OECD Releases BEPS Discussion Draft; Includes Intra-Group Service Fees

---

BNA Snapshot

Key Development: The Organization for Economic Cooperation and Development released a discussion draft relating to intra-group services.

Impact: The draft would include a simplified allocation key to determine low value-adding services.

Next Step: The organization will accept comments until Jan. 15, 2015.

By Alex M. Parker

Nov. 3 — A discussion draft released by the Organization for Economic Cooperation and Development calls for an “allocation key” to determine fees for intra-group, low value-added services.

The draft, issued Nov. 3 by Working Party No. 6, addresses item 10 of the OECD's action plan on base erosion and profit shifting (BEPS), which calls for rules to prevent base erosion through “transactions which would not, or would only very rarely, occur between third parties,” and which require “special measures” for their prevention.

According to the working party, the guidance seeks to “achieve the necessary balance between appropriate charges for low value added services and head office expenses and the need to protect the tax base of payor countries.”

The draft would allow taxpayers to create an allocation key for low value-adding, intra-group services as a simplified alternative to the standard transfer pricing analysis. The allocation key would apply to services such as accounting, auditing, human resource management, processing and management of accounts receivable and accounts payable, and employee health administration, according to the draft.

Rather than justifying the individual charges using the arm's-length principle, taxpayers would identify a pool of costs associated with the services. Then the taxpayer could choose an allocation key which would “reasonably reflect the level of benefit expected to be received by each recipient of the particular service.”

Safe Harbor

The allocation key is effectively a safe harbor for routine or low-cost services, according to practitioners, who note that services transfer pricing regulations in the U.S. include a similar provision.

“I think, once again, the world is finding that the U.S. has already been there in some of these BEPS issues,” said David Rosenbloom of Caplin & Drysdale.

David Ernick, a former Treasury official currently with PricewaterhouseCoopers LLP in Washington, D.C., agreed.

“Looking at this from a U.S. perspective, the approach that they've taken seems pretty familiar, pretty similar to what we have in the U.S. regulations,” Ernick said.

“It seems like an encouraging start to this particular work stream that they're doing,” he said, adding that if these recommendations are adopted, they could add “uniformity” to the global system.

The OECD draft also includes more detailed descriptions of situations in which a service fee shouldn't be allowed. Those include when the fee is for a service that is already being performed by the recipient itself, and so-called shareholder services, or services that are only provided due to the service provider's role as shareholder of the recipient.

Rosenbloom said the rules could be helpful to jurisdictions that believe that mispricing of management and service fees contribute to erosion of the tax base and shifting of profits offshore.

“It will give some source countries legitimate grounds for challenging payments going out of their countries,” Rosenbloom said. “It will give them ammunition to beef up their challenges to transfer pricing.”

The group will be accepting comments until Jan. 14, 2015.

To contact the reporter on this story: Alex M. Parker in Washington at aparker@bna.com

To contact the editor responsible for this story: Molly Moses at mmoses@bna.com

But despite the seemingly open-ended legal authority packed into these sentences, decades of tax treaties, regulations and court decisions have refined and narrowed Treasury's ability to combat what it views as questionable tax structures.

And, the tradition in the blurry, often complex relationship between the executive and legislative branches is to avoid aggressive or expansive readings of statutory authority.

Stonewalling

Some speculate that, with a standstill Congress and legislative stonewalling reaching unprecedented levels, that practice soon may change.

"It's the type of thing that, 20 years ago, you'd say, 'No way, they wouldn't do that,' " said Daniel Shaviro, a professor of taxation at the New York University School of Law. "I think we're entering a new era where this type of thing is going on more. Right or wrong, if you're the Obama administration, you're going to say, 'This is all we can do, and we're not really losing anything, because they're not playing ball anyways.' "

In its annual budget requests to Congress, the Obama administration has outlined several policy proposals to "reform [the] U.S. international tax system," including many items that—in theory—could be dealt with administratively.

Check-the-Box Rules

Perhaps the most prominent of those is the check-the-box election, a product of regulations that allow multinational corporations to define offshore subsidiaries as "disregarded entities," potentially shielding transactions that otherwise would create taxable Subpart F income.

Finalized in 1996, the check-the-box regime under Regs. § 301.7701-3 was instituted as a way to simplify entity classification for organizations, using one form to determine whether an entity is a corporation and saving the agency, and taxpayers, mountains of paperwork.

Almost immediately, the rules became controversial. One reason is that some business entities with a single owner could elect to be treated as a disregarded entity, or a branch of that owner. In the international tax arena, this raised the prospect of "hybrid mismatch arrangements," as an organization operating abroad may be considered a branch by U.S. law but a separate subsidiary according to the laws of the local country.

1998 Proposed Rules

On Jan. 16, 1998, the Internal Revenue Service issued Notice 98-11, aimed at combating what it characterized as "using arrangements involving 'hybrid branches' to circumvent the purposes of subpart F." The notice was followed by proposed regulations in March of that year.

"Treasury and the Service believe that it is appropriate to prevent taxpayers from using these types of hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of subpart F income," the IRS said in the notice.

Notice 98-11 laid out examples of possible hybrid arrangements, including a loan between two countries that, due to the entity classification rules, would be treated as happening only in one country, thereby avoiding Subpart F.

The proposed regulations provoked outrage among taxpayers and members of Congress. Treasury eventually repealed them in Notice 98-35, issued in June 1998, and proposed a more refined approached, aiming to squarely target hybrid mismatches.

Notice 98-35

Treasury's fix as outlined in the new notice would have identified non-Subpart F income generated through a hybrid mismatch arrangement and recharacterized it as Subpart F income, requiring immediate U.S. taxation.

This scaled-back version, however, did not satisfy critics. Under threat of legislation preventing the department from issuing any guidance on hybrids, Treasury and Congress ultimately agreed in 1999 to forestall any possible regulations until at least 2006. To date, those proposals have not reemerged.

In the 15 years since that agreement, “check the box” has grown into a key villain for critics of the international tax system, often blamed for contributing to elaborate tax avoidance strategies, including the “Double Irish” plan employed by many tech companies.

In his 2010 budget request, Obama called for nixing the rule through legislation.

“In certain cases, locating a foreign disregarded entity under a centralized holding company (or partnership) may permit the migration of earnings to low-taxed jurisdictions without a current income inclusion of the amount of such earnings to a U.S. taxpayer under the subpart F provisions of the Code.”

The administration's proposal would have prohibited some companies from using check the box to create disregarded entities. Allegedly under pressure from taxpayers and corporations, the administration dropped this proposal from subsequent budget proposals.

‘Quasi-Legislative Status.'

In theory, because check the box was created by regulations, it can be undone through regulations.

But, there are many caveats.

“Treasury traditionally seems to treat some of these long-standing regulations as if they had a quasi-legislative status,” said Edward Kleinbard, a professor of law at the University of Southern California and former chief of staff for Congress's Joint Committee on Taxation.

Aside from precedents set by 15 years of regulatory tradition, courts also might view the related but distinct “look-through rule,” which was approved by Congress in 2006, as a legislative sanction of check the box. The look-through rule allows some active earnings between related parties to be exempt from Subpart F. The rule, however, expired at the end of 2013.

Simply repealing the regulations issued in 1996 wouldn't be adequate, experts say.

“They could theoretically repeal check the box,” Kleinbard said. “They'd have to replace it with something. ... Check the box has certainly been a handmaiden of tax avoidance. Replacing it is not at all easy.”

If the Obama administration were inclined to pursue this route, the previously issued—but subsequently withdrawn—Treasury proposals from 1998 may provide a guide.

Under Notice 98-35, portions of payments between the controlled foreign corporation of a U.S. company and the CFC's hybrid branch would be recharacterized as Subpart F income if each of the following is true:

• the hybrid branch payment reduces the foreign tax of the payer;

• the hybrid branch payment would have been foreign personal holding company income (a Subpart F category) if made between separate controlled foreign corporations; and

• there is a significant disparity between the effective rate of tax on the payment in the hands of the payee, and the hypothetical rate of tax that would have applied if the income had been taxed in the hands of the payer.

In this scenario, the amount of recharacterized Subpart F income would be the gross amount of the hybrid branch payment, limited by the amount of the CFC's earnings and profits attributable to non-Subpart F income.

The regulations also specified that this recharacterization would not otherwise affect the branch's status as a disregarded entity for other tax purposes.

No Easy Fix

But plugging check-the-box transactions might not be as simple as pulling these 15-year-old proposals out of the drawer and dusting them off.

At the time they were proposed, they were blasted by taxpayers and some lawmakers as an egregious overstepping of Treasury's powers.

“The Treasury Department is not only making policy that is has no right to make, it is also making bad policy,” said then-Rep. Connie Mack (R.-Fla.), who cosponsored a bill reining in the department's powers in this area.

His cosponsor, then-Sen. John Breaux (D-La.), questioned why this was a priority for the Treasury Department since the key objective of these arrangements was to avoid foreign, not U.S., taxes.

Such issues no doubt would be raised again, in the legal courts and the courts of public opinion.

Furthermore, transitioning away from the check-the-box regime—potentially disrupting corporate structures worth billions of dollars—could be destructive.

“It would be chaotic,” said David Rosenbloom of Caplin & Drysdale, a former international tax counsel for the Department of Treasury. “You'd have all sorts of transitional issues that would be literally mind-blowing. ... The problem with check the box is, it cuts very deep at this point. It's been around for a long time, people have relied on it. Undoing it would be quite a task.”

According to Treasury estimates, plugging the check-the-box loopholes in 2010 would have raised more than $10 billion annually by 2015, and a total of $87 billion between 2010 and 2019.

Intangibles

There are other areas where the Obama administration might look to its own powers to achieve some of its policy goals.

Included in each of Obama's annual budget requests has been a proposal to “limit shifting of income through intangible property transfers” (22 *Transfer Pricing Report* 1364, 3/6/14).

Obama calls for including in the definition of intangibles workforce in place, goodwill, going concern value and “any other item owned or controlled by a taxpayer that is not a tangible or financial asset and that has substantial value independent of the services of any individual.”

The legal definition of intangibles has a more narrow focus and refers to items that are legally owned, such as patents, inventions, copyrights, trademarks, franchises, licenses and contracts. Other items falling under the legal definition, which is outlined in Section 936(h)(3)(B), include legally privileged information, such as methods, programs, systems, procedures and “know-how.”

The definition also includes “any similar item” as a possible intangible asset.

Obama's first budget proposal in 2009 said it would “clarify” the intangibles definition—implying, to some critics, that the administration viewed it as a correct interpretation of the law, and possibly something that could be achieved through regulations.

“Clarifications belong in regulations,” David Bowen, of Grant Thorton LLP, said at the time. “This is a statutory change. In no way is this a clarification; that is clear from the prior legislative history” (18 *Transfer Pricing Report* 3, 5/14/09).

Others claim the legal meaning and regulatory history are more muddled.

“The meaning of this provision is less than clear,” Ken Christman, a former Treasury official, told BNA in 2010 (19 *Transfer Pricing Report* 746, 11/4/10).

Christman noted that some IRS regulations clearly take the position that items such as goodwill are not part of the definition, while others imply that they could be.

But even if the law couldn't fully accommodate Obama's expansive view of intangibles, it certainly has enough ambiguity to allow for more aggressive interpretations.

“A lot of the issues that are concerning intangibles can be addressed through regulations,” said Peter Barnes of Caplin & Drysdale. “It would be controversial.”

Obama continued to use the word “clarify” in his budget proposals regarding the intangibles definition until this year, when it was replaced with the more ambiguous phrase “provide.”

According to the Treasury Department, limiting the shifting of income through intangible property transfers could raise $2.7 billion over 10 years.

Inversions

The current hot-button issue in Congress, corporate inversions or expatriations for tax purposes, also could conceivably be dealt with through regulations—but only indirectly.

The practice of inverting through a merger with an offshore company, in the hopes of achieving a foreign tax residency and greatly reducing the U.S. tax bill, has recently come under fire by both the administration and Congress. (See stories on a recent Senate hearing and on proposed legislation that would limit defense contracts for inverted companies.)

It's doubtful that the Treasury Department has the authority to combat these transactions outright, so long as they comply with the anti-inversion restrictions included in the 2004 American Jobs Creation Act of 2004.

However, the Department of Treasury could conceivably deal with some of the incentives that drive these transactions—including the earnings stripping that often occurs, many tax experts claim, after such a deal is finalized.

Willard Taylor of Sullivan & Cromwell said one of the key goals of an inversion is to create a U.S. subsidiary of a newly created foreign parent so it can be heavily leveraged, eroding the U.S. tax base through deductible interest payments. The administration could look at current thin capitalization rules as a way to deal with the issue.

"We have an earnings stripping rule, and we could seriously tighten that up," Taylor said.

Political Hurdles

However, despite the legal plausibility of such initiatives, there are significant political hurdles to Obama's acting unilaterally on international corporate taxation.

While observers often are pessimistic about the chances for a bipartisan tax overhaul in the near future, it remains a significant policy agenda for both parties, and the administration may be reluctant to throw a monkey wrench into that process.

"Tax reform is so important, and the changes that are being considered are so important, that we need stability in whatever emerges," said Barnes of Caplin & Drysdale. "The minute you have doubt about whether the changes are long-lasting, you've undermined the effectiveness of any reform."

Kleinbard agreed that unilateral executive action would be a risky move. "There's definitely stuff you can do in the anti-abuse arena. But doing that puts tremendous pressure on an already unstable system," he said. Such aggressive action reflects the hope that "by sticking the pig again, it will squeal loudly enough that we'll get the corporate tax reform," he said. "This is a risky strategy," he added. "Given the special problems of tax administration, vis à vis the Congress right now, it would be a risky strategy to try to stick the pick again."

To contact the reporter on this story: Alex M. Parker in Washington at aparker@bna.com

To contact the editor responsible for this story: Molly Moses at mmoses@bna.com