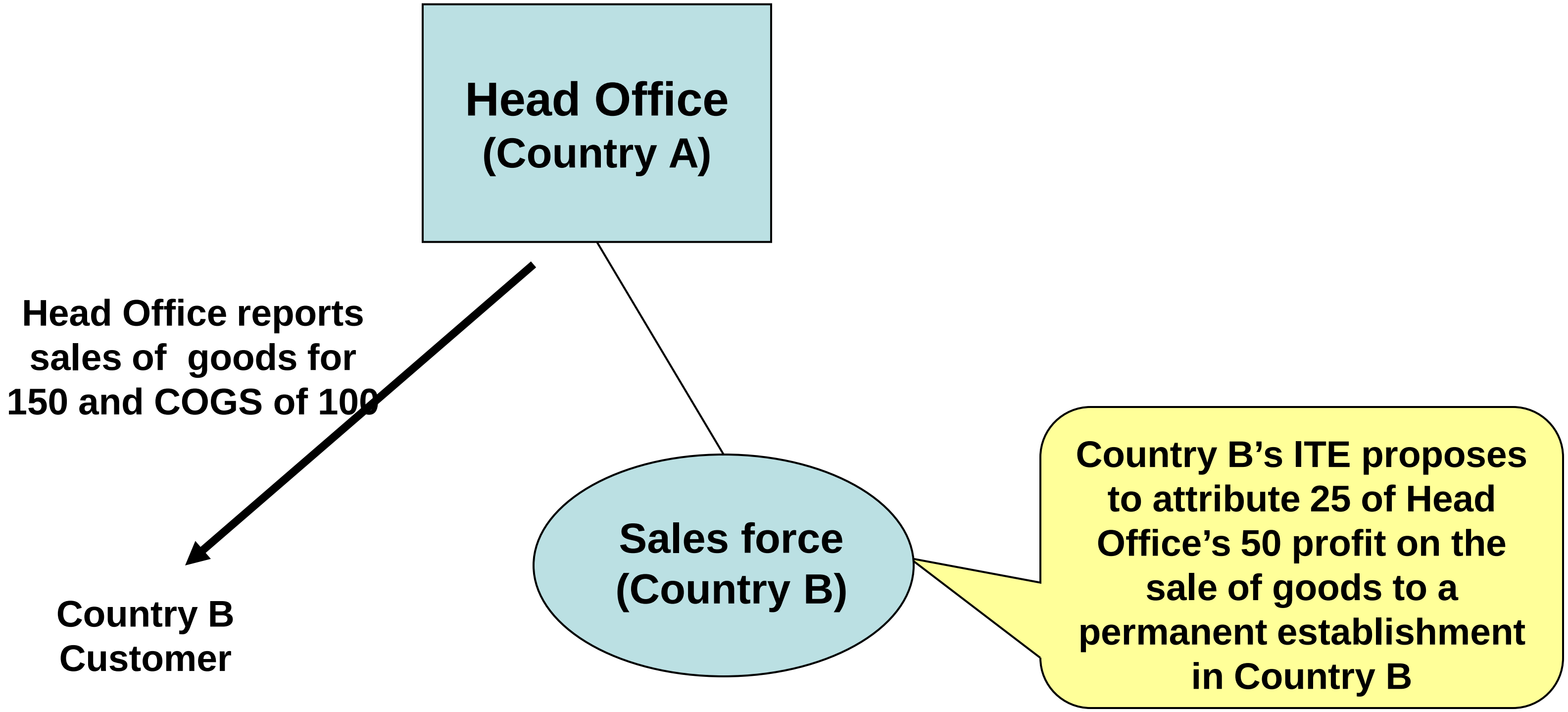
ITE's adjustment to Subsidiary's income creates potential for double taxation because the adjustment does not automatically reduce the amount of sales income of Parent taxed in Country A

Double Tax Example 2



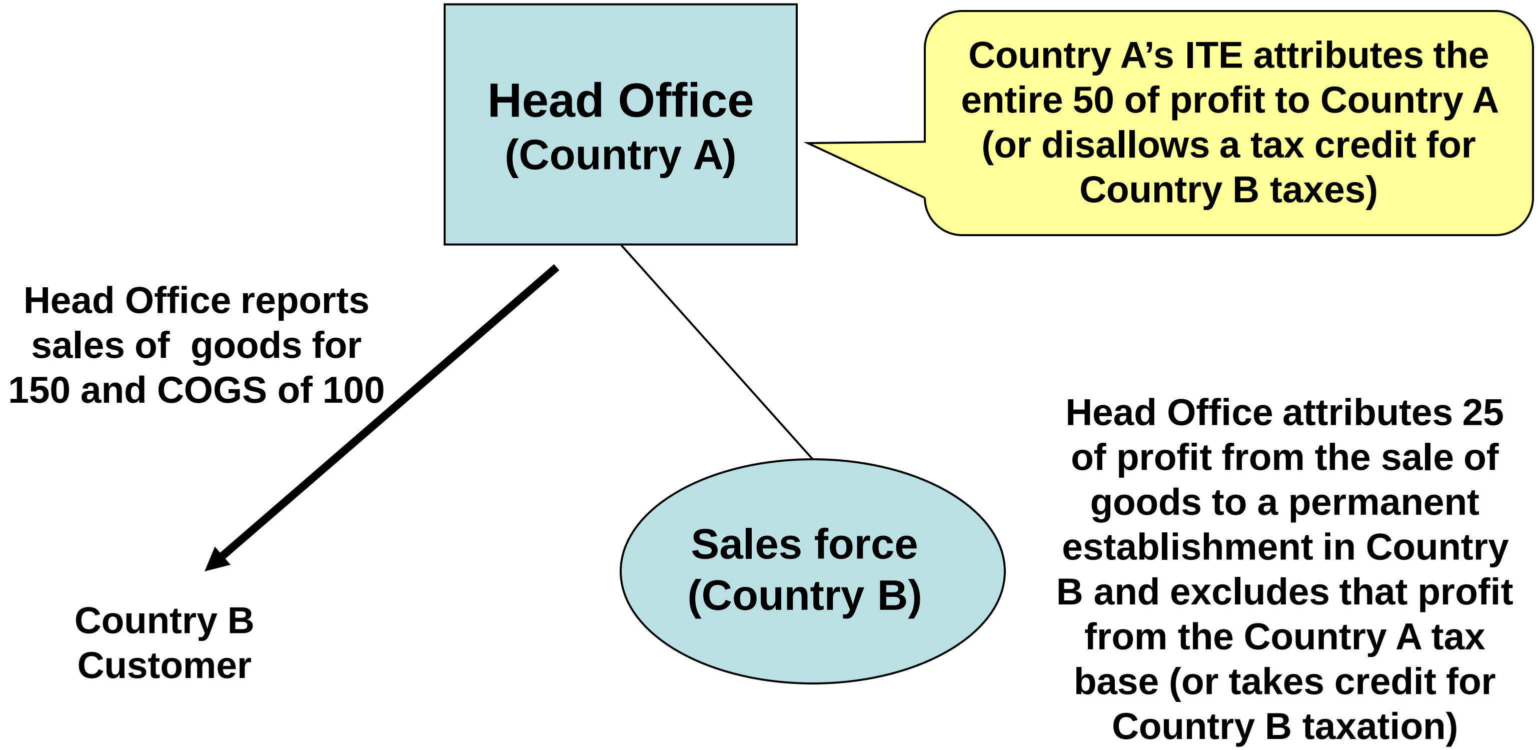
ITE's adjustment to Parent's income creates potential for double taxation because the adjustment does not automatically reduce the amount of sales income of Subsidiary taxed in Country B

Double Tax Example 3



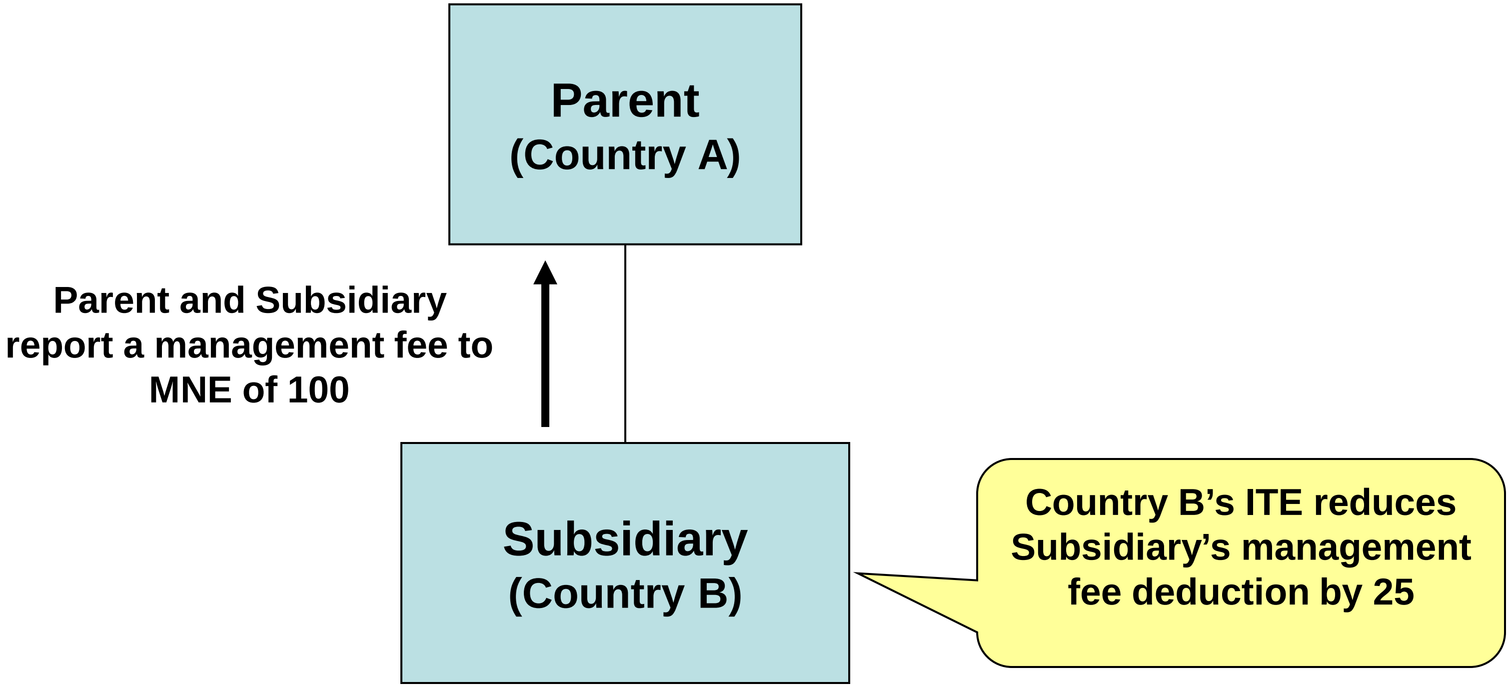
ITE's adjustment creates potential for double taxation because the adjustment does not automatically reduce the amount of sales income of Head Office taxed in Country A

Double Tax Example 4



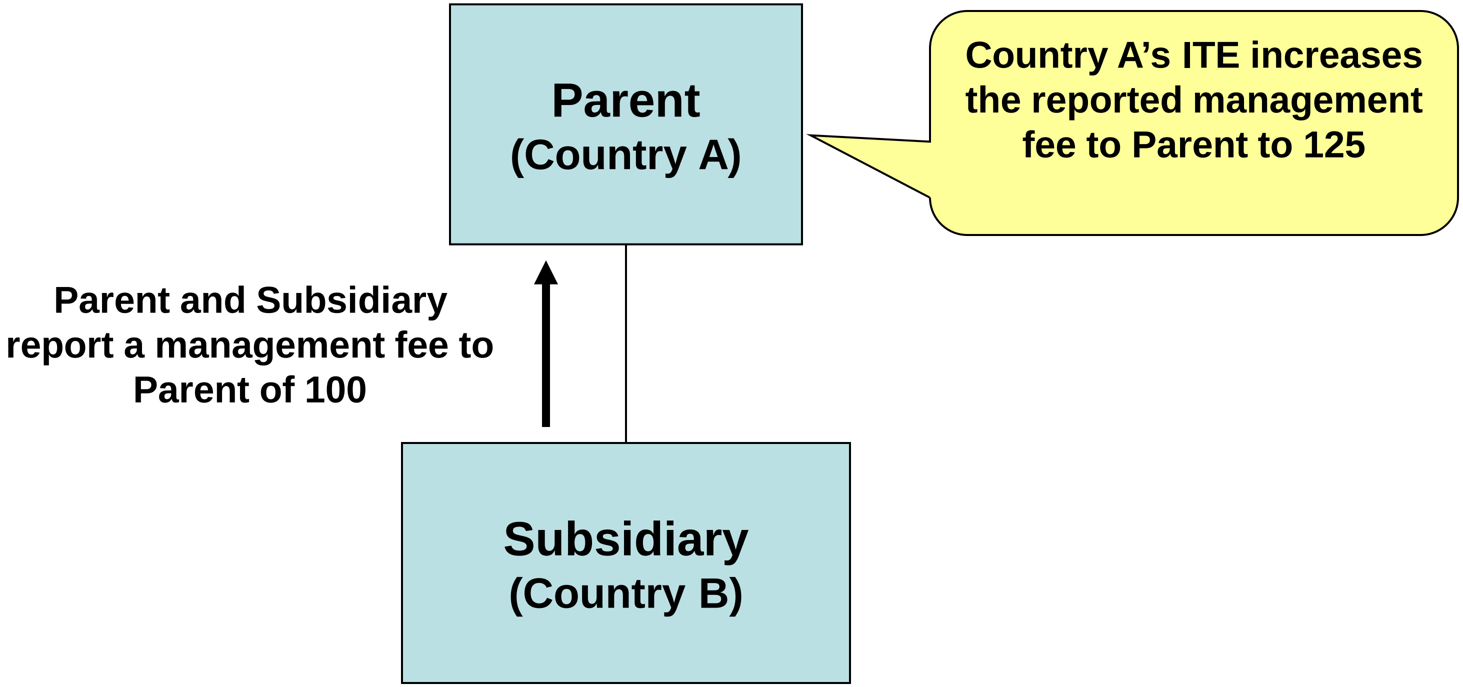
ITE's proposed adjustment creates potential for double taxation because the adjustment does not automatically reduce the amount of sales income of Head Office taxed in Country B

Double Tax Example 5



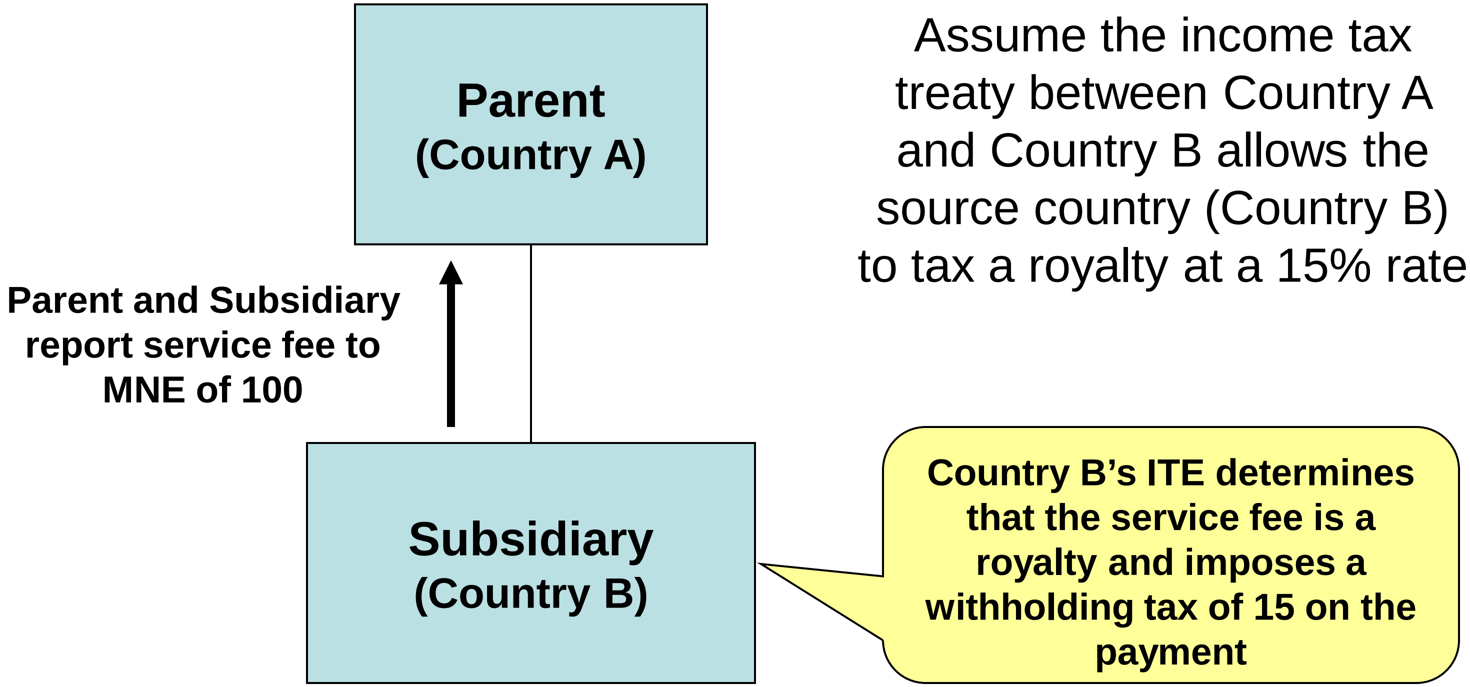
ITE's adjustment to the management fee creates potential for double taxation because the adjustment does not automatically reduce the management fee reported in Country A

Double Tax Example 6



ITE's adjustment to the management fee creates potential for double taxation because the adjustment does not automatically increase in the management fee deducted in Country B

Double Tax Example 7



Assume the income tax treaty between Country A and Country B allows the source country (Country B) to tax a royalty at a 15% rate

ITE's adjustment creates potential for double taxation because the adjustment does not automatically reduce the service fee taxed in Country A (assuming no credit is provided for the withholding tax)

Goals of Bilateral Tax Treaties

- There are more than 3,000 bilateral income tax treaties globally designed to eliminate double taxation and allocate taxing rights on MNEs engaged in business or investment activities involving two or more countries
- Countries that have entered into income tax treaties have agreed to a basic proposition – that the two countries should seek to eliminate double taxation when the country of residence is not unilaterally able to arrive at a satisfactory solution (e.g., providing a foreign tax credit for the additional foreign tax)
- The elimination of double taxation is viewed as desirable so as not to impede cross-border business activity and investment between the tax treaty partners

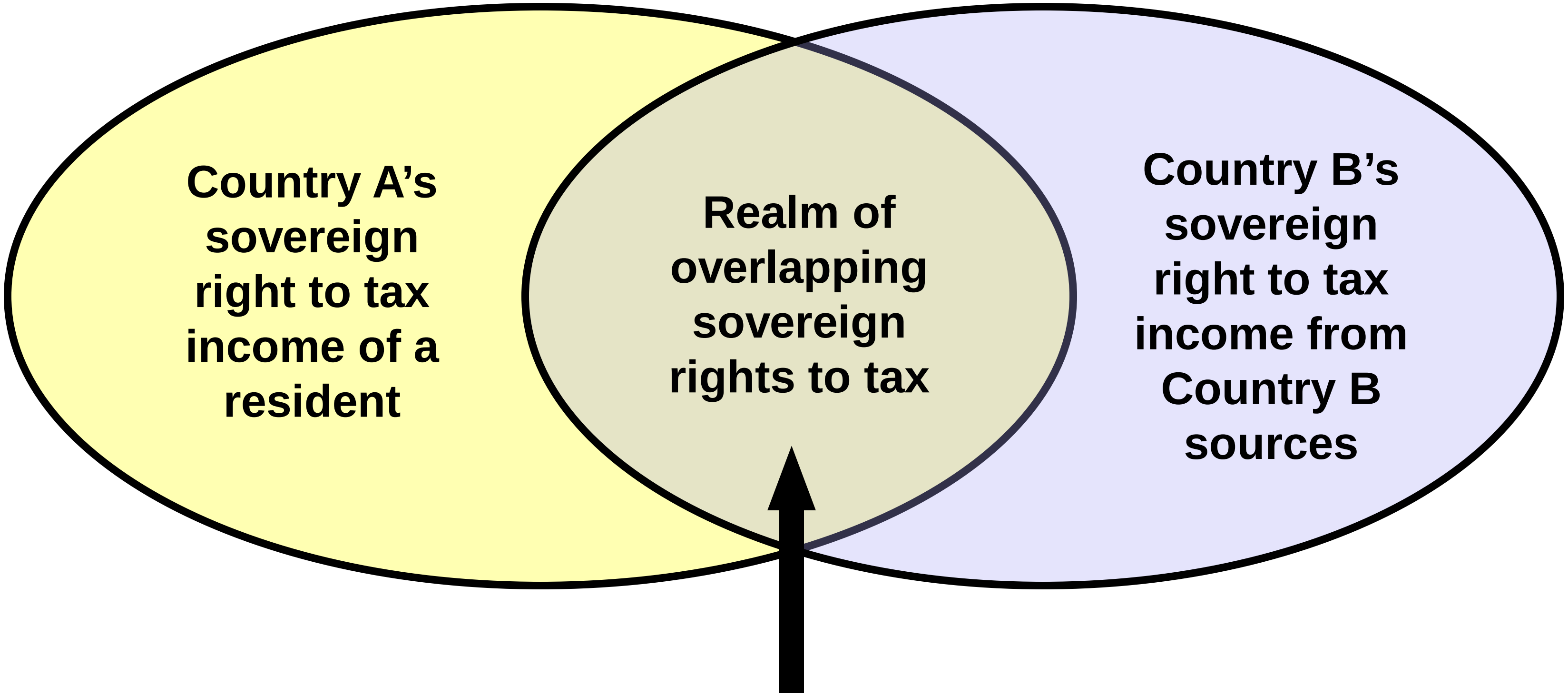
Treaty Partners Work Together

- To achieve their goal of eliminating double taxation, treaty partners should work together to establish:
  - a mutual understanding of the business operations and global organizational structure of an MNE
  - a mutual understanding of the tax results and open issues presented by the business operations and global organizational structure of an MNE
  - a mutual acceptance of established principles to help resolve situations when cross-border tax adjustments by either treaty partner result in double taxation

General Operation of Tax Treaties

- The country in which an MNE is a "tax resident" is considered to be the "residence country" for treaty purposes
- The country in which an MNE is engaged in a business or investment activity is considered the "source country"
- Tax treaties generally operate by:
  - requiring the residence country to relieve taxation of income properly taxed by the source country and
  - providing the extent to which the source country can tax income from sources in that country
  - Reducing the source country withholding tax rates on passive income (e.g., interest, dividends and royalties)

Reconciliation of Sovereign Rights



A fundamental purpose of tax treaties is to reconcile one country's sovereign right to tax the income of its tax residents with another country's sovereign right to tax income from sources within the country

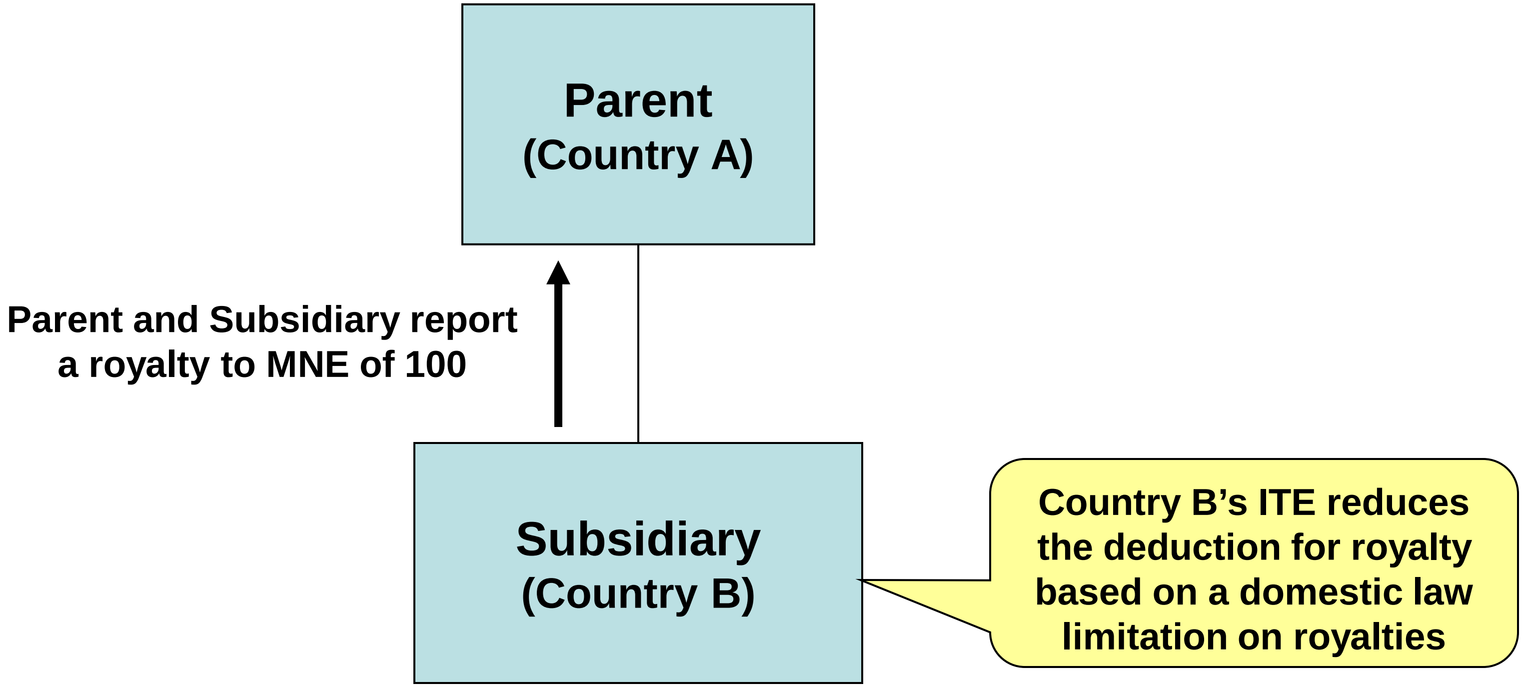
General Operation of Tax Treaties

- Under tax treaties, the residence country agrees to relieve double taxation of income properly taxed in the source country by:
  - Excluding the income from its own tax base; or
  - Providing a tax credit for the source-country tax (e.g., U.S)
- Proper source-country taxation is established by:
  - Requiring that transfer pricing between related enterprises be in accordance with the "arm's length principle"
  - Limiting the taxation of an MNE's business profits derived from the source country to situations where the physical presence or local activities constitute a permanent establishment (PE) in the source country
  - Defining the character and source of certain cross-border payments and limiting the extent to which the payments can be subject to source country withholding taxes

Global Awareness Considerations

- It is important that tax treaties be consistently applied to eliminate double taxation whenever possible, regardless of the nature of the adjustment giving rise to potential double taxation
- Tax treaties are typically applied in this way when adjustments are made under the transfer pricing rules of one of the treaty partners
- Depending on the terms of the applicable tax treaty and the mutual understanding between the countries, the treaty may also apply when an adjustment made under the "domestic" law gives rise to double taxation

Scope of Tax Treaties



ITE's adjustment creates potential for double taxation because the adjustment does not automatically reduce the royalty taxed in Country A; the treaty between Country A and Country B should be considered

Effect of Tax Treaties

- Treaties may override domestic tax law and/or call for deference to foreign tax law regarding:
  - **<u>Taxpayer residency</u>**, by, for example, resolving cases where a taxpayer is considered a resident of both countries under the domestic laws of each by use of the treaty's tie-breaker rules
  - **<u>Characterization of income</u>**, by attempting to resolve cases where the residence country and the source country classify the same item of income or capital differently
  - **<u>Timing of income</u>**, by, for example, providing that the residence country must provide relief from double taxation in a different year than the one in which the source country would tax the same income or by finding another way to relieve double taxation
  - **<u>Source of income</u>**, by providing, in some treaties, that income taxable under the treaty by one contracting state may be deemed to be sourced in that country, regardless of the tax laws of the other country

Competent Authority

- Tax treaties delegate responsibility for resolving situations of double taxation to a "competent authority" (CA) in each country
- Countries have delegated this responsibility to specific individuals, or a specific office, within their tax administrations
- Tax treaties contemplate that these CAs will work closely together to resolve double tax matters through a process referred to as the "Mutual Agreement Procedure" (MAP)
- Most tax treaties have a MAP article that specifies how and when MAP can be initiated by a taxpayer and how the treaty partners should handle the MAP request

The U.S. Competent Authority

- The U.S. Competent Authority is the Deputy Commissioner (International)
- Two groups under the U.S. CA are charged with resolving MAP issues: APMA and TAIT
- Transfer pricing double taxation issues involving MAP and APAs (Advance Pricing Agreements) are now handled by APMA (Advance Pricing and Mutual Agreement)
- Non-Transfer pricing tax treaty issues eligible for MAP (e.g., residency, limitation on benefits, withholding rates) are handled by TAIT (Treaty Assistance and Interpretation Team)

Taxpayer's Right to MAP Access

- Tax treaties grant the right to invoke MAP to seek double tax relief to any taxpayer that is a resident of one of the treaty countries when there is taxation not in accordance with the treaty
- Taxpayers typically initiate this process by filing a formal MAP request with the CA of the taxpayer's country of residence (or country where the taxpayer is a "national" if not resident in either country)
  - Each CA establishes its own procedures for initiating requests
  - The taxpayer may file a request for MAP assistance before adjustments are finalized but only when the audit is sufficiently advanced such that the adjustment is not a mere possibility

Denying access to MAP

- OECD commentary states that a MAP request by a taxpayer should not be rejected without good reason (undefined).
- U.S. CA can deny MAP consideration or assistance under Rev. Proc. 2006-54 for several reasons, including if:
  - the taxpayer is only willing to accept a settlement under conditions that are unreasonable or prejudicial to the interests of the U.S. government
  - the taxpayer does not furnish sufficient information to determine whether the treaty applies to the taxpayer's facts and circumstances or is uncooperative
  - the taxpayer acquiesced in a foreign initiated adjustment that involved significant legal or factual issues that otherwise would be properly handled through MAP and then unilaterally made a corresponding correlative adjustment or claimed an increased foreign tax credit, without initially seeking U.S. CA assistance

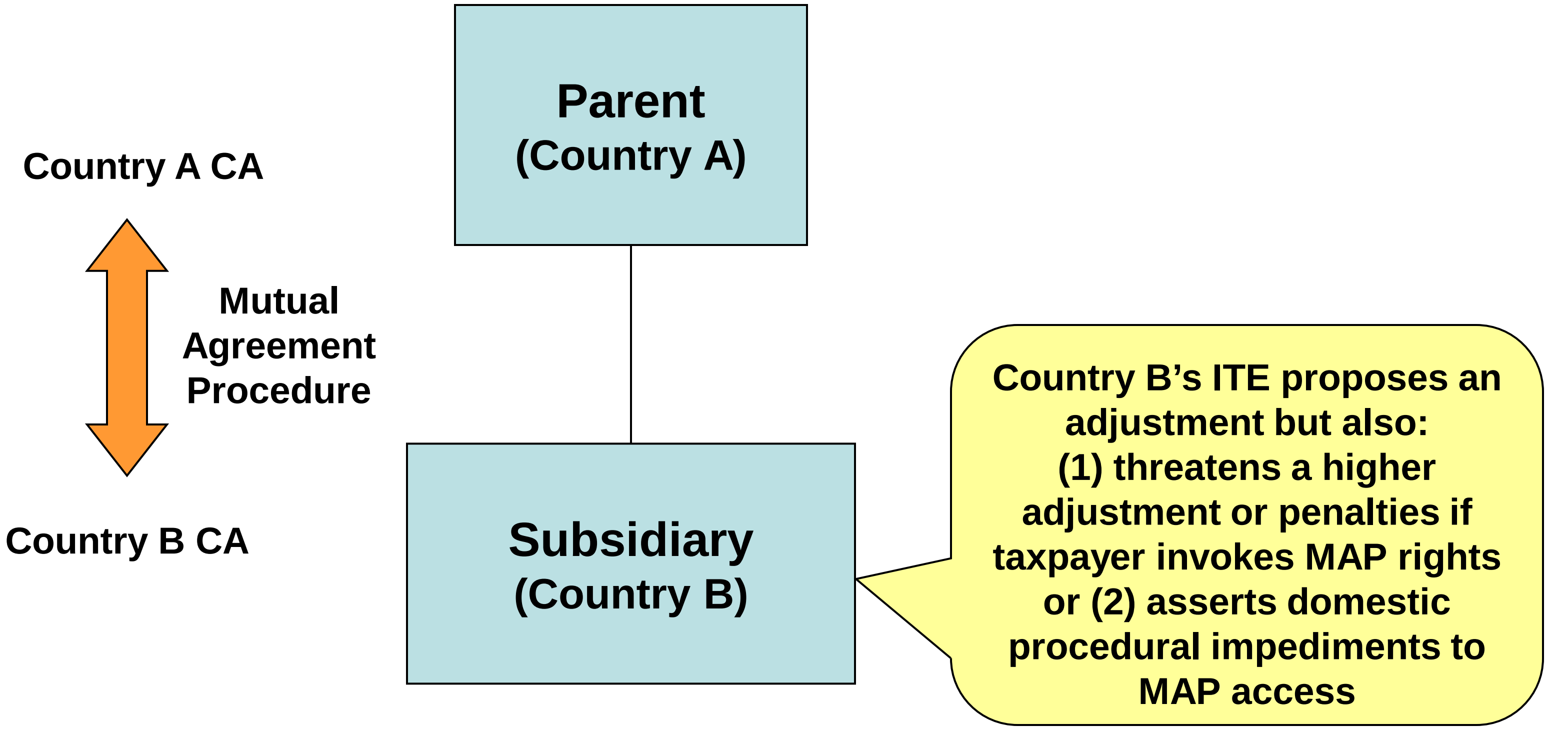
Global Awareness Considerations

- Typically, when a tax examiner proposes an adjustment to the income of a taxpayer, resolution of the matter is conducted on the basis of domestic legislation and the matter is between the tax authority and the taxpayer alone
- However, when an ITE proposes an adjustment that gives rise to double taxation, securing relief from double taxation may involve MAP negotiations with another tax authority by application of the applicable tax treaty
- The MNE may well be indifferent as to how double taxation is avoided in the treaty partner negotiations except in cases where the adjustment subjects the MNE's income to a significantly higher tax rate
- ITEs must inform the MNE of its rights and obligations if they wish to resolve double taxation through the mutual agreement procedure

Role of Competent Authorities

- The CA in each country should be respectful of its responsibility to eliminate double taxation so as to minimize conflict between tax administrations and promote international trade and investment
- CAs seek to resolve cases with integrity, transparency, and on a principled basis
- ITEs should:
  - be aware of the principles that are employed by CAs in the MAP
  - make best efforts to apply those principles in developing their adjustments to provide the CAs with a solid basis for principled discussion with the treaty partner CA
  - ensure that the MNE understands its rights to the MAP and that those rights are not impeded or restrained

Access to Mutual Agreement Procedure



The actions of Country B's ITE undermine the integrity of the MAP, as called for under the treaty between Country A and Country B, by impeding or restraining the MNE's MAP rights

Principled Resolution

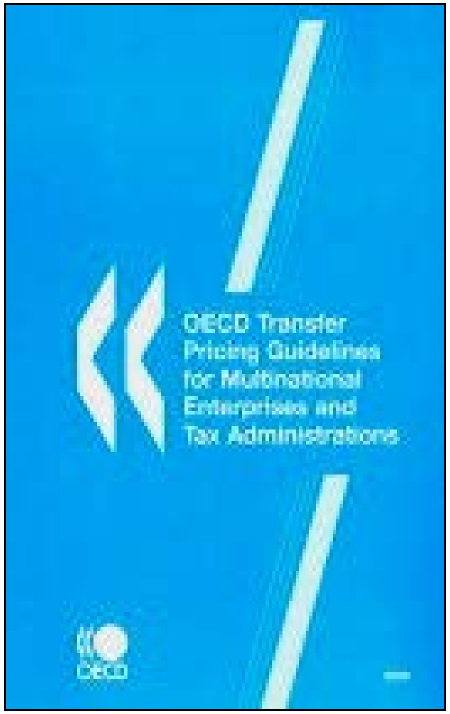
- Tax treaties do not provide detailed rules for resolving every double tax issue that can arise between CAs
- Thus, CAs resort not only to the text of the treaty but also to principles and general guidelines for resolving double tax matters, as established between the two CAs over time
- Principled resolution of double tax issues is important to ensure:
  - uniformity of resolutions from case-to-case,
  - consistency of resolutions over time, and
  - the integrity of the process itself

Source of Treaty Principles

- Working together over time, CAs often reach mutual understandings on working principles to govern the resolution of cases between them (e.g., MOUs between CAs)
- In addition, the OECD has a Model Tax Convention (current version is from 2010) that is the foundation for many bilateral tax treaties between OECD member countries
- The OECD Model Convention and the OECD Commentaries on the Convention have become a principal "means of settling on a uniform basis the most common problems that arise in the field of international double taxation"
- A U.S. Model also exists, which is substantially similar to the OECD Model

Source of TP Principles

- The OECD has established an extensive set of guiding principles for resolving transfer pricing matters
- The ***OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*** includes these principles as well as detailed descriptions of transfer pricing methods



"These international [transfer pricing] principles have been chosen by OECD member countries as serving the dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation, thereby <u>minimising conflict between tax administrations and promoting international trade and investment</u>."

- OECD Transfer Pricing Guidelines, ¶ 7

Global TP Principles

- The OECD TP Guidelines are generally used in the MAP process with treaty partners to negotiate U.S. transfer pricing adjustments made under IRS Sec. 482 since other countries have their own TP rules and regulations
- The OECD TP Guidelines provide a common global framework of principles for treaty partners to apply to TP cases
- The OECD Guidelines are generally consistent with the US TP regulations but there are some key differences which can impact MAP negotiations
- The US rules main focus is on whether the results reflected on the U.S. income tax return are arm's-length but OECD Guidelines focus less on results and more on whether the transfer prices were established in an arm's-length manner

Global TP Principles

- OECD Guidelines prefer use of traditional transaction methods for testing whether transfer prices for transfers of tangible property are arm's-length ('specified methods' under the U.S. regulations)
- The only OECD pricing method for intangibles that is specifically approved is the CUP method, which is equivalent to the comparable uncontrolled transaction (CUT) method in the US regulations
- However the OECD Guidelines give cautious endorsement to use of profit split methods or the TNMM (Transactional net margin method) when it is difficult to apply a transactional method
- The operating rules for TNMM are substantially the same as those for CPM under the U.S. regulations

Arbitration of MAP cases

- Some U.S. tax treaties provide for mandatory arbitration where the CAs are unable to reach a resolution (e.g., Belgium, Canada, France, Germany and soon with Japan U.K. and Switzerland)
- The arbitration procedures are agreed between the CAs, usually in an MOU and use "baseball" arbitration which allow the arbitrators to pick on side or the other but not to reach any other settlement position
- After specified time periods, the taxpayer may trigger arbitration of double tax and APAs where the CAs are unable to reach agreement
- Details of arbitration proceedings are not made public

Global Awareness Considerations

- The mutual agreement procedure conducted by CAs is a negotiated resolution of the case between two CAs based upon internationally accepted principles for reconciling their respective sovereign rights to tax
- Cross-border tax adjustments reviewed by CAs in the MAP are thoroughly considered and then sustained, modified, or withdrawn in light of the principles that the CAs have agreed will govern the bilateral resolution of cases between the two treaty partners
- The competent authorities are under a duty merely to use their best endeavors and are not required to achieve a result in all cases
- Some U.S. tax treaties (e.g., with Canada) provide for arbitration where the CAs are unable to agree on a resolution

Principles Are Applied in Context

- CAs consider proposed tax adjustments and apply resolution principles in the specific taxpayer context
- When considering adjustments to the filed tax returns of MNEs, it is critical that ITEs fully understand the MNE's cross-border business operations in the context of its global operations and practices
- MNE's often engage in complex global business operations that involve adopting transfer pricing and cost allocation models to satisfy the reporting and tax requirements of multiple jurisdictions
- Frequently, the position the MNE has taken in a particular country is a position the MNE has taken in multiple jurisdictions around the world under its standard global transfer pricing policies

OECD Transfer Pricing Guidelines

- The OECD transfer pricing guidelines, on which CAs commonly rely, seek to determine an arm's length price for transactions between associated enterprises similar to the arm's length standard under U.S. tax law
- When associated enterprises transact with each other, they often seek to replicate the dynamics of market forces that determine prices between independent entities
- Tax administrations should not automatically assume the associated enterprises have sought to manipulate profits
- The OECD guidelines further provide that tax administrations should keep these considerations in mind to facilitate efficient allocation of their resources in selecting and conducting transfer pricing examinations

Base Erosion and Profit Shifting (BEPS)

- The G20 countries asked the OECD to create an action plan to address tax base erosion and profit shifting (BEPS)
- The G20 and OECD believe some multinational companies have reduced taxation in their home countries by pushing profits abroad to low or no tax jurisdictions
- Three common mechanisms for doing this are hybrid mismatches, special purpose entities (SPEs), and transfer pricing
- Multi-year process with staged implementation over time
- Only applicable in US if formal legislation passed or treaties revised on substantive law
- BEPS may become increasingly visible during audits in other countries as other countries pass similar or related mechanisms

Action Plan on Base Erosion and Profit Shifting

OECD issued its "Action Plan on Base Erosion and Profit Shifting" on July 19, 2013:

- Identifies 15 actions steps needed to address BEPS including in the areas of hybrids, inbound financing, CFC rules, treaties and permanent establishments, transfer pricing, dispute resolution, and exchange of information
- Sets deadlines at 12 months, 24 months and after 2 years to implement the actions for each action step
- Changes to domestic tax laws and/or treaties will be needed to implement the steps
- Relates chiefly to instances where the interaction of tax rules in different countries leads to double non-taxation or stateless income. It also relates to arrangements that result in no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits tax place.

BEPS Action Items

Action 1: Address the tax challenges of the digital economy
Action 2: Neutralize the effects of hybrid mismatch arrangements
Action 3: Strengthen controlled foreign company (CFC) rules
Action 4: Limit base erosion via interest deductions and other financial payments
Action 5: Counter harmful tax practices more effectively, taking into account transparency and substance
Action 6: Prevent treaty abuse
Action 7: Prevent the artificial avoidance of PE status
Action 8: Transfer Pricing: Intangibles

BEPS Action Items (continued)

Action 9: Transfer Pricing: Risk and capital
Action 10: Transfer Pricing: Other high-risk transactions
Action 11: Establish methodologies to collect and analyze data on BEPS and the actions to address it
Action 12: Require taxpayers to disclose their aggressive tax planning arrangements
Action 13: Re-examine transfer pricing documentation
Action 14: Make dispute resolution mechanisms more effective
Action 15: Develop a multilateral instrument

BEPS Timeline for Reporting

September 2014
- Digital economy
- Hybrid mismatches
- Harmful tax practices – phase 1
- Treaty abuse
- Intangibles – phase 1
- Transfer pricing documentation
- Multilateral instrument – phase 1

September 2015
- CFC rules
- Permanent establishment
- Interest deductions – phase 1
- Harmful tax practices – phase 2
- Intangibles – phase 2
- Risks and capital
- Other high-risk transactions
- Disclosure of aggressive tax planning
- Dispute resolution
- Data collection and analysis measuring BEPS

December 2015
- Interest deductions – phase 2
- Harmful tax practices – phase 3
- Multilateral instrument – phase 2

2016-Onwards
- Continued efforts for implementation

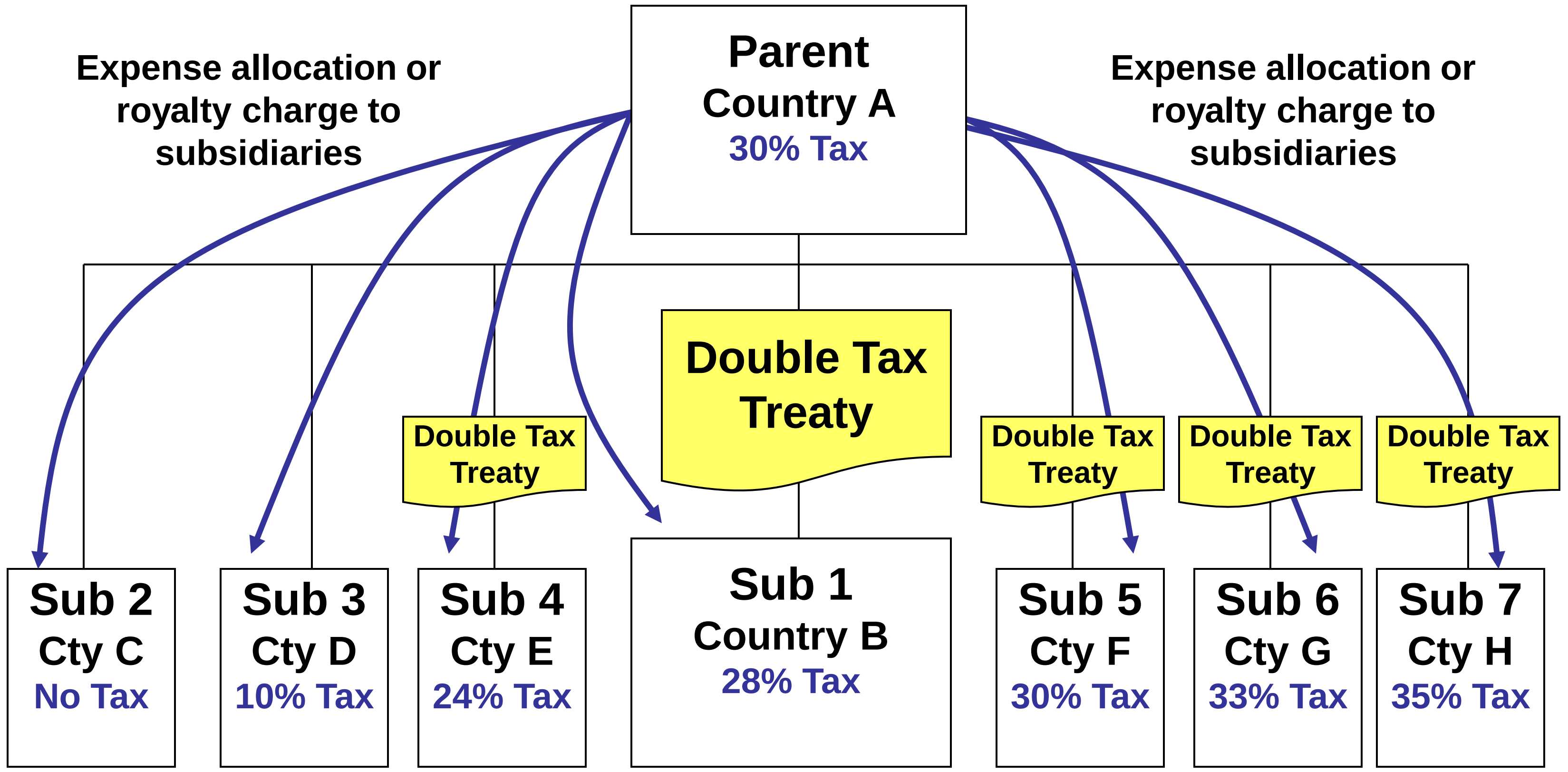
OECD Principles Recognize Practicalities

- Audit difficulties can arise from failure to comprehend the challenges of creating transfer pricing documentation
- OECD guidelines provide that taxpayers should not be expected to:
  - incur disproportionately high costs and burdens to obtain documents from foreign associated enterprises (OECD *Transfer Pricing Guidelines,* ¶ 5.6),
  - retain documents prepared or referred to in connection with transactions occurring in years for which adjustment is time-barred, beyond a reasonable period consistent with domestic law (OECD *Transfer Pricing Guidelines,* ¶ 5.8), or
  - require production of documents not in the taxpayer's possession or control, or require excessive translation or other creation of new documents (OECD *Transfer Pricing Guidelines*, ¶¶ 5.11, 5.12)

The Role of the ITE

- An ITE working anywhere in the world is an active participant in global tax administration and plays an important role in ensuring that taxation is in accordance with accepted OECD and MAP principles
- Each ITE should be aware of the context in which an adjustment would be proposed by:
  - understanding the MNE's global business operations and tax posture,
  - understanding the MNE's pricing and cost allocation models,
  - understanding whether the MNE's business operations and pricing models are designed to replicate market forces and not to artificially manipulate profits to reduce its tax liability
  - understanding the practical implications of their documentation requirements of an MNE

Understanding the MNE



If Parent allocates out expenses incurred for the benefit of each subsidiary, or charges each subsidiary a royalty for the use of intellectual property, it will likely use a uniform methodology for doing so

Analysis of MNE’s Global Practice

- When considering whether or not Country B should adjust the fee or royalty paid by Sub 1 to Parent, Country B’s ITE and the CAs of Country A and Country B should consider:
  - whether there are facts indicating that the MNE is acting at other than arm’s length in making the allocation of fees or royalties to its subsidiary in Country B
  - whether the methodology used by the MNE is consistent with the arm’s length principles in the OECD transfer pricing guidelines
  - whether the allocation of fees or royalties to Sub 1 provides an overall tax benefit to Parent
  - whether it is practical to expect that the MNE can tie its allocation to specific economic benefits realized by each and every subsidiary
  - whether the methodology used by the MNE was designed to apply globally in accordance with reasonable business assumptions
  - whether the allocation of fees or royalties to Sub 1 is made on the same basis as it is to all of Parent’s subsidiaries, and whether the methodology has already been agreed to between the CA for Country A and the CAs in other countries

Best practices for an ITE

- It is well established in the MAP that the country that has initiated the cross-border tax adjustment bears the burden of demonstrating to the other competent authority that the adjustment "is justified both in principle and as regards to the amount"
- In order to support the cross-border tax adjustment, the ITE should provide a well-documented audit file setting forth a reasonable approach in adjusting the taxpayer's position and explaining how the documentation in the file supports application of the relevant MAP and OECD principles

Best practices for an ITE

- An ITE contemplating a cross-border adjustment that could result in double taxation should take steps to ensure the adjustment can be properly addressed by the MAP:
  - The case file should be accurate and complete to allow the CAs to proceed quickly and efficiently
  - The case should be fully developed so that the CAs can easily understand the key facts of the case and the MNE's global business operations and pricing models without the need for significant post-adjustment inquiries
  - The proposed adjustment should be in line with tax treaty principles used by the CAs to resolve double tax cases with the relevant treaty partner

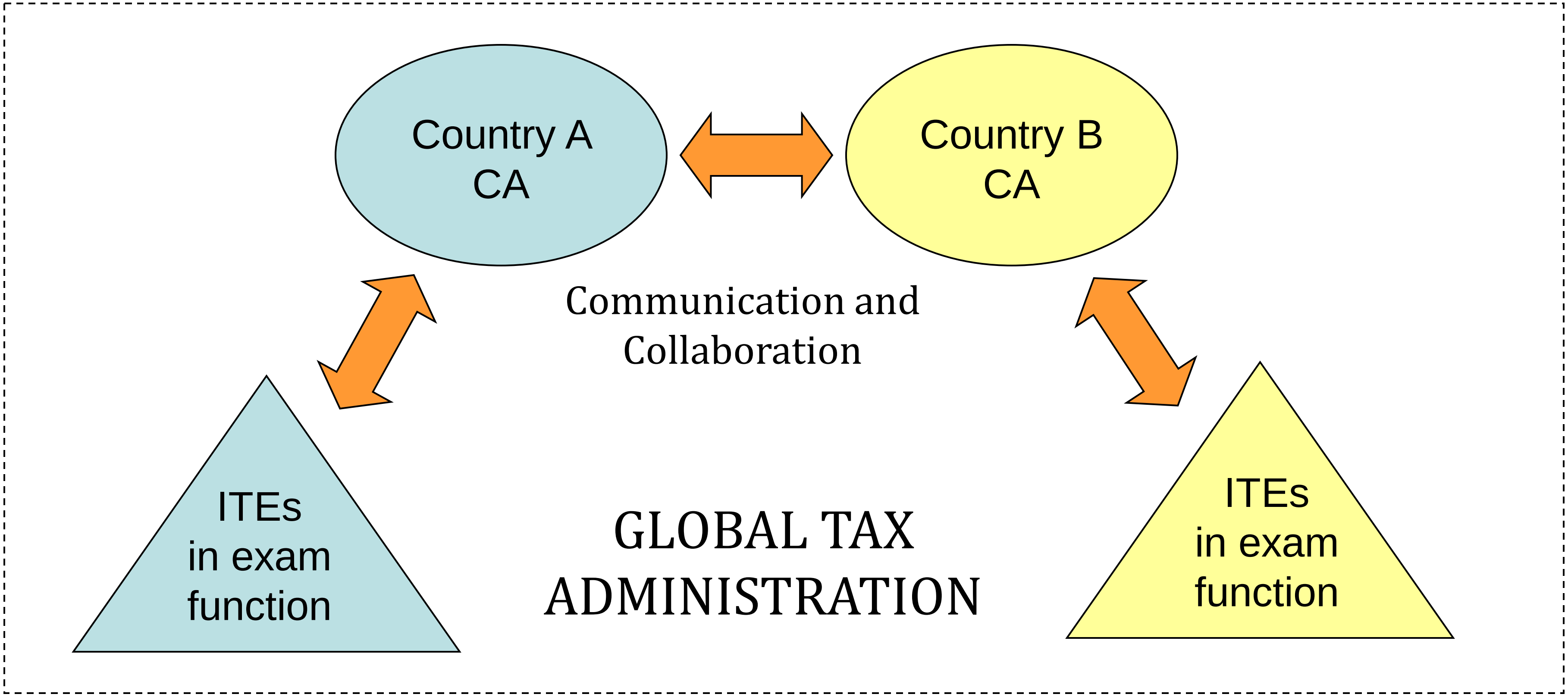
Best practices for an ITE

- In connection with a transfer pricing audit, an ITE should:
  - have a strong understanding of the global business of the MNE and a detailed understanding of the audited entity's participation in, and contribution to, the MNE's global operation
  - have a strong understanding of the taxpayer's position, rationale and analysis, which may include an economic analysis, TP report and/or supporting legal opinion
  - provide a written statement of the tax administration's position, rationale, and analysis including economic analysis and reports, as may be needed to support the adjustment
  - provide substantial analysis of the facts and circumstances relevant to the comparability factors referred to in the OECD Transfer Pricing Guidelines, with references to source documentation

Best practices for an ITE

- ITEs should also:
  - take into account both the time limits under the domestic tax law for making tax adjustments and under the relevant tax treaty before finalizing audit adjustments
  - inform the MNE of its rights under both domestic law and the MAP to appeal or contest the adjustment
  - advise the MNE to take appropriate steps to ensure the tax years in question are kept open in both jurisdictions so the MAP can be accessed without procedural blocks

Coordination between CAs and ITEs



It is critical that CAs communicate and collaborate with ITEs in their respective examination functions to ensure that ITEs have a strong understanding of their important role in global tax administration