IRS issues final country-by-country reporting rules, addresses voluntary reporting for 'gap year,' along with a few points of clarification

July 6, 2016

In brief

The IRS on June 29, 2016, issued final regulations (TD 9773) requiring annual country-by-country (CbC) reporting for US-parented multinational enterprise (MNE) groups. The information collection requirements in these regulations are to be satisfied by submitting a new reporting form, Form 8975, Country-by-Country Report, with the taxpayer's income tax return. Form 8975 calls for information on a country-by-country basis related to the MNE group's income and taxes paid, together with several other data items. The final regulations apply to reporting periods of 'ultimate parent entities' of US MNE groups that begin on or after the first day of a taxable year of the ultimate parent entity that begins on or after June 30, 2016.

The final regulations adopt—with only a few significant changes—proposed regulations issued December 23, 2015 (REG-109822-15), taking into account certain comments the IRS received, as well as a public hearing on May 13, 2016. (See PwC's Tax Insight of December 24, 2015). In general, the final regulations modify the proposed rules to align more closely with the 2015 Final Report for Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting) of the Organisation for Economic Co-operation and Development (OECD) and Group of Twenty (G20) Base Erosion and Profit Shifting (BEPS) Project (Final BEPS Report).

Most notably, the new rules will allow voluntary filing of CbC Reports for reporting tax periods beginning on or after January 1, 2016 and before June 30, 2016, the effective date of the final regulations under a procedure to be provided in "separate, forthcoming guidance."

Need to know

1. *The final regulations apply to FYs beginning on or after June 30, 2016,*
2. *Voluntary filing allowed for gap year,*
3. *OECD recommends countries accept voluntary filings,*
4. *US permits surrogate parent entity filings in the US by ultimate parent entities of US territories only,*
5. *Section 6038 penalties apply, and*
6. *Income from Partnerships and other transparent entities will be reported as stateless and in the jurisdictions of the owners of these entities.*

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In detail

Final regulations under Treas. Reg. Sec. 1.6038-4 maintain the framework of the proposed rules, with certain changes and clarifications. The CbC report now has an official IRS form number: Form 8975.

Applicability date and voluntary filing to address 'gap year' issue

The final regulations apply to reporting periods of 'ultimate parent entities' of US MNE groups that begin on or after June 30, 2016. Consistent with the proposed regulations, the final regulations apply only to taxable years of ultimate parent entities beginning on or after the date of publication of the final regulations (June 30, 2016), though voluntary filing for earlier taxable years will be permitted for the reasons described below.

This effective date creates a so-called 'gap year,' during which US-parented MNEs could be required to file the CbC report directly in foreign jurisdictions. That result could occur because other countries have adopted CbC reporting rules for annual accounting periods beginning on or after January 1, 2016, requiring reporting of CbC information by constituent entities of MNE groups with an ultimate parent entity resident in a tax jurisdiction that does not have a CbC reporting requirement for the same annual accounting period.

The final regulations address the gap year problem by allowing US ultimate parent entities to file, on a voluntary basis, Form 8975 for reporting periods that begin on or after January 1, 2016 and before June 30, 2016, in accordance with a procedure to be provided in separate, forthcoming guidance. On the same day that the final regulations were released, the OECD issued "Guidance on the Implementation of Country-by-Country Reporting," recommending that other countries accept reports filed voluntarily in the United States and in other countries for years beginning on or after January 1, 2016 (the OECD refers to this as 'parent surrogate filing').

The IRS is working with other countries to reach agreement that constituent entities of US MNEs will not have to file a CbC report in such foreign jurisdictions if the parent files a Form 8975 with the IRS in accordance with the forthcoming procedure and the CbC report is exchanged with the foreign jurisdiction subject to a Competent Authority agreement.

Observation: The IRS acknowledges the burden of the gap between implementation of CbC reporting in the United States and in foreign jurisdictions and is working to address it. Considerable work remains in order to implement CbC reporting, including 'turning off' potential requirements during the gap period for US-parented MNEs to file a CbC report directly in foreign jurisdictions. The IRS has to have in place with each such jurisdiction both (1) an income tax treaty or tax information exchange agreement and (2) a Competent Authority agreement for the automatic exchange of CbC reports. To 'turn off' potential requirements during the gap year, each jurisdiction has to agree to accept 'parent surrogate filings' in lieu of direct local filing.

Filing requirements

The final regulations retain the US MNE group annual revenue threshold of $850 million, which was determined by reference to the USD equivalent of €750,000,000 on January 1, 2015, as provided in the Final BEPS Report. The IRS did not change the reporting threshold in response to requests to lower it to the equivalent of €40,000,000 in order to subject more taxpayers to CbC reporting, since those taxpayers otherwise would not have to file a CbC report.

The time and manner of filing the CbC report–with the ultimate parent's income tax return for the taxable year on or before the due date, including extensions for filing that income tax return– remain the same as in the proposed regulations. Multiple comments were received requesting that taxpayers be permitted to file a CbC report up to one year from the end of the ultimate parent entity's taxable year or annual accounting period, in order to facilitate the taxpayer's ability to use statutory accounts or tax records of constituent entities to complete the CbC report. While that recommendation was not adopted, the final regulations provide that Form 8975 may prescribe an alternative time and manner for filing.

With respect to penalties, the rules under Section 6038 generally apply, including reasonable cause relief for failure to file. Comments requesting a national security exception for reporting CbC information were not adopted, as the IRS consulted with the Department of Defense, which concluded that CbC reporting generally does not pose a national security concern. Nonetheless, the Department of Defense will continue to consider the national security implications of the CbC report, and further guidance may be issued in the future.

Partnerships and stateless entities

The final regulations provide that tax jurisdiction information with respect to constituent entities that do not have a tax jurisdiction of residence, or 'stateless entities,' would be aggregated and reported in a separate row of the CbC report. A business entity that is treated as a partnership

in the tax jurisdiction in which it is organized and that does not own or create a permanent establishment in that or another tax jurisdiction generally will have no tax jurisdiction of residence under the definition in proposed §1.6038-4(b)(6) (other than for purposes of determining the ultimate parent entity of a U.S. MNE group). Consequently, the tax jurisdiction information for these entities is to be reported in the 'stateless' row of the CbC report. The regulations further provide, however, that each owner of a stateless entity (such as a partner) also must report its share of revenue and profit in the information for the tax jurisdiction of its residence. The rule applies irrespective of whether the stateless entity-owner is liable to tax on its share of income in its tax jurisdiction of residence. This 'double counting' of some items, including them both in the stateless line of the CbC report and in the jurisdictions of the partners, is intentional.

Under the final regulations, generally partners do not include distributions from a partnership in their revenue. Similarly, the constituent entity-owner does not include remittances from a permanent establishment in its revenue.

Confidentiality and use of CbC report

CbC reporting to the IRS on Form 8975 aids confidentiality, according to the preamble to the final regulations, since treaty partners will exchange such forms under Competent Authority agreements intended to safeguard data and confidentiality. The IRS can cease to exchange reports with any government that fails to protect taxpayer confidentiality. Further, the IRS plans to establish a procedure to report suspected violations of confidentiality and other misuses of the CbC report information.

Although the preamble to the final regulations does not provide details, it recites Treasury's commitment to entering into bilateral Competent Authority agreements for the automatic exchange of the CbC report in a timely fashion with treaty and Tax Information Exchange Agreement (TIEA) partners, "taking into consideration the need for appropriate review of systems and confidentiality safeguards in the other jurisdiction."

The preamble states that the IRS has determined that CbC reports constitute tax return information and are thus subject to the confidentiality protections of Section 6103. This characterization accords with the Final BEPS Report, requiring tax administrations to take all reasonable steps to prevent public disclosure of CbC reports.

Observation: Section 6103(d) allows the IRS to share return information with state agencies for tax administration purposes, in certain circumstances. Given the increase in transfer pricing audits by US states, taxpayers should be mindful of these rules.

With respect to confidentiality of the CbC information, several comments recommended public disclosure of CbC reports. That recommendation was not adopted; as noted, the final regulations state that information provided on the CbC report is return information subject to the confidentiality protections of Section 6103. However, US-parented MNE groups will not have the confidentiality protections of Section 6103 if they are required to file CbC information locally in foreign jurisdictions in which they are doing business, as a result of the so-called 'secondary mechanism' described in the Final BEPS Report. That could occur, for example, if a US-parented MNE group is doing business in a country where the IRS does not have in place (1) an income tax treaty or TIEA, and (2) a Competent Authority agreement for the automatic exchange of CbC reports.

Additionally, any confidentiality protections provided in the final regulations effectively may be 'overridden' by rules in other jurisdictions in which US companies are doing business mandating public disclosure of CbC reports. For example, the European Commission has developed a proposal for a directive which, if approved by the European Parliament and Council of Ministers, will require public CbC reporting of tax and other financial data by large companies operating in the European Union. (See PwC's Tax Policy Bulletin/Tax Insight dated April 20, 2016).

The preamble to the final regulations indicates that the CbC report is to be used as a 'high-level' risk assessment tool and that transfer pricing adjustments will not be made solely on the basis of a CbC report. The preamble also indicates that the United States intends to incorporate such limitations into the Competent Authority agreements negotiated with its treaty and tax information exchange partners. Like the proposed regulations, the final regulations do not provide guidance as to how CbC reports should be used to conduct a transfer pricing risk assessment.

Tax jurisdiction of residence and fiscal autonomy

The final regulations clarify that the IRS does not intend to treat all entities in tax jurisdictions with territorial tax regimes as stateless entities. To that end, the final regulations provide that a business entity's income will only be considered stateless if it is liable to tax solely with respect to gross income from sources within the jurisdiction without reduction for expenses.

Under the final regulations, American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the US Virgin Islands are considered to have fiscal autonomy for CbC reporting purposes. The final regulations do not provide any further definition of fiscal autonomy absent international consensus on its meaning.

The final regulations do not treat a corporation as stateless if it is organized or managed in a jurisdiction that does not impose an income tax on corporations (e.g., zero-percent rate of tax). Rather, such a corporation is treated as a resident of that tax jurisdiction (unless treated as a resident of another tax jurisdiction under another provision of the final rules.)

Constituent entities

The preamble to the proposed regulations solicited comments regarding whether the IRS needed to issue further guidance regarding which US persons must file Form 8975 or which entities it would consider constituent entities of the filer. The final regulations provide the following additional guidance:

- Variable interest entities (VIEs): The final regulations do not modify the definition of constituent entity. A constituent entity is any separate business entity of a US MNE group except a foreign corporation or foreign partnership for which the ultimate parent entity need not provide information under Section 6038(a).

- Permanent establishments (PEs): Aligning more closely with the Final BEPS Report, the final regulations allow a taxpayer to determine PE status under applicable law rather than having to conduct a separate analysis under the OECD Model Tax Convention solely for purposes of completing the CbC report. Specifically, a PE includes i) a branch of a constituent entity that is treated as a PE in the jurisdiction where it is located under a treaty to which that country is a party, ii) a branch that is liable to tax in the tax jurisdiction in which it is located under domestic law of the country, or iii) a branch treated in the same manner for tax purposes as an entity separate from its owner by the owner's tax jurisdiction of residence.

- Grantor trusts and decedents' estates: The final regulations exclude decedents' estates, individuals' bankruptcy estates, and Section 671 individual-owned grantor trusts from business entities required to file Form 8975, to the extent they are owned by individuals.

- Deemed domestic corporations: Foreign insurance companies electing domestic status under Section 953(d) are considered US business entities with a US tax jurisdiction of residence.

Employees

Form 8975 will reflect employees of a constituent entity in the tax jurisdiction of residence of the constituent entity; in contrast, the Proposed Regulations would have used the location in which employees performed work as their location for CbC reporting purposes. The revised approach is intended to be consistent with the Final BEPS Report. The rules allow rounding or approximation of the number of employees that does not materially distort the relative distribution of employees across various tax jurisdictions.

Unchanged from the proposed regulations and without further elaboration, the final regulations require the total number of employees to be reported on a full-time equivalent basis. Taxpayers may use any reasonable, consistently applied approach to determine the number of employees and may include independent contractors participating in usual business activities in the number of full-time equivalent employees.

Observation: In permitting the approximation of employees provided it does not materially distort the number of employees *across* tax jurisdictions, the regulations allow for more flexibility than if they required that the approximation did not materially distort the number of employees reported *in* a particular jurisdiction. For example, choosing not to report independent contractors might distort the number of employees reported in country X (20 employees vs. 100 independent contractors), but may not distort the number of employees in country X relative to the employees reported in the United States and United Kingdom (each with 1,000 employees and zero independent contractors).

Clarification of terms

The final regulations clarify certain reporting requirement issues:

- Tangible assets do not include intangibles or financial assets.

- Imputed earnings and deemed dividends that are taken into account solely for tax purposes are treated like dividends for purposes of CbC reporting.

- "Total income tax paid on a cash basis to each tax jurisdiction" in Treas. Reg. §1.6038-4(d)(2)(iv) means total income tax paid on a cash basis to a country by constituent entities with a tax residence in a particular tax jurisdiction of residence but not the aggregation of taxes paid by

constituent entities with different tax residences. The final rules do not change the language of the regulation.

- Form 8975 requires taxpayers to provide information for each tax jurisdiction as an aggregate of the information for all constituent entities resident in that tax jurisdiction.
- 'Revenue' for a tax-exempt organization (i.e., amounts used to calculate the $850 million threshold) includes only unrelated business taxable income.

Source of data and reconciliation

The final regulations provide that the reporting period for Form 8975 is the period of the ultimate parent's annual financial statement ending with or within its taxable year. A broad list of sources for constituent-entity information is provided, including applicable financial statements, books and records maintained with respect to the constituent entity, regulatory financial statements, and records used for tax reporting or internal management control purposes.

As in the proposed rules, under the final regulations taxpayers do not have to create or maintain records to reconcile CbC reporting information to consolidated financial statements or tax returns, though they must still maintain records sufficient to support the report.

Surrogate parent entity filing

In general, the final regulations do not allow a foreign-headquartered company to designate a US entity to file a CbC report with the IRS in order to meet CbC reporting obligations elsewhere. Also, the regulations do not require CbC reporting for a foreign-headquartered company for which a US entity exercises the 'mind and management' function. However, the final regulations allow a parent entity located in a US territory to designate a US entity that it controls to file a CbC report on its behalf.

The takeaway

As noted, the final regulations requiring CbC reporting for US-parented MNEs above the $850 million annual revenue threshold were issued on the same day that the OECD recommended that tax jurisdictions accept CbC reports voluntarily filed in the United States and other countries not requiring the reports as of January 1, 2016. Although a gap in filing requirements exists for taxable years beginning between January 1 and June 30, 2016, both the IRS rules allowing voluntary filing and the corresponding OECD guidance provide a means for the United States and other countries to coordinate and allow a reasonable filing mechanism for taxpayers during the first year of this new documentation requirement.

The Country-by-Country Report, Form 8975, represents the next step toward global tax transparency as the United States prepares to simultaneously exchange CbC reports with treaty and TIEA partners with which it enters into Competent Authority agreements. Guidance has not yet been provided, however, by either the IRS or the OECD as to how a CbC report should be used in assessing transfer pricing risk. Transfer pricing controversies could increase depending on how tax authorities around the world view and utilize the additional information provided under this new reporting requirement.

A significant amount of work remains for the IRS to complete the bilateral Competent Authority agreements necessary to exchange the CbC reports on a confidential basis so that US-parented MNEs will not be forced to file CbC reports directly in foreign jurisdictions in which they are doing business under the 'secondary mechanism' described in the Final BEPS Report. While the IRS states that Section 6103 will provide confidentiality protections for information reported on Form 8975, taxpayers should prepare the new CbC report with the awareness that such confidentiality protections may be effectively overridden to the extent other jurisdictions adopt CbC reporting with mandatory public disclosure provisions or the information is disclosed involuntarily.

Let's talk

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