KIRKLAND ALERT

January 2016

The First BEPS Changes Come to the U.S.: The IRS Issues Proposed Regulations on Country-by-Country Reporting

On December 21, 2015, the U.S. Treasury and the Internal Revenue Service (the "IRS") proposed important new regulations that will have significant impact on multinational enterprises ("MNEs") with annual revenue of at least $850 million. It is important that MNEs and their decision makers be aware of these new rules. The background and key aspects of these new rules are explained below.

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Background

In recent months, international tax reform has been high on the political agenda, with several government officials expressing concern that MNEs have been exploiting gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where the MNEs have little or no economic activity. These tax planning techniques are often broadly referred to as base erosion and profit shifting or simply "BEPS."

On July 19, 2013, the Organisation for Economic Co-operation and Development (the "OECD") and the G20 countries adopted a global action plan to address certain BEPS concerns. The action plan was divided into 15 key areas where the OECD members and G20 countries would address and/or modify international tax rules in a coordinated manner. The OECD issued its final reports on October 5, 2015.

The final OECD reports recommended that each participating country implement "country-by-country" reporting in 2016 with a related government-to-government exchange mechanism to start in 2017 ("CbC Reporting" and any such report, a "CbC Report"). The purpose of the CbC Report is to provide tax authorities with greater information as to the activities of an MNE on a global basis (including where profits are earned and where taxes are paid) to determine where BEPS may be occurring.[1]

On December 21, 2015, in a highly anticipated move, the Treasury and the IRS began their implementation of the final OECD reports by issuing proposed regulations imposing new CbC Reporting requirements on U.S.-based MNE groups (the "Proposed Regulations"). The Proposed Regulations largely reflect the rules and standards outlined in the final OECD reports, but (as discussed below) there a few important differences, notably with respect to the effective dates.

1 Under current law, many tax authorities have expressed concerns about a lack of transparency regarding the activities of an MNE group that occur outside of their borders.

The new CbC Reporting rules will, for the first time, provide tax authorities with a breakdown of where MNE groups allocate profits on a global basis, the amount of taxes paid with respect to those profits and certain other economic indicators. For that reason, MNEs are likely to face an increased number of cross-border transfer pricing disputes going forward. In addition, these new rules are likely to impose significant new compliance costs on large MNEs, since most companies do not currently compile the required information as part of their financial books and records.

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Who must file the annual CbC Report?

Under the Proposed Regulations, every U.S. person that is the ultimate parent of a U.S. MNE group must file an annual CbC Report, but only if the annual revenue of the U.S. MNE group for the immediately preceding annual accounting period was equal to or greater than $850 million.

In general, the ultimate parent of a U.S. MNE group is a U.S. business entity that:

- Owns, directly or indirectly, a sufficient interest in one or more other business entities, *at least one of which is organized or tax resident in a tax jurisdiction outside the United States*, such that the U.S. business entity is required to consolidate the accounts of the other business entities with its own accounts under U.S. generally accepted accounting principles ("GAAP") (or would be so required if equity interests in the U.S. business entity were publicly traded on a U.S. securities exchange); and

- Is not owned, directly or indirectly, by another business entity that consolidates the accounts of such U.S. business entity with its own accounts under GAAP in the other business entity's tax jurisdiction of residence (or would be so required if equity interests in the other business entity were traded on a public securities exchange in its tax jurisdiction of residence).

A "business entity" is defined as any person that is not an individual (and includes a corporation, a partnership, a disregarded entity or a permanent establishment). A "U.S. business entity" is a business entity that is organized or has its jurisdiction of tax residence in the United States.

With respect to a U.S. MNE, a "constituent entity" is any separate business entity of such U.S. MNE group, with certain carve-outs for foreign partnerships and foreign corporations that are not "controlled" by the ultimate parent (within the meaning of the tax rules).

Under the Proposed Regulations, a direct or indirect U.S. subsidiary of a foreign parent would not be required to file a CbC Report with the IRS if the foreign parent consolidates the accounts of the U.S. subsidiary with its own accounts under GAAP in the foreign parent's jurisdiction of tax residence.

What information must be included on the CbC Report?

The CbC Report is intended to provide the IRS and other tax authorities with an overview of a U.S. MNE group's global allocation of income, taxes paid and economic activity. Based on a standard template (which all G20 countries have generally agreed to use without significant modification), each covered U.S. MNE group must provide information with respect to (1) its constituent entities and (2) its activities by jurisdiction.

In particular, the CbC Report must include the following information with respect to each constituent entity of the covered U.S. MNE group:

- Tax jurisdiction in which the constituent entity is resident and, if different, tax jurisdiction in which the constituent entity is organized or incorporated; and
- Main business activity or activities of such constituent entity (based on a list of enumerated categories).

More significantly, the CbC Report must also include the following information for each jurisdiction in which a covered U.S. MNE group does business:

- Revenues generated from transactions with other group members;
- Revenues not generated from transactions with other group members;
- Profit or loss before income tax;
- Total income tax paid on a cash basis, and any taxes withheld on payments received;
- Total accrued tax expenses recorded on taxable profits or losses, reflecting only the operations in the relevant annual accounting period and excluding deferred taxes or provisions for uncertain tax liabilities;
- Stated capital;
- Total accumulated earnings;
- Total number of employees on a full-time equivalent basis in the relevant tax jurisdiction; and
- Net book value of tangible assets other than cash or cash equivalents.

All of the required information must be reported in U.S. dollars. The source of such information should be based on applicable financial statements, books and records maintained with respect to the constituent entity, or records used for tax reporting purposes. Taxpayers are not required to reconcile income tax returns or financial statements with amounts provided on CBC Reports. It is expected that the final CbC Report will include a section to provide additional information, including a brief description of the sources of data used in preparing the form, and, if a change

is made in the source of data from year to year, an explanation of the reasons for the change and its consequences.

The CbC Report will be required to be filed with the ultimate parent entity's income tax return for the taxable year on or before the due date for filing that person's income tax return (including extensions). This differs from the final OECD report, which recommended that an ultimate parent file the CbC Report by the end of the year following the year covered by the report (for example, in the case of a calendar year taxpayer, by December 31 of the year following the year covered by the report).

Importantly, both the final OECD report and the preamble to the Proposed Regulations state that tax authorities should use the CbC Report primarily to assess high-level transfer pricing risk with respect to an MNE and should not use the CbC Report as a substitute for a detailed transfer pricing analysis of individual transactions under the arm's length standard (including a full comparability analysis). In addition, the final OECD report states that the CbC Report (whether submitted to the IRS or a different tax authority) should not be used to propose transfer pricing adjustments based on global formulary apportionment of income.

The Proposed Regulations do not include any new penalties for failure to file a CbC Report, though general reporting-related penalties may apply.

Automatic government-to-government exchange

The preamble to the Proposed Regulations states that any information contained in the CbC Report will be subject to the same strict confidentiality rules that apply to U.S. tax returns generally. However, the preamble also states that the United States intends to enter into competent authority arrangements that will provide for the automatic exchange of CbC Reports to other tax authorities pursuant to information exchange agreements to which the United States is a party.

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Consistent with international standards, all of the information exchange agreements to which the United States is a party require the information exchanged to be treated as confidential by both parties, and generally prohibit the parties from using the information for any purpose other than for the administration of taxes. The preamble to the Proposed Regulations states the United States will closely review a tax jurisdiction's legal framework for maintaining confidentiality of taxpayer information and its track record of complying with that legal framework. Where appropriate, the United States will pause automatic exchange of CbC Reports if it determines that a tax jurisdiction is not in compliance with confidentiality requirements.

Application to private equity funds

A typical U.S.-based private equity fund would not seem to be an ultimate parent entity because most private equity funds are not required to consolidate with their portfolio companies under U.S. GAAP (and it appears they would not be required to if the equity of the fund were publicly traded). Accordingly, most private equity funds should not be subject to CbC Reporting under the Proposed Regulations.

A typical U.S.-based private equity fund would not seem to be an ultimate parent entity because most private equity funds are not required to consolidate with their portfolio companies under U.S. GAAP (and it appears they would not be required to if the equity of the fund were publicly traded).

However, if a private equity fund is required to consolidate with a non-U.S. entity for U.S. GAAP purposes (or would be required to if the equity of the fund were publicly traded) it may become subject to CbC Reporting. In addition, a U.S. portfolio company of a private equity fund may itself be subject to CbC Reporting under the Proposed Regulations if the portfolio company has annual revenue of at least $850 million.

Effective date

The rules described in the Proposed Regulations will apply to taxable years of ultimate parent entities of U.S. MNE groups that begin on or after the date the Proposed Regulations are adopted as final regulations. Because the Proposed Regulations are subject to a notice and comment period that will last until at least March 22, 2016, U.S. MNEs that use the calendar year for their tax returns will not be subject to U.S. CbC Reporting until the 2017 taxable year at the earliest. This is a departure from the final OECD report that recommended a 2016 taxable year start date.

Even though the U.S. rules may not apply until the 2017 taxable year, U.S. MNE groups (or subsets thereof) may still be subject to CbC Reporting requirements in the 2016 taxable year. As a general matter, the final OECD reports attempt to create a single CbC Reporting requirement for each MNE group based on the tax residence of its ultimate parent. However, the OECD model legislation recommends imposing CbC Reporting on subsidiaries of an MNE group in situations where such reporting is not required by the ultimate parent's jurisdiction of tax residence (a "secondary mechanism"). As a result, a U.S. MNE may need to begin compiling data in 2016 if another tax jurisdiction in which such U.S. MNE does business adopts CbC Reporting requirements for the 2016 taxable year with a secondary mechanism (unless transitional exceptions apply).

U.S. MNEs may need to begin collecting data in 2016 if other non-U.S. tax jurisdictions where such MNEs do business adopt CbC Reporting requirements for the 2016 taxable year with a secondary mechanism.

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

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