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January 2017

INTERNATIONAL TAXATION

Information on the Potential Impact on IRS and U.S. Multinationals of Revised International Guidance on Transfer Pricing

Accessible Version

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GAO Highlights

Highlights of GAO-17-103 a report to the Chairman, Committee on Finance, U.S. Senate

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Why GAO Did This Study

Globalization has increased incentives for multinational corporations to shift profits from country to country to use differences in the countries' corporate tax systems to reduce taxes. This profit shifting can lead to the erosion of U.S. and other countries' corporate tax bases, reducing tax revenues. OECD did a comprehensive analysis of corporate base erosion and profit shifting and, in the fall of 2015, issued 15 action plans to address the problem. GAO was asked to analyze the effects on the U.S. economy of adopting OECD actions.

GAO analyzed the potential effects of the two actions furthest along in implementation: revised transfer pricing guidelines and new transfer pricing documentation, including country-by-country reporting. For these actions, GAO examined (1) how likely it is that the action would reduce BEPS, (2) what is known about the potential administrative and compliance costs of the action, and (3) what is known about the potential effects the actions could have on the U.S. economy. GAO reviewed documents, conducted a literature review, and interviewed officials from IRS, the U.S. Department of the Treasury, OECD, and trade groups of industries likely to be affected by the actions.

What GAO Recommends

GAO does not make recommendations in this report. GAO provided a draft of this report to IRS and Treasury for review and comment. IRS provided technical comments, which were incorporated, as appropriate.

View GAO-17-103. For more information, contact James R. McTigue, Jr. at (202) 512-9110 or mctiguej@gao.gov.

What GAO Found

In 2015, the Organization for Economic Co-Operation and Development (OECD) issued revised guidelines, including 15 actions to help reduce base erosion and profit shifting (BEPS) of multinational enterprises (MNEs). One action focuses on transfer pricing guidance with the intent of aligning MNE profits with the location of economic activity, and preventing corporations from shifting and assigning profits to lower-taxed related corporations by artificially setting below-market transfer prices of property and services. Another action makes MNE activities more transparent, through documentation and reporting shared among countries.

Transfer Pricing Guidance: OECD's guidance emphasizes that transfer price analysis should reflect actual economic activities, such as who controls decisions related to risk and who has the financial capacity to bear the risk. This clarifies prior guidelines, which also included risk analysis based on functions, but that now focus on the parties' ability to control and finance risk. GAO found that

- OECD's revised guidance may reduce BEPS if it encourages MNEs and tax authorities to ensure that transfer prices are based on real economic activity. U.S. regulations consider risk as part of the analysis of transfer prices. The arm's length principle, which treats transactions between related parties as if they were unrelated, is widely accepted for evaluating transfer prices. However, its application to risk is problematic because related parties cannot transfer risk the way unrelated parties can. Without addressing the application of the arm's length principle under these situations, uncertainty about the correct transfer prices may allow for continued BEPS.
- Administration costs of implementing the guidelines will be minor according to Internal Revenue Service (IRS) officials because IRS's transfer price reviews are consistent with the revised guidance. However, taxpayer compliance costs are uncertain because they will depend on how MNEs respond to the revisions.
- According to stakeholders and industry literature, U.S. employment and investment are unlikely to be significantly affected because the transfer pricing guidance affects a relatively narrow area of the tax code.

Transfer Pricing Documentation and Reporting: OECD's guidance includes new country-by-country (CbC) documentation and reporting actions where information on MNEs activities in different countries will be shared among the countries' tax authorities. GAO found that

- CbC reporting may decrease BEPS because more consistent information will be available to tax authorities on the worldwide activities of MNEs.
- According to IRS officials, CbC implementation costs are uncertain at this time, but can be mitigated by using existing systems and processes. However, MNE compliance costs would likely increase due to new data system needs, according to stakeholders.
- The economic effect of CbC reporting is uncertain because it depends on the extent to which MNEs move business functions to low-tax countries in response to the potential increased scrutiny of BEPS.

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Abbreviations

ALP	arm's length principle
BEPS	base erosion and profit shifting
CbC	country-by-country
CFC	controlled foreign company
EU	European Union
FATCA	Foreign Account Tax Compliance Act
G20	Group of Twenty
IDES	International Data Exchange Service
IRS	Internal Revenue Service
MAP	mutual agreement procedures
MNE	multinational enterprise
OECD	Organisation for Economic Co-operation and Development
TIEA	tax information exchange agreement
Treasury	U.S. Department of the Treasury

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
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January 27, 2017

The Honorable Orrin Hatch Chairman Committee on Finance United States Senate

Dear Mr. Chairman:

As the United States and other countries have become more globally interconnected, the disparities among countries' corporate tax systems have provided increasing incentives for multinational corporations to shift profits to exploit those differences and reduce their tax liabilities. This artificial shifting of profits from one tax jurisdiction to another can erode some countries' corporate tax bases.

The United States, along with other Group of Twenty (G20) members, agreed to implement a plan developed by the Organization for Economic Co-Operation and Development (OECD) to address international tax base erosion and profit shifting (BEPS).[1] OECD undertook a comprehensive analysis of the international tax policy issues surrounding corporate tax base erosion and profit shifting, and issued a final plan for addressing base erosion and profits shifting in the fall of 2015. OECD's plan contained 15 action items that addressed a variety of BEPS issues. OECD's recommended actions are based largely on analysis of their effect on OECD member countries' tax revenues and economies.

You asked us to analyze how the OECD BEPS actions affected the U.S. economy. In this report, we analyze the potential effect of 2 of the 15 action items: the revision of transfer pricing guidelines and the new transfer pricing documentation including the country-by-country reporting (CbC) requirements.[2] We focus on these actions because they are furthest along in implementation by the United States and other countries. For each of these actions, we (1) examine how likely it is that the action

[1]G20 is a group of 19 member countries, including the United States, along with the European Union that meet annually to discuss international and world economic development issues. OECD is an organization of 35 member countries, including the United States, created to foster economic development. www.oecd.org/tax/beps-2015-final-reports.htm .

[2]Transfer pricing is a method of setting prices for the exchange of property, both real and intangible, between related parties, such as from a parent multinational enterprise to a subsidiary.

would reduce base erosion and profit shifting, (2) describe what is known about the potential administrative and compliance costs of the action, and (3) identify what is known about the potential effects the actions could have on the U.S. economy.

To determine how likely it is that the two actions would reduce BEPS, we reviewed OECD documents and interviewed OECD officials to identify the purpose and describe the design of each of the two BEPS actions. To assess the effectiveness of the actions, we use the criteria of a good tax system including equity, efficiency, and revenue adequacy.[3] To describe what is known about the administrative and compliance costs, we interviewed Department of the Treasury (Treasury) and Internal Revenue Service (IRS) officials to determine the potential administrative costs of adopting the actions. To describe the potential compliance costs for U.S. multinational enterprises (MNE), we reviewed public comments submitted to OECD in response to the BEPS plan. We also used these comments to identify and select seven U.S. stakeholder groups whose members are likely to be most affected by the BEPS actions and interviewed them.[4] These stakeholders included representatives of trade groups, international tax law practitioners, tax reform advocacy groups, and non-governmental organizations. Finally, to identify what is known about the potential effects of the actions on the U.S. economy, we reviewed economic studies relevant to the actions to identify key factors that could affect U.S. employment, investment, and tax revenue. We also interviewed the above selected trade groups about likely reactions to the actions concerning investment and employment location decisions. The information gathered from these interviews and the literature is not generalizable to all MNEs.

We conducted this performance audit from November 2015 to December 2016 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to

[3]For a detailed description of the criteria of a good tax system, see GAO-05-1009SP and GAO-13-167SP.

[4]We identified 44 potential stakeholders to interview from public comments submitted to OECD. We found that 16 met the following criteria: having a US headquarters, providing multiple comments, and acting as interest groups instead of personal opinions. Of these 16, we excluded 1 because it was a law firm advocating a viewpoint and another because it was part of OECD. Of the remaining 14, we limited interviews to those groups representing corporations, non-governmental organizations, or groups formed purposely to respond to the BEPS initiative.

obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

In the context of international corporate taxation, countries determine their method to tax on two factors: the residence of the taxpayer and the source of the income to be taxed. The U.S. government taxes U.S. corporations largely on a residence basis, meaning that the worldwide income (both domestic and foreign) of corporations that are incorporated (have residence) in the United States is taxed by the United States. Alternatively, most other countries, including most OECD member countries, use a largely source-based or territorial approach that exempts certain foreign-earned income of their domestic corporations from taxation. In this latter case, they assert jurisdiction to tax income that is sourced within the taxing country and not the income earned abroad.[5] Regardless of the tax system, some counties—often called tax havens—assess little or no corporate income tax.

The U.S worldwide approach is sometimes called a hybrid system because it has some features that resemble the territorial approach such as deferring tax on some foreign income earned by foreign corporate subsidiaries until that income is remitted or “repatriated” to the U.S. parent company (often in the form of a dividend payment). Both the worldwide and territorial systems provide incentives for corporations to shift income to low tax jurisdictions: under the worldwide system, the incentive is to take advantage of the deferral of taxation until income is repatriated, while, under the territorial system, the incentive is to take advantage of permanent exemption.

To avoid double taxation, countries, like the United States, that tax on a worldwide basis provide a credit against domestic corporate tax liability for foreign taxes paid. In addition, countries maintain tax treaties with each other that cover a wide range of tax issues but have two primary purposes: (1) avoiding double taxation—when two or more countries levy taxes on the same income—and (2) enforcing the domestic tax laws of

[5] In general, under both worldwide and territorial systems, countries tax income earned by foreign entities based on source.

treaty partners. Treaties can prevent double taxation, which can occur, for example, when more than one country, under its domestic laws, considers a taxpayer to be a resident. In these cases, double taxation is often avoided through tax treaties that outline which country has jurisdiction to tax under specific circumstances.

Large U.S. MNEs are often made up of groups of separate legal entities that have complicated ownership relationships. A parent corporation may directly own (either wholly or partially) multiple subsidiary corporations, which in turn may own subsidiaries themselves. Large MNEs have an incentive to shift profits among entities to reduce overall taxes by exploiting differences in countries' laws and regulations defining taxable income, tax rates, and when tax is owed.[6]

Transfer pricing is the area of international tax law that involves setting prices for tax purposes for transferring property, both real and intangible, between foreign related parties such as from a parent MNE to a subsidiary.[7] MNEs can use transfer pricing to artificially shift profits from one jurisdiction to another to reduce taxation. When an MNE transfers a product from one party, such as the parent corporation, to another, such as a foreign subsidiary, it has to determine the price of that product—effectively "selling" products within the same MNE. To lower their taxes, MNEs can shift profits by underpricing products or assets transferred from an entity located in a high-tax jurisdiction to a related party located in a lower-tax jurisdiction, thus increasing the profits reported by entities located in low-tax countries.

The international standard for determining transfer prices is the "arm's length" principle. A transaction between related parties meets the arm's length standard if the results of the transaction are consistent with the result that would have been realized if unaffiliated taxpayers executed a comparable transaction under comparable circumstances.[8] That is, the transfer price should correspond to the price that unrelated parties would

[6]For more details on how U.S. firms are organized and taxed, see GAO-08-950.

[7]In addition to transfer pricing, corporations can use a number of tax strategies to artificially shift profits from one jurisdiction to another to reduce taxation. Two other main ways firms can shift profits are debt allocation and entity classification. For more information on strategies for profit shifting see Congressional Budget Office, *Options for Taxing U.S. Multinational Corporations* (January 2013).

[8]The arm's length principle is incorporated into section 482 of the International Revenue Code, the regulations thereunder, and U.S. income treaties.

agree upon in an open market. While there is no single approach to determining a transfer price, in theory, the arm's length principle provides an objective measure of the value of goods by relying on market forces to determine the price.[9]

To illustrate, table 1 shows the example of a hypothetical chocolate company we call "Chockolet" that sells the right to use its trademarked name to its distributing subsidiary at an arm's length price and at a price below market value—that is, below the arm's length price.[10] As the table shows, the MNE group is able to reduce its overall effective tax rate by shifting profits (through the lower price) to the distributing subsidiary located in a lower-tax jurisdiction.

Table 1: Change in Effective Tax Rate When Arm's Length Pricing Is Replaced by Underpricing

- Market price for a license: $160
  - markup of 60% on license development costs of $100
- Sales price of Chockolet's product: $191.5
  - equal to the sum of market price of the license, distribution costs of $30 and distributer's normal return of $1.5 (5% mark-up on distribution costs)

[9]As discussed later in this report, there are multiple approaches to determining transfer prices because any single method can be difficult to apply in all circumstances.

[10]For the sake of illustrating the potential for profit shifting, in this illustration we chose a simplistic transfer price equal to the cost of maintaining the tradename. This method shifts all the profit to the distributing subsidiary. There are other methods for determining transfer prices that would result in different profit allocations. For an example of an alternative profit allocation method, see appendix II.

	Arm's Length Pricing			Underpricing		
	Transfer Price equal to Market Price			Transfer Price is less than Market Price		
	Chockolet Parent	**Distributing Subsidiary**	**MNE group**	**Chockolet Parent**	**Distributing Subsidiary**	**MNE group**
Development and distribution costs	$100	$30	$130	$100	$30	$130
Transfer price as revenue to parent	$160	-	-	$100	-	-
Transfer price as cost to subsidiary	-	$160	-	-	$100	-
Total costs	**$100**	**$190**	**$130**	**$100**	**$130**	**$130**
Total revenue	**$160**	**$191.5**	**$191.5**	**$100**	**$191.5**	**$191.5**
Net profit	$60	$1.5	$61.5	$0	$61.5	$61.5
Country tax rate	30%	15%	-	30%	15%	-
Tax liability (net profit multiplied by the tax rate)	$18	$0.2	$18.2	$0	$9.2	$9.2
MNE group's effective tax rate	**-**	**-**	**29.6%**	**-**	**-**	**15.0%**

Legend: MNE=Multinational enterprise, - = not applicable

Source: GAO analysis. | GAO-17-103

In this example, the Chockolet parent corporation spends $100 developing its trademark, which is an intangible asset that allows Chockolet to charge $160 for a license to distribute its product (a markup of 60 percent over its development costs). This is the "arm's length price"—the price at which it would be willing to license the use of the trademark to an unrelated distributing company. The Chockolet subsidiary has distribution costs of $30 on which it earns a normal return of $1.5 (a markup of 5 percent over its distribution costs). The sales price of the product is $191.50, which covers (1) the costs of development and distribution, (2) the 60 percent return on the trademark intangible asset and (3) the 5 percent normal return on the distributer's costs. In the arm's length pricing case in table 1, the Chockolet parent has a net profit of $60—the revenues of $160 from charging the arm's length license fee to its subsidiary less its development cost of $100.The distributer has a net profit of $1.50—the sales price of $191.50 less the license fee of $160 and its distribution cost of $30. Each corporation pays the local country tax rate on its net profits which together add up a total tax liability for the MNE group of $18.2 and an average tax rate of 29.6 percent. However, because these corporations are related, there is an incentive to underprice the license so that the Chockolet parent could shift profits to its subsidiary located in the low-tax jurisdiction. As the underpricing example in table 1 shows, by agreeing on a transfer price of $100 that is equal to the cost of developing the trademark, the Chockolet parent reports zero net profits, while the $60 profits accorded to the trademark gets shifted to the related distributing subsidiary, which is located in the lower tax jurisdiction. This underpricing of its trademark results in an average tax rate of 15 percent for the MNE group.

To address this base erosion and profit shifting, OECD issued a plan in October 2015 with 15 separate action items that would address different areas of potential weakness in international tax enforcement. Countries that adopted the BEPS plan agreed that they would implement four minimum standards: 1) countering harmful tax practices (action 5), 2) preventing treaty abuse (action 6), 3) increasing transfer pricing documentation with CbC reporting (action 13), and 4) increasing dispute resolution effectiveness (action 14). In addition to implementing country-by-country reporting, IRS is implementing procedures and practices to meet the minimum standards of improving dispute resolution. IRS is also implementing procedures for meeting the minimum standard of exchanging rulings pursuant to preventing harmful tax practices. According to Treasury, no additional steps need to be taken to meet the other minimum standards.[11] Other countries may require legislation to implement the agreement.

Transfer Pricing Guidelines

Revised Transfer Pricing Guidelines May Reduce BEPS but Other Challenges Remain

OECD revised its guidance on how risk bearing should be accounted for in transfer price contracts. Transfer price contracts can include compensation for bearing the economic consequences of an uncertain event should it occur, such as paying the cost of a product recall. OECD's revised guidance emphasizes that the transfer price should reflect actual economic activities, such as who controls decisions related to risk and who has the financial capacity to bear risk. Prior OECD guidelines included risk analysis based on functions performed. However, OECD was concerned that an emphasis on the terms of the contract for risk allocation could allow for manipulation and continued base erosion and profit shifting. This concern stems from the fact that a contract may

[11]For more information of the OECD BEPS action Items see appendix I.

specify which of the related parties is responsible for assuming the risk of a particular event occurring but the specified party may not correspond to the party that is actually bearing the economic risk. Without examining the functions of each party and the economic substance of the contract, risk allocation could be used to shift profits between parties to reduce taxes furthering base erosion.

To illustrate how the specifications of a transfer price contract can be used to allow BEPS, consider the example of Chockolet the company described earlier that licenses an intangible asset—the Chockolet trademark—to its wholly-owned subsidiary. In this case, the contract specifies that the parent corporation receives royalty payments and that the subsidiary bears the risk (i.e., would bear the cost) of a product recall, were one to occur. Under this contract, the royalty payment the subsidiary pays to Chockolet would be less than it would be if the parent was specified in the contract as bearing the risk. In other words, by agreeing to bear the risk of a recall, the subsidiary can pay a lower royalty for the license. However, if the parent is actually making major decisions that mitigate recall risk, then it is apparent that the specifications of the contract do not represent the economic reality. In such a case, although the contract specified that the subsidiary assume risk, in reality the parent corporation would bear the cost of managing recall risk. Contractually assigning risk without economic substance is one way a parent could shift profits to lower-tax jurisdictions: the parent receives less revenue in the form of lower royalty payments and the subsidiary has lower costs due to the smaller royalty payments. Therefore, risk can be used as part of a contract for the transfer price of an intangible asset to shift profits from one party in a high-tax jurisdiction to a related party in a lower-tax jurisdiction, resulting is base erosion.

According to OECD and other subject matter specialists, the revised guidelines are likely to be an improvement over prior guidelines in reducing BEPS if it encourages MNEs and tax authorities to ensure that transfer prices are set based on real economic activity. The guidelines underscore the focus on supporting contractual agreements with economic activity.[12] In particular, the revised guidelines focus on the

[12]In total, OECD revised six areas of its guidance: arm's length principle, commodity transactions, profit split method, intangibles, low value-adding intra-group services, and cost contribution arrangements. Generally, OECD's changes in these areas were narrower in scope or made to remain consistent with the changes in applying the arm's length principle. Proposed changes on the profit split method are discussed in appendix II.

ability of the parties to control risk by making decisions about risk taking functions and on their financial capacity to bear risk.[13] In the example above, focusing on the actual functions of both parties would reveal that the parent continued to manage recall risk, not the subsidiary as specified by the contract. Exhibiting control and the financial capacity to absorb risk would be stronger indicators of who bears the risk than the terms of the contract alone. The scope for profit shifting is likely to be lower under an enforcement regime that considers the true allocation of economic activity rather than just the terms of contractual agreements. According to OECD, the revisions are intended to address the concern that taxpayers have sought to transfer risk, and the potential for profits associated with an allocation of risk, through contractual allocation alone, without accompanying economic substance. By increasing the emphasis on the actual conduct of the parties, the revised guidance could increase the ability of tax authorities and MNEs to better align the taxation of income with the creation of value.

However, challenges remain for tax authorities and MNEs in applying the arm's length principle because the guidance does not account for all the ways that entities can bear risk. For example, even if a parent corporation's transfer prices align with economic activity, it cannot fully transfer risk to its subsidiary because any costs incurred by the subsidiary will be reflected in a change in the market value of the parent corporation. In general, related corporations do not have the same ability to transfer risk as unrelated corporations. This is the case even when the ability to control and the capacity to absorb risk has been isolated in one of the related parties to the transaction. The parent that transfers an intangible asset to its subsidiary has an equity interest in the subsidiary that ensures that it will gain or lose from any future anticipated or unanticipated profits and losses in a way that an unrelated corporation does not.

The Chockolet Company described above illustrates the limitations on the ability of related parties to transfer risk. Chockolet's subsidiary, acting as its distributor in another country, is assigned all risk of product recall in that country by contract. Following the new guidelines, the contract stipulates that the subsidiary has the authority to manage any recalls and

[13]The changes to risk allocation on applying arm's length pricing are also the main change in guidance in two of the other six areas: 1) the new guidance for transfer of intangibles relies on the new risk allocation method, and 2) evaluation of cost contribution arrangements use the new guidance on arm's length pricing for delineating the transaction, allocating risk, and valuing intangibles.

the financial ability to absorb the cost of a recall should it occur.[14] To show that Chockolet's limitations on its ability to shift risk to the subsidiary, we examine below the consequences of a recall for the value of the parent corporation Chockolet under the two possible financial situations of its subsidiary.

- **The subsidiary has sufficient profits to absorb the cost.** If the recall occurs, Chockolet incurs the risk of a reduction or cessation of the royalty payments and damage to the value of its brand. However, because the subsidiary is owned by the parent MNE, Chockolet has additional risks because, as a shareholder, its assets decline as the subsidiary's profits decline with the recall cost. Ultimately, the MNE as a primary, if not sole, shareholder will bear a loss in profits.
- **The subsidiary does not have sufficient profits to absorb the costs.** In this case, the subsidiary would require equity from the parent MNE or would have to borrow to pay for recall costs. If it receives equity from the parent to pay for the recall, then the MNE is directly affected with the loss in equity. If the subsidiary borrows from an unrelated party then that debt affects the amount of leverage the MNE group has and could restrict the ability of the parent to borrow for its operations. Thus, the parent still bears costs and risks of a recall that it does not bear when dealing with unrelated parties.

Unrelated corporations on the other hand, have greater ability to transfer risk because the lack of an ownership relationship limits the potential impact of a recall on the asset value of the corporation. If Chockolet contracts with an independent distributer, it still incurs the risk of a reduction or cessation of the royalty payments and damage to the value of its brand. However, because the distributer is not owned by the parent MNE, Chockolet does not have the additional risks as a shareholder described above.

As this example shows, the use of arm's length principle (ALP) becomes problematic when allocating risk between related parties. As we noted earlier, the arm's length price is based on treating transactions between related parties as if they were unrelated. According to OECD and

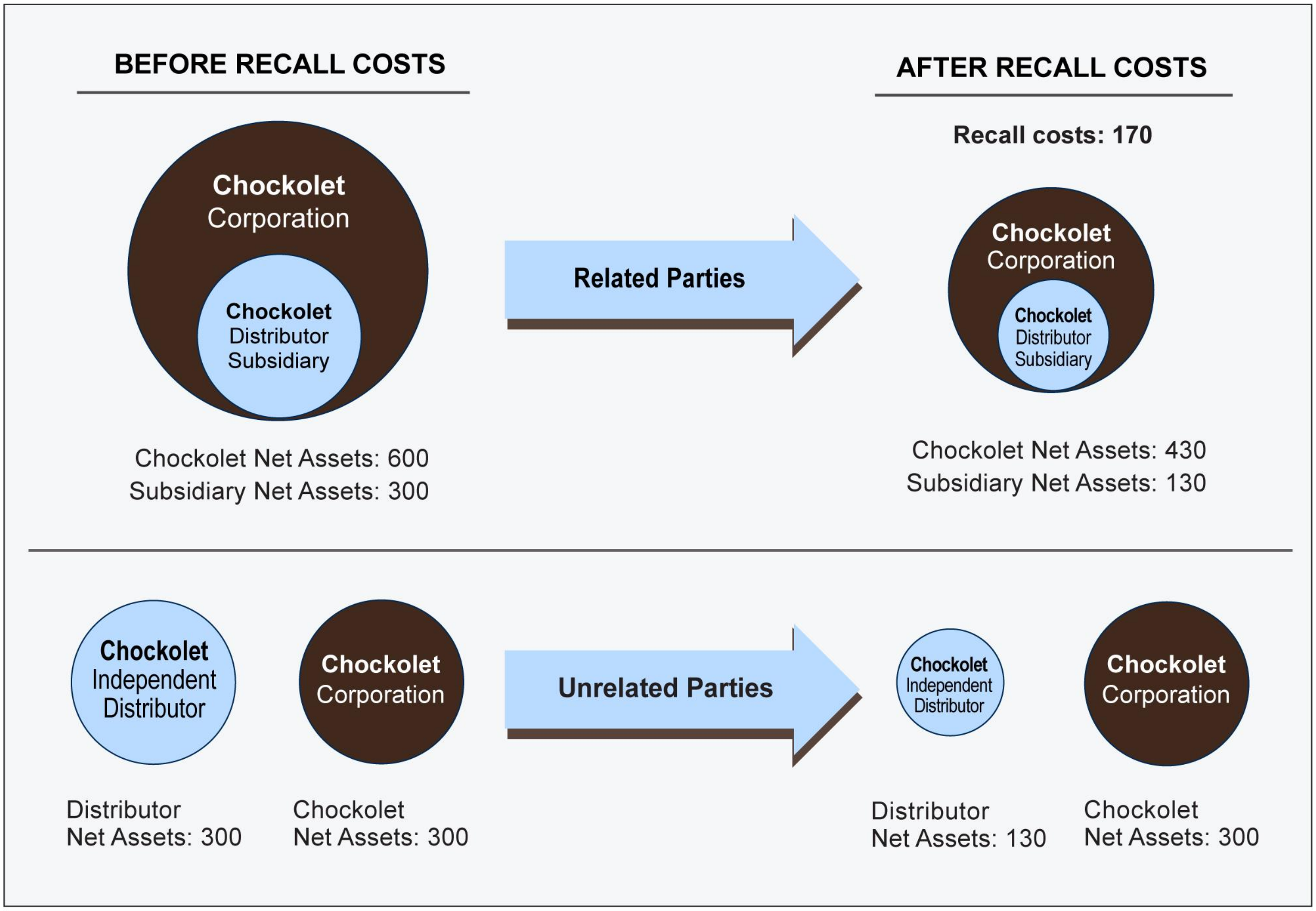
[14] This example is simplified to the case of a single wholly owned subsidiary. Large MNEs are extremely complex interrelated firms consisting of a variety of firm structures including corporations, limited liability companies, and partnerships. Because of this complexity, it may be possible to shift some risk among those parties. We show here, however, that it should not be assumed that the risk can be economically transferred or that those who have control over risk or the ability to absorb costs actually bear the burden.

Treasury, the ALP allows risks to be assumed by one entity or another in a related party transaction in the same way it can be assumed with unrelated parties. One entity can be protected (or isolated) from the risk in a contract that assigns risk bearing to the party that undertakes certain functions. However, as we show in the example, the application of the ALP is problematic in this situation because risk cannot be allocated between parties by the very fact that they are related. In the case of recall risk, the allocation of risk to a subsidiary based on functions of control and capacity does not protect the MNE from exposure to the risk of loss in asset value. Unrelated parties can isolate this risk while related parties cannot and this difference in the ability to transfer risk makes the application of the ALP more difficult.

The difference between the way risk is incurred by related and unrelated parties is illustrated in figure 1. Chockolet, by being a shareholder of the distributing subsidiary, is affected by the subsidiary's loss in profits. In the figure, both the parent and its subsidiary's net assets decline by the recall cost of $170 and the total value of the MNE shrinks from $600 to $430 (as illustrated by the reduction in the relative size of the circles in the figure). Therefore, the parent is affected, which would not be the case between unrelated parties who do not own shares of each other's assets. As the figure illustrates, the value of Chockolet is $300 when it does not own the distributor and this value is unaffected by the recall cost, while the value of the unrelated distributor declines by the $170 recall cost.

OECD guidance may be less effective than it could be in reducing BEPS because, without considering all the ways that entities can bear risk, uncertainty about the correct transfer prices remains that could still allow opportunities for profit shifting and, consequently, base erosion. For related parties, the focus on functions related to risk may have little or no relation to how much of the risk is actually borne by the parent company and its subsidiary. Whatever the terms of a contract or however resources are allocated between the related parties (as clarified by the revised guidelines), the parent bears some or all of the costs of the event at risk, in this case, a product recall.

Figure 1: Effect on Assets due to Costs of Recall Risk Under Two Scenarios



Source: GAO analysis. | GAO-17-103

Identifying who ultimately bears the burden of the risk is similar to determining the incidence of a tax because both require consideration of how market changes affect who bears the economic costs. With tax incidence, the parties that pay the tax may not economically bear the cost as when, for example, the payroll tax is collected and remitted by a business to the tax authority, but the employees bear the burden of the tax in the form of reduced wages.[15] The tax incidence is determined by market adjustments, in this case, a drop in wages. Similarly, risk incidence is determined by market adjustments like the change in the asset value of the MNE in the recall case. The potential market adjustments that determine risk incidence depend on a number of factors such as the type of transaction, the degree of the MNE's integration of corporate structure and function, and the MNEs market power in the products it buys or sells. Aligning profits with risk requires determining the economic incidence of the risk, which may not reflect either the explicit terms of the contract or the explicit assignment of risk to particular functions.[16]

IRS considers risk as part of its overall economic analysis when determining transfer prices during transfer pricing audits. According to Treasury and IRS officials, the expanded guidance on risk allocations under OECD guidelines is consistent with, but more detailed than, the current U.S. transfer pricing regulations under section 482 of the Internal Revenue Code.[17] Under these regulations, the risk allocation between related parties should be examined by reviewing the terms of contracts between the parties and the economic substance of the transaction(s) between them.[18] The regulations provide guidance on interpreting the terms of these intercompany contracts and on facts that are relevant to determining the economic substance of the transaction under the ALP method that treats related parties as unrelated. Treasury and IRS officials stated that among the factors relevant to determining whether a purported risk allocation has economic substance are (1) whether the pattern of the taxpayer's conduct over time is consistent with the risk allocation, (2) whether the taxpayer has the financial capacity to assume the risk, and (3) the extent to which the parties exercise managerial or operational

[15]The concept of economic incidence is not limited to taxation, but can also refer to the incidence of other kinds of costs. For example, in the case of employer provided health insurance, the costs of providing the service can be shifted from employers to employees through reduced wages. Blumberg, Linda J. "Perspective: Who Pays For Employer-Sponsored Health Insurance?" *Health Affairs*, vol. 18, no.6, (1999): 58-61 http://content.healthaffairs.org/content/18/6/58.full.pdf.

[16]For more a discussion on economic and tax incidence, see GAO-05-1009SP.

[17]26 C.F.R. §§ 1.482-1 to 1.482-9.

[18]According to Treasury and IRS, the U.S. transfer pricing guidelines have included looking at the economic activities as well as contracts since 1994.

control over the business activities that directly influence the amount of income or loss realized.

Treasury and IRS officials stated that risk allocations are critical to a proper application of the arm's length standard. The section 482 regulations require review of many aspects of intercompany transactions when determining appropriate transfer pricing outcomes, notably the functions performed, the assets employed, and the risks assumed by the respective parties.

However, the problems of applying the ALP to risk and to certain other aspects of the transaction complicate IRS's task of adequately assessing transfer prices. While the ALP is widely accepted for evaluating transfer prices and applicable in many transactions, difficulties may arise in certain situations, such as what to do about risk and how to allocate profits among the entities in an integrated MNE. As OECD notes, the separate entity approach may not always account for economies of scale and interrelation of diverse activities created by integrated businesses. According to OECD, there are no widely accepted criteria for allocating the benefits of integration between associated entities.[19] Our analysis indicates that risk is another area where the application of the ALP may be stressed because risk cannot be allocated between associated entities.

These shortcomings of the ALP can have implications for economic efficiency and for the equity of transfer pricing administration. For example, if the issues concerning risk are not addressed, profit allocations may not be equitable because profits could be unfairly allocated to parties on the basis of risk bearing that do not actually bear the burden of risk. As we have said in our prior reports, one criteria of a good tax system is the equitable treatment of all taxpayers.[20] In addition, the revised guidance may be less likely to be effective in helping to reduce BEPS because, without considering risk incidence, an uncertainty about the correct transfer prices remains that could allow profit shifting.

[19]OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010* (OECD Publishing, Paris, 2010), p. 34 1.10. http://dx.doi.org/10.1787/tpg-2010-en.

[20]GAO-13-789, GAO-13-167SP, and GAO-05-1009SP.

The Revised Guidelines Effect on IRS Administrative Costs is Likely Small, But The Effect on Compliance Costs for U.S. MNEs is Uncertain

OECD revisions to the transfer pricing guidelines are currently being implemented so no data are available to estimate prospective administrative and compliance costs for IRS and U.S. MNEs. The change in costs, including whether the revised guidelines result in decreased or increased costs, depends on a number of factors—as explained below—that make even a qualitative estimate of the effect on cost difficult at this time.

According to Treasury officials, the revised guidance would not have a significant effect on U.S. tax administration because current U.S. regulations already embody both the arm's length standard and the role of functions performed, assets employed, and risks assumed in determining arm's length prices between related entities. However, the clarifications to the risk allocation guidance could increase the administration costs for other countries to the extent those countries were not already incorporating functional analysis in reviewing transfer pricing cases.

The compliance costs of U.S. MNEs from the revised risk allocation guidelines are also uncertain because they depend on what, if any, new or additional actions are undertaken by MNEs to ensure compliance. For companies that set transfer prices based, at least in part, on relative risk, the costs can vary depending on whether the current specified risk allocation aligns with parties' capacity to assume and ability to control risk. The costs can range from relatively small costs, if an MNE only needs to make changes to existing contract language, or would be significantly more costs if broader changes in corporate strategies are necessary. According to subject matter specialists, relying on function analysis as required by the clarified risk allocation guidance may induce MNEs to rely even more on complex tax planning techniques to rearrange what entities control which processes, increasing their costs.

OECD Transfer Pricing Guidelines May Have a Small Effect on the U.S. Economy

According to subject matter specialists, because the revised guidelines emphasize the importance of real business functions, such as employment and investment, they may encourage MNEs to better align their actual business activities with their reported profits. The net effect on the U.S. economy depends on whether MNEs adjust actual activities to support current profit allocations, move reported profits to where their business activities are occurring, or choose to make no adjustment. Furthermore, the effect also depends on whether these shifts happen among foreign countries or between the United States and other countries.

According to subject matter specialists, because the revised guidance focuses on the location of decision making as support for allocating risk and profits, MNEs may be encouraged to decentralize decision making from the parent company to multiple jurisdictions to ensure that risk could be attributed to low-tax countries. This could result in some U.S. employees being relocated to tax-favored jurisdictions and reduced demand for employment in the United States.

It is extremely difficult to predict how MNEs will respond. As subject matter specialists have noted in the literature, the complexity of transfer pricing administration and tax planning of those businesses makes it even more challenging to predict how they will respond to numerous countries changing guidelines in potentially different ways. However, given the limited scope of the revised guidelines relative to the entire tax system, as discussed below, it is unlikely that these changes would result in significant changes in U.S. investment or employment.

We found no estimates of the effect of revisions to transfer pricing guidance on investment, employment, or revenue. However, estimates have been made of certain types of responses to other tax changes. According to the studies we reviewed, these measures can help provide a context for assessing the possible magnitude of any net change to the U.S. economy. Though evidence on how corporations shift profits in response to tax rates varies by study, the amount is generally low. Studies suggest that a 1 percentage point reduction in a country's tax rate could lead to an increase in profits reported in that country by up to 5 percent, but the actual amount is likely to be much lower.[21]

The responsiveness of businesses' allocation of investment to changes in tax rates is also likely to be low, according to the studies we reviewed. One study found that a 1 percent reduction in a host country's tax rates leads to an increase of total foreign direct investment between 0.3 percent and 1.8 percent.[22] Another study conducted a meta-analysis of studies on foreign direct investment and found the median measure of responsiveness to a percentage point reduction in the tax rate resulted in an increased investment by 2.49 percent.[23]

The profit and investment shifting responses discussed above are to a major change in a tax system—its tax rate. While it is difficult to predict how firms will respond to changes in tax administration, the responsiveness to a change in one aspect of the enforcement of a tax law—like a clarification of existing guidelines—could be much smaller and possibly even zero. Additionally, based on our analysis of the economic literature, the effect on labor is likely to be much smaller than the effect on investment because labor is considered generally much less able to move than investment, and thus would be even less likely to shift.[24]

The effect on U.S. tax revenue is also unclear. According to subject matter specialists, the revised guidelines increase the focus on functional analysis, which could result in increases in taxes assessed by higher tax countries like the United States, if more of the real business activities are concentrated in those countries. However, these costs may be mitigated to the extent that MNEs respond to OECD changes by re-locating business activities to lower-tax countries to better align real business activities with reported profit allocations. However, based on our review of the international tax policy literature, there may still be an effect on U.S. tax revenue even if MNEs make no significant adjustments to their

[21]Gravelle, Jane G. "Policy Options to Address Profit Shifting: Carrots or Sticks?" *Tax Notes*, (July 4, 2016):121-134.

[22]Schwarz, Peter. "Estimating Tax-Elasticities of Foreign Direct Investment: The Importance of Tax Havens," *Economics Bulletin*, Vol. 31 no.1, (2011): 218-232.

[23]Feld, Lars P. and Jost H. Heckermeyer. "FDI and Taxation: A Meta Study," *Journal of Economic Surveys,* Vol. 25, no. 2, (2011): 233–272.

[24]McClelland, Rob, and Shannon Mok. "A Review of Recent Research on Labor Supply Elasticities," Congressional Budget Office, Working Paper 2012-12.

activities. Any increased foreign taxes that could result from an increased focus on economic function and risk would reduce U.S. revenues in two ways: (1) by increasing foreign tax credits when the income from that country is repatriated, and (2) reducing U.S. shareholder's capital gains taxes due to reduced MNE profits.[25]

Transfer Pricing Documentation and Country-by-Country Reporting

Country-by-Country Reporting Will Improve Transparency For Tax Authorities but May Have Unintended Consequences

One factor contributing to base erosion and profit shifting has been a lack of consistent information on MNEs' business activities across tax jurisdictions. According to OECD, the new transfer pricing documentation addresses this deficiency and benefits tax authorities by providing information on MNEs' business activities that can be used to assess the risk of profit shifting and improve the deployment of audit resources. MNEs will be required to report transfer pricing policies under this approach. OECD states that requiring MNE parent entities to submit a single country-by-country (CbC) report to their tax jurisdictions, which, in turn, will share the report through government exchanges, ensures consistent documentation across countries at the same time limiting compliance cost for MNEs.

While Treasury officials said their current documentation and reporting requirements are sufficient for transfer pricing administration, they will be implementing one tier of the transfer pricing documentation. OECD's transfer pricing documentation consists of a three-tiered approach: a CbC report filed with the tax jurisdiction of the MNE's parent entity covering each jurisdiction in which the MNE operates, and a master file and local file submitted, where required, by the MNE to the tax administration in each jurisdiction in which it operates.[26] On June 30, 2016, Treasury

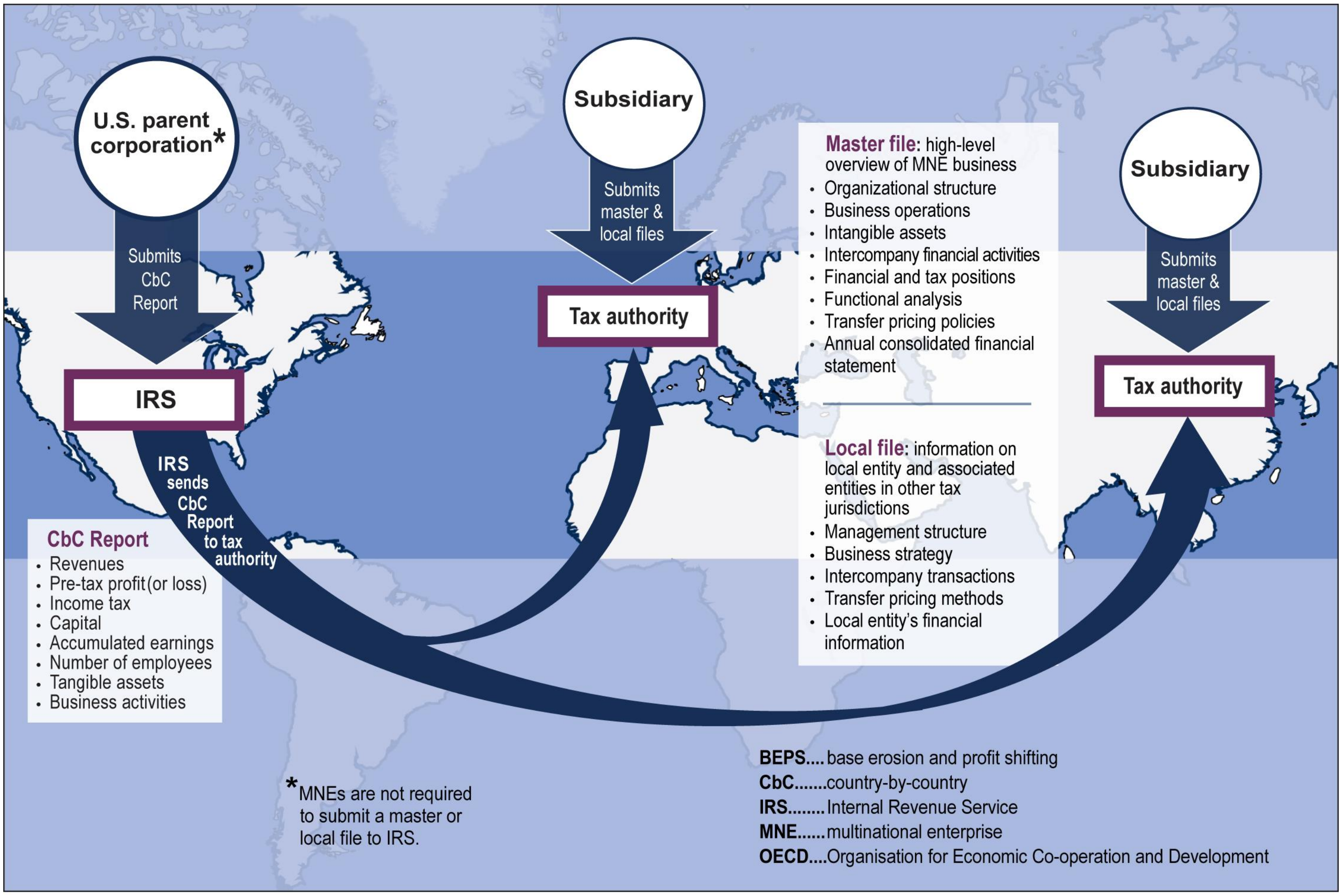
[25]For a review of the OECD BEPS action plans, see "Background, Summary, and Implications of the OECD.G20 Base Erosion and Profit Shifting Project," Joint Committee on Taxation, November 30, 2015, JCX-139-15

[26]OECD plans to reassess the documentation requirements by the end of 2020 to determine whether it should be modified.

issued final regulations for implementing CbC reporting as one of the BEPS minimum standards.[27] Treasury will not be requiring MNEs to submit master and local files. While U.S. MNEs are not required to prepare or file transfer pricing documentation, IRS officials stated that most provide some documentation voluntarily to IRS that is typically more detailed and informative than the information found in a CbC Report. Additionally, they said that the information OECD recommends for inclusion in the master or local file is generally available to IRS upon request. Figure 2 illustrates the new transfer pricing documentation mechanism.

[27] 81 Fed. Reg. 42,482

Figure 2: Organization for Economic Co-Operation and Development (OECD) Recommended New Transfer Pricing Documentation



Source: GAO analysis of OECD BEPS Action 13 information. | GAO-17-103

The type of data CbC reporting provides—aggregated information for each tax jurisdiction in which the MNE operates including revenues, pretax profits (or losses), income taxes, capital, accumulated earnings, number of employees, tangible assets, and business activities—will improve transparency of MNEs' activities for tax authorities to the extent that such global information has not previously been reported.[28] As we

[28]The parent entity of MNEs will be required to file a form with its own tax authority. The CbC Report will be shared with other tax jurisdictions through government-to-government automatic information exchanges.

reported in 2012, IRS does not have information on how much business a non-U.S. MNE operating in the United States does in any particular country, including the United States.[29]

Master and local file documentation could potentially provide tax authorities substantially more information on global operations. However, tax jurisdictions are not bound to implement these reports.[30] As outlined by OECD, the master file would consist of a high-level overview of the MNE's global business, such as organizational structure, business operations, intangibles, and financial and tax positions. The local file would include more detailed information on the local entity and intercompany transactions with entities in different tax jurisdictions, including transfer pricing methods. Local tax jurisdictions would need to implement these reporting requirements through local legislation and administrative procedures presenting the jurisdiction the opportunity to tailor the transfer pricing documentation for their own purposes.

Stakeholders we spoke with raised concerns about unintended consequences. Stakeholders noted the possibility that tax authorities may use the CbC reports in ways in which they were not intended. While OECD explicitly states the CbC Reports should be used for high-level risk assessment and not for assessing tax or as a substitute for a detailed transfer pricing analysis, stakeholders worried that the reports could be misused for these purposes.[31] In particular, the format and data items of the CbC Reports provide key business factors, such as revenues and number of employees in each tax jurisdiction an MNE operates. The availability of such data may facilitate the ability to implement formulary apportionment, a factor-based tax system that would allocate an MNE's global profits based on the share of their business factors, which could lead to double taxation. Varied stakeholders were concerned that, in extreme cases, concurrent misuse by several countries could result in

[29]GAO, *International Taxation: Information on Foreign-Owned but Essentially U.S.-Based Corporate Groups Is Limited,* GAO-12-794 (Washington, D.C.: July 16, 2012).

[30]Both master and local files are submitted by MNE entities directly to the tax administrations in each jurisdiction in which they operate that have adopted the documentation requirement.

[31]OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 – 2015 Final Report.* OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, Paris 2015). http://dx.doi.org/10.1787/9789264241480-en and Marie Sapirie, "Competent Authority Will Be The Key to CbC Reporting," *Tax Notes*, (Jan. 11, 2016): 177-179.

assessments totaling more than 100 percent of MNE profits. Excessive taxation would lead to audit disputes and potentially requiring resolution among tax authorities which, in turn, result in additional cost for both the MNEs and the competent authorities.

Another concern stakeholders we spoke with had is that countries may not be implementing transfer pricing documentation consistently. OECD officials stated OECD does not have any enforcement authority and will rely on a review mechanism and “peer pressure” to foster compliance with its recommendations. Nevertheless, countries generally implemented CbC information requirements that are consistent with the BEPS’ minimum requirements, while diverging from the BEPS master and local files recommendations. Countries varied on which entities are required to report and the threshold for reporting. For example, Germany set its threshold at €750 million for CbC reporting and €100 million for master file reporting while Netherlands has thresholds of €750 million and €50 million for CbC and master file respectively.[32]

Administrative and Compliance Costs of Country-by-Country Reporting Are Uncertain, but Could Be Mitigated.

IRS’s costs for implementing, exchanging, and analyzing CbC reporting are uncertain, but it has taken steps to mitigate costs. IRS’s use of existing data exchange systems should help to control the administrative costs of implementing country-by-country reporting. Other administrative costs related to CbC, such as form development and training, are similar to other comparable tax regulation changes. The compliance costs of firms are more uncertain and likely vary by size and type of firm. The main cost to firms of CbC is likely to be developing systems to provide consistent data to tax authorities.

IRS Costs to Implement and Administer CbC Reporting Are Likely to Be Similar to Costs of Other Regulatory Changes of Comparable Scope and Complexity

Because IRS does not intend to require the master file or local file reporting of the OECD approach, its cost of adopting BEPS transfer pricing documentation is essentially the cost of adopting CbC reporting.

[32]The U.S. threshold of $850 million for CbC reporting is about the same as that for Germany and Netherlands, but the United States will not require master file reporting.

This cost is expected to include of costs of developing systems to collect, store, and exchange CbC reports, and integrate CbC data with existing IRS applications. IRS does not have estimates of these costs, but factors that impact these costs can be identified.

IRS has issued final regulations for CbC reporting which requires U.S. MNEs with consolidated annual revenue of at least $850 million to file Form 8975 *Country-by-Country Report* electronically for the tax year beginning on or after June 30, 2016. MNEs with fiscal years beginning on January 1, 2016, or before the effective June 30, 2016 date may file voluntarily enabling IRS to provide the CbC Report to other tax authorities as appropriate. Form 8975 will be an attachment to the U.S. corporation income tax return Form 1120 and subject to statutory confidentiality and disclosure protections.[33] IRS officials said they expect the form—currently under review—that U.S. MNEs are to file in 2017 to be generally consistent with the BEPS CbC template. IRS plans on issuing additional guidance in early 2017 to outline the process for voluntary filing according to officials.

To try to minimize implementation cost, IRS plans to use its existing International Data Exchange Service (IDES) system with modifications to support CbC. IRS developed IDES to facilitate the secure transmission and exchange of Foreign Account Tax Compliance Act (FATCA) data. Pursuant to the 2010 law, foreign financial institutions are to report to IRS on accounts held by U.S. taxpayers.[34] According to officials, IRS is examining IDES to determine the extent to which it can be used to exchange CbC Reports with other tax authorities. IRS officials stated that treaty and tax information exchange agreement (TIEA) partners enrolled to use IDES for FATCA reporting would be able to use IDES for CbC exchanges. Currently, Treasury has signed 87 FATCA intergovernmental agreements.[35] According to IRS officials, the United States has treaties or TIEAs with all but 6 of the 44 jurisdictions that have agreed to exchange

[33]26 USC § 6103.

[34]Pub. L. No. 111-147, title V, subtitle A, 124 Stat. 71, 97 (Mar. 18, 2010). Foreign institutions are also to report on accounts of foreign entities in which U.S. taxpayers hold a substantial ownership interest.

[35]All Group of Twenty members have adopted BEPS, but the United States does not have a tax information exchange agreement with Argentina or Saudi Arabia, according to the IRS. As of June 30, 2016, their respective status for implementing transfer pricing documentation is unknown. However Argentina has signed the “Multilateral Competent Authority Agreement on the Exchange of CbC Reports”. Saudi Arabia has not.

CbC Reports as of June 30, 2016.[36] IRS officials said that the number of CbC Reports does not drive the system cost but rather the number of connections needed to exchange CbC Reports with other tax jurisdictions. They believe that these are significantly less than those required for FATCA.

IRS spent about $50 million for FATCA operations in fiscal year 2015 and the first quarter of 2016. This cost excludes the development costs of IDES.[37] According to IRS officials, the costs for developing and configuring IDES for FATCA were around $7 million annually in 2015 and 2016, and are expected to increase to about $9 million in 2017.

While IRS has a plan for how it will collect CbC data, a decision is pending on whether to establish a new database to store CbC data or use an existing FATCA platform. According to IRS officials, their strategy for assessing transfer pricing risk is still evolving and will influence the decision. IRS still needs to decide how to use CbC data in conjunction with other international data. IRS officials said they expect the CbC costs will be less than the cost of implementing FATCA because CbC information is exchanged only between tax authorities, while FATCA information is exchanged with individual banks as well as tax authorities. In addition to developing systems to collect, store, and exchange CbC Reports, implementation costs also include integrating CbC data with existing IRS applications used in transfer pricing risk assessment, developing Form 8975 and its instructions, online taxpayer assistance, and staff training. IRS officials said they do not have an estimate for these costs and will be in a better position to provide an estimate after the IRS Information Technology Team develops its plan for filing and processing the CbC form. According to these officials, these costs are routine for implementing tax regulatory changes that involves a new IRS form, and that the costs for CbC are not expected to be significantly different.

IRS will also incur some additional operational costs for annually collecting, exchanging, and using CbC. These operational costs will be

[36]Countries that agreed to implement CbC may elect to sign the “Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports” for the secure exchange of CbC Reports. Treasury officials have said that United States will not sign the multilateral agreement, but rather use bilateral treaties or TIEAs for exchanging CbCs. Officials said they do not anticipate negotiating new treaties or TIEAs to for the purpose of CbC.

[37]GAO-16-545.

affected by the number of CbC Reports IRS receives from U.S. and non-U.S. MNEs in addition to the number of CbC Reports from U.S. MNEs that IRS will need to transmit to other tax authorities. IRS estimated about 2,200 U.S. MNEs would meet the $850 million threshold for filing CbC Reports. IRS will need to transmit the CbC Reports of these U.S. MNEs to the tax jurisdictions in which the respective MNEs have business operations.

Based on BEPS CbC reporting requirements, IRS will receive CbC Reports from non-U.S. MNEs with business operations in the United States, although these CbC Reports will come from the respective tax jurisdictions of the foreign parent entity. The European Commission estimates around 5,000 non-U.S. MNEs meet the BEPS €750 million threshold for CbC reporting.[38] If all these large non-U.S. MNEs have business operations in the United States, IRS could potentially be receiving about 5,000 CbC Reports from other tax jurisdictions. However, there is no reason to assume that all non-U.S. MNEs have operations in the United States. Previously, our analysis of 2008 IRS data found that at least 2,356 non-U.S. MNEs had business operations in the U.S. at that time.[39] IRS officials said they do not expect significant additional costs associated with exchanging CbC Reports.[40]

IRS is uncertain of whether it will need additional resources for CbC risk assessments. IRS officials said that they are studying the most efficient and effective means for using the CbC Reports and may be using the reports in conjunction with other data sources IRS uses for risk assessment, such as, for example, the data reported on Form 5471—*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*.

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[38]The European Commission's estimate is based on S&P Capital IQ, which it notes has important data gaps indicating that the actual numbers could be substantially higher. European Commission, *Commission Staff Working Document – Impact Assessment: assessing the potential for further transparency on income tax information* (Strasbourg, France, Apr. 12, 2016).

[39]GAO's 2012 study used Form 5472 *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business* data of non-U.S. MNEs with at least $500 million in total receipts that have reportable transactions. As non-U.S. MNEs without reportable transactions would not be filing a Form 5472, the data undercount the number of non-MNEs operating in the United States. At the same time, it is unclear how many of the 2,356 would meet the €750 million threshold for CbC reporting. GAO-12-794

[40]By comparison, IRS receives about 400,000 FATCA reports.

In addition to the initial startup and operating costs, adopting BEPS also entails indirect costs affecting other areas of IRS. According to IRS officials, due to budgetary constraints, CbC implementation may require adjusting agency spending priorities and redirecting resources from other IRS efforts. However, until IRS determines how it will use the CbC Reports, it does not know whether it would need to divert resources for CbC risk assessments.

Country-by-Country Reporting May Entail Additional Compliance Costs for U.S. MNEs That Would Vary by Size and Complexity of the MNE

According to OECD, CbC reporting could reduce compliance costs by standardizing documentation across tax jurisdictions and limit the need for multiple filings. However, stakeholders we interviewed said that the reporting requirement will increase compliance costs because CbC information is not information U.S. MNEs routinely collect or report, and thus will require new data systems and processes. Moreover, stakeholders we spoke with believe that the new transfer pricing reporting requirements will increase audit activities and disputes, and potentially increase competitive and reputational risks.

Stakeholders we spoke with were concerned that the new transfer pricing documentation requirements would increase compliance burden. While stakeholders we interviewed have generally commended Treasury officials for successfully reducing potential compliance burden by decreasing the amount of CbC information to be reported, they do not expect the additional reporting requirements to reduce compliance burden because of streamlined or consolidated reporting, as OECD has suggested.[41] Rather, they said that the reporting requirements will add to and in some cases duplicate current reporting requirements. For example, certain items, such as revenues, number of employees, pretax profits or loss, and income tax, are reported in both the European Union's

[41]Whereas OECD's draft CbC template required reporting on 17 data items for individual MNE entities by country, the final CbC template required aggregated information on 10 data items by tax jurisdiction. Stakeholders also noted that master file requirements may be a greater burden on non-public MNEs which do not have similar regulatory reporting requirements as public MNEs.

(EU) CbC reporting requirements for banks and investment firms as well as the BEPS CbC Report.[42]

According to stakeholders interviewed, most transfer pricing documentation implementation cost for MNEs comes from developing the necessary information technology system and processes for CbC reporting even though U.S. MNEs will also have to submit local and master files to local tax authorities where the U.S. MNE has operations. These stakeholders noted that the initial cost for implementing CbC reporting varies widely depending on the size and complexity of the MNE and particularly on its ability to extract CbC information from existing data systems. For example, stakeholders explained, MNEs may need to extract CbC information from hundreds or thousands entities which use incompatible data systems with different accounting methods, in different languages. This may be the case if a U.S. MNE expanded through mergers and acquisitions without centralizing its financial systems. Accordingly, the relative burden of CbC reporting for MNEs will vary.

More transparent data on MNE's could help tax authorities better identify potential profit shifting and focus limited enforcement resources. However, increased audit activity would increase cost to MNEs.[43] OECD specifies that MNEs do not need to reconcile the information reported in their CbC Reports with similar information reported for other purposes. However, stakeholders we spoke with pointed out that if global CbC information is not reconciled with master and local file information, tax authorities might misinterpret the information or request additional information for clarification.

[42]EU's Capital Requirements Directive IV, implemented January 1, 2014, requires public CbC reporting of specific data by banks and investment firms. In March 2016, the European Commission agreed to amend its 4th Directive on Administrative Cooperation to enable the coordinated implementation of BEPS CbC reporting requirements. On April 2016, the European Commission proposed amending its Accounting Directive to require MNEs including non-EU MNEs doing business in Europe with global revenues exceeding EUR 750 million a year to publish CbC information including number of employees, pretax profits, and income tax paid and accrued.

[43]For example, in public comments to OECD, Deloitte reports that in its 2014 webcast and poll of 930 clients, more than half (55 percent) said they expect their compliance cost due to new transfer pricing documentation to increase by at least 40 percent. They cite estimates that range from a high of at least 70 percent increase in compliance cost estimated by 22 percent of the clients to an increase of between 10 and 40 percent estimated by 37 percent of the clients. However, it is unclear from their comments whether clients were using the same measures for compliance cost or these responses are generalizable.

One stakeholder pointed out that the compliance cost for a local audit often entails contracting for local tax professionals to manage the audit including site visits and interviews, which may be in different languages, because MNEs generally do not have local tax personnel. For example, one large MNE with operations in about 120 countries has tax personnel in only a fourth of those countries.

Stakeholders we spoke with also expect audit disputes to increase where local tax authorities may misinterpret or use global CbC information in ways inconsistent with OECD's recommendations. Of particular concern is the use of CbC Reports for formulary allocation or tax assessment. Formula apportionment is a factor-based tax system that would allocate an MNE's global profits based on the share of its business factors, such as sales, employment, or physical capital, located in a given country. The data included in CbC Reports are the type of factors that have been proposed for use under formulary tax systems. MNEs would incur additional costs to resolve disputes with the local tax authority and may require resolution among authorities of different tax jurisdictions. According to OECD, disputes under mutual agreement procedures (MAP) were taking on average 2 years to resolve.[44] Furthermore, OECD reported that at the end of 2014—the most recent data available—there were 5,423 unresolved MAP disputes among OECD members, more than double the number of cases for 2006. Recognizing the need to improve the effectiveness and efficiency of the dispute resolutions, tax jurisdictions adopting BEPS minimum standards agreed to change their mutual agreement approach to dispute resolution. Whether the changes will actually result in greater efficiency remains to be seen.[45]

MNEs could also incur costs through the inadvertent or deliberate disclosing of transfer pricing information, resulting in competitive or reputational risks. According to stakeholders, CbC information could potentially reveal where an MNE is expanding or contracting especially if the MNE has a single product in a particular country or is just entering a market. Such marketing information could be valuable to a competitor. Stakeholders also expressed concern about the exposure of confidential

[44]OECD's Model Tax Convention provides a mechanism, MAP, independent of the ordinary legal remedies available under domestic law, through which tax authorities may resolve differences.

[45]MAP issues identified as needing improvement include MAP implementation by tax jurisdictions, obstacles to MAP access for MNEs, and lack of resolution when MAP is activated.

information in master files. For example, transfer pricing policies and cost contribution arrangements are considered confidential and not publicly available. While MNEs need to prepare master files with accurate information, a balance must be struck so that information reported would not be harmful if publicly disclosed.

Although CbC reporting is protected from disclosure by law, MNEs could also incur costs if disclosure occurs and ultimately damages the MNE's reputation. Stakeholders said differences in the way items are reported on the CbC Report and tax returns—such as profits and taxable income, which includes allowable deductions and credits—could lead to reputational risk. One such risk is public perception that the MNE is not paying its fair share of taxes to the local jurisdiction.

IRS safeguards CbC information through treaty and TIEA provisions governing tax information exchanges, but dissemination of CbC Reports to the many local tax authorities where U.S. MNEs operate increases the risk of disclosure. IRS officials maintain that their ability to pause exchanges if foreign tax jurisdictions fail to meet the confidentiality requirements and data safeguards creates an incentive for foreign tax jurisdictions to safeguard CbC information. Stakeholders we spoke with expressed concern about how effective this strategy would be in deterring disclosure.

Increased Transparency of MNEs' Global Activities Could Lead to a Reallocation of Real Economic Activity For Tax Purposes but the Net Effect is Uncertain

The CbC Report includes information on where an MNE's income, capital, and employment are located. Stakeholders pointed out that in cases where there is an apparent disparity between the location of profits and the location of employment and investment, MNEs may have an incentive to realign their profits with their real business activities. As we noted earlier, MNEs could respond by: (1) relocating profits to align with current location of real activity or (2) adjusting the location of their business activities, such as employment and physical capital, to better support the current location of reported profits.

Based on international tax policy literature, the implications for U.S. revenue depend on how and whose profits are relocated. To illustrate, if U.S. MNEs relocate profits out of low-tax jurisdictions into non-U.S. higher-tax jurisdictions, that would result in higher foreign tax credits and lower corporate profits, which, in turn, would reduce U.S. corporate tax revenues. However, if U.S. MNEs relocate profits from low-tax foreign countries into the United States, then that would result in increased U.S. corporate tax revenues. Additionally, if foreign MNEs relocate profits from low-tax jurisdictions into the United States, U.S. corporate tax revenues would also increase.

Alternatively, MNEs may relocate employment and investment to support the distribution of profits across jurisdictions. If U.S. MNEs relocate real business activities among foreign countries, there would be likely no effect on U.S. employment and investment. However, if MNEs relocate U.S. operations abroad to support reported profits, then that would lower U.S. investment, particularly to the extent that most BEPS by U.S. MNEs is done to avoid U.S. taxes.[46]

While some business groups suggested that MNEs would be more likely to move employment and investment to align their real activity with their reported profits, others thought that both reactions were likely. They also noted that some MNEs rely on differences in the taxation of entities across jurisdictions, such as the use of debt, to support their profit allocations. Such MNEs may be less affected by transfer pricing revisions than MNEs that rely on uncertainty in transfer pricing outcomes. MNEs that rely on the differences in taxation would be less likely to relocate their employment and investment.

As we noted earlier, it is extremely difficult to predict how individual MNEs will react to the increased scrutiny, or if that scrutiny is even sufficient to change their behavior. Each MNE would make decisions weighing the relative costs of moving business functions against the tax savings. Thus, the net effect is unknown.

Conclusions

OECD’s revised guidance expands prior guidance on transfer pricing to try to better ensure that profits are aligned with economic activities. The revisions address the concern that taxpayers have sought to transfer risk, and the compensation for bearing the risk, through contractual

[46]A shift of investment by U.S. multinationals to foreign markets can cause a loss of particular U.S. jobs (because a manufacturing plant is closed, for example, or a new one is not built). But, over the long term, the economy as a whole generates enough jobs to compensate for those losses.

arrangements alone without accompanying economic substance. The guidelines are intended to emphasize that the ability to control risk and the financial capacity to absorb risk are key functions for supporting the contractual arrangements. By increasing the emphasis on the actual conduct of the parties, the revised guidance could increase the ability of tax authorities and MNEs to better align the taxation of income with the economic activity that creates that income. IRS considers risk as part of its overall economic analysis when determining transfer prices during exams, and views the OECD revised guidance as consistent with but more detailed than its own regulations.

The arm's length principle (ALP) is widely accepted for evaluating transfer prices and is applicable in many transactions. In particular, OECD guidance on risk allocation is based on the ALP. However, this principle has limitations that make its application to risk allocation problematic. Because of these limitations, uncertainty about the correct transfer prices could allow for profit shifting.

Agency Comments

We provided a draft of this report to the Commissioner of Internal Revenue and the Secretary of the Treasury for comment. In its written comments, reproduced in appendix III, IRS agreed with the importance of addressing risk allocation between related parties. IRS and Treasury also provided technical comments, which we incorporated where appropriate. Subsequently, we met with Treasury and IRS officials to discuss these technical comments and based on new information they provided we removed a recommendation that we had included in the draft. We had recommended that IRS clarify its guidance on risk allocation between related parties. We determined that the challenges of risk allocation are inherent in the arm's length principle that is the international standard for determining transfer pricing and that clarifying IRS guidance would not necessarily address this issue.
We are sending copies of this report to appropriate congressional committees, the Department of the Treasury, and other interested parties. In addition, the report will be available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions regarding this report, please contact me at (202) 512-9110 or by email at mctiguej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix IV.

Sincerely yours,

James R. McTigue, Jr Director, Tax Issues Strategic Issues

Appendix I: Organization for Economic Co-operation and Development Action Items

Action 1 – Addressing the Tax Challenges of the Digital Economy

The Organisation for Economic Co-operation and Development (OECD) proposes rules and implementation mechanisms for cross-border business-to-consumer transactions in the digital economy to facilitate the efficient collection of value-added tax. The digital economy's features and business models such as e-commerce, online advertising, and online payment, exacerbate profiting shifting risk. OECD rules and mechanisms, based on the country where the consumer is located, are also intended to level the playing field between domestic and foreign suppliers. As the digital economy continues to develop, work on this issue will also continue and developments monitored. OCED expects a report on these efforts to be produced by 2020.

Action 2 – Neutralizing the Effects of Hybrid Mismatch Arrangements

OECD provides recommendations for designing domestic rules and treaty provisions to address hybrid mismatch arrangements—arrangements which exploit differences in tax treatment of entities or instruments between two or more tax jurisdictions to achieve little or no taxation. The rules and provisions are intended to increase the coherence of global corporate income taxation. For example, mismatches have resulted in multiple deductions for a single expense, deductions without corresponding taxation, and the generation of multiple foreign tax credits for a single amount of foreign tax paid. OECD also provides guidance on asset transfer transactions (such as stock-lending and repo transactions), imported hybrid mismatches, and the treatment of payment that is included as income under a controlled foreign company tax system.

Action 3 – Designing Effective Controlled Foreign Company Rules

OECD provides recommendations for controlled foreign company (CFC) rules, or rules that apply to foreign companies that are controlled by shareholders in a parent jurisdiction. The CFC rules are to prevent the shifting of profits from the parent entity into foreign companies, in particular shifting mobile income such as those from intellectual property (such as copyrights and patents), services, and digital transactions. Existing CFC rules have design features which do not effectively prevent base erosion and profit shifting (BEPS) and need to be revised to address changes in the international business environment.

Action 4 – Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

OECD developed best practices for designing rules to prevent the use of interest deductions to shift profits. Since money is mobile and fungible, favorable tax outcomes can be achieved by adjusting the amount of debt among entities of the multinational enterprise MNE. Moreover debt at the MNE's individual entity level can be multiplied through intra-group financing. Additionally, financial instruments, which are economically equivalent to interest but have different legal forms, can be used to avoid restrictions on the deductibility of interest. OECD analyzed several best practices and recommends an approach to address these risks. Technical work continues on specific areas of the recommended approach and is expected to be complete in 2016. Additional work on the transfer pricing aspect of financial transactions also continues during 2016 and 2017.

Action 5 – Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

OECD developed a methodology for assessing preferential regimes that provides preferential tax treatment to determine their risk for profit shifting and a framework for mandatory spontaneous exchange of information on rulings that could give rise to such concerns. Such rulings include those for preferential regimes, cross border unilateral advance pricing arrangements, and permanent establishments. Concern over harmful tax practices currently relates primarily to the risk of using preferential regimes to artificially shift profits and the lack of transparency on rulings. The information exchange commences from April 1, 2016 for future rulings. Exchanges for certain past rulings need to be completed by December 31, 2016. Both agreement with the methodology for assessing preferential regimes and the framework for compulsory spontaneous exchange of ruling is one of the four BEPS minimum standards.

Action 6 – Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

OECD provides new treaty anti-abuse provisions with safeguards to prevent treaty abuse, including treaty shopping strategies through which a taxpayer who is not a resident of a particular tax jurisdiction attempts to obtain benefits of a tax treaty concluded by that tax jurisdiction. However, the adoption of treaty anti-abuse provisions is not sufficient to address tax avoidance strategies that circumvent domestic tax law, and such abuse must be addressed through domestic anti-abuse rules. Accordingly

OECD also provides recommendations for designing domestic rules to prevent granting of treaty benefits inappropriately. Inclusion of anti-abuse provisions in tax treaties including a minimum standard to counter treaty shopping as well as flexibility for implementation is one of the four BEPS minimum standards agreed upon by countries adopting BEPS.

Action 7 – Preventing the Artificial Avoidance of Permanent Establishment Status

OECD provides recommendations for changes to the definition of permanent establishment in its Model Tax Convention—widely used as the basis for negotiating tax treaties—to address some commonly used tax avoidance strategies. As generally specified in tax treaties, a foreign enterprise’s business profits are taxable in a jurisdiction only to the extent that the foreign enterprise has a permanent establishment in that jurisdiction to which the profits are attributable. For example, one strategy used to avoid taxes replaces subsidiaries that traditionally acted as distributors with commissionaire arrangements where the entity would begin selling products in its own name (on behalf of the foreign enterprise). This arrangement would technically eliminate the foreign enterprise’s permanent establishment status without any substantive change to the functions the former subsidiary performed. Profits could, then, be shifted out of the jurisdiction where sales occurred.

Action 8-10 – Aligning Transfer Pricing Outcomes with Value Creation

OECD revised the existing transfer pricing rules used for tax purposes to determine the conditions, including price, for transactions between related entities within an MNE which result in the allocation of profits among the MNE entities in different countries. The misapplication of the transfer pricing rules can lead to profit allocations that are not aligned with where the economic activity that produced the profits occurred. OECD focuses on:

- transfer pricing issues relate to intangibles which are inherently mobile and hard-to-value;
- contractual allocation of risk and the resulting allocation of profits based on those risks;
- other high-risk areas such as transactions that are not commercially rational, profit diversion from the most economically important

activities for the MNE and the use of certain payments, like management fees, among related entities to erode the tax base.

Further work on the transfer pricing guidance will be undertaken related to profit splits and financial transactions. Additionally the guidance will be supplemented following OECD's work on the impact of BEPS on developing countries.

Action 11 – Measuring and Monitoring BEPS

OECD recommends improving access to and enhancing the analysis of existing data to measure and monitor BEPS, as well as evaluate the impact of actions taken to address BEPS. OECD points out that some useful information already collected by tax administrations is not analyzed or made available for analysis. Although currently available data across jurisdictions and MNEs are limited, the country-by-country information (required under action item 13) has the potential for significantly enhancing economic analysis of BEPS.

Action 12 – Mandatory Disclosure Rules

OECD provides a framework for designing mandatory disclosure rules to obtain early information on potentially aggressive or abuse transactions, arrangements, or structures and their users. With timely, comprehensive, and relevant information, tax authorities have the opportunity to respond quickly to tax risks through informed risk assessments, audits, or changes to legislation or regulations. For countries that already have mandatory disclosure rules, the framework can also be used to enhance the effectiveness of those rules.

Action 13 – Transfer Pricing Documentation and Country-by-Country Reporting

Taking into consideration the compliance cost for business, OECD developed a three-tiered standardized approach to its revised transfer pricing documentation to enhance transparency for tax administration. The country-by-country (CbC) report provides aggregated information such as the MNE's global allocation of income, taxes paid, and number of employees by each tax jurisdiction in which the MNE operates. A high-level overview of the MNE's global business operations and transfer pricing policies is reported in the master file. The local file provides detailed transactional transfer pricing documentation specific to the tax jurisdiction. Tax authorities can use information from these three documents to assess transfer pricing risks, determine most effective deployment of audit resources, as well as determine whether to initiate an audit. CbC reporting is one of the four BEPS minimum standards.

Action 14 – Making Dispute Resolution Mechanisms More Effective

OECD developed measures to strengthen the effectiveness and efficiency of the mutual agreement procedure (MAP)—a mechanism independent of the ordinary legal remedies available under domestic law, through which the competent authorities of the tax jurisdictions may resolve differences regarding the interpretation or application of the OECD Model Tax Convention on a mutually-agreed basis. Improving the dispute resolution mechanism should reduce uncertainty for MNEs as well as unintended double taxation. Commitment to the effective and timely resolution of disputes through MAP including the establishment of an effective monitoring mechanism to ensure its effective implementation is one of the four BEPS minimum standards.

Action 15 – Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

Based on its analysis of tax and public international law, OECD concludes that a multilateral instrument on tax treaty measures for BEPS is desirable and feasible. Given the number of bilateral treaties, conforming to BEPS changes by updating the current tax treaty network would be highly burdensome especially considering the substantial amount of time and resources required for most bilateral tax treaties. OECD began developing a multilateral instrument to streamline the implementation of the tax treaty-related BEPS measures in May 2015, and plans to open the instrument for signature by December 31, 2016. Participation in the development of the multilateral instrument is voluntary and open to all interested countries on an equal footing. Moreover participation does not entail a commitment to sign the resulting instrument.

Appendix II: The Organisation for Economic Co-operation and Development's (OECD) Proposed Revisions on Profit Splits Focus on Risk Which Present Difficulties

The practical challenges with using arm's length principle (ALP) have led to employing other methods to value the sale of goods and services within a multinational enterprise (MNE). ALP is difficult to use as a method for valuing market power, synergies, and other firm related benefits unique to related party transactions within an MNE. These challenges drive the demand for continued refinements to transfer pricing guidelines that rely on the ALP and for alternative methods when the ALP proves difficult.

As we have reported in the past, the arm's length principle works well to the extent that a market exists for the sale of the good in question or for a good that is comparable. As products become increasingly differentiated, finding a comparable product being sold in the market place becomes increasingly difficult.[1] The difficulty of finding comparables becomes even greater in the case of unique intangible assets, such as goodwill, trademarks, and production techniques. The relationship between unrelated parties is fundamentally different than that between related parties. For example, intangible assets that are licensed to independent parties are more at risk to lose value than if they are licensed to affiliates. Additionally, MNE's greater size and centralized control can result in greater efficiencies and thus greater cost savings than if the companies were separate. Thus, transfer prices in such cases will not be the same as the arm's length price used by independent companies. For these reasons, tax authorities and MNEs have difficulty applying the arm's length principle for these assets and MNEs.

One method used as an alternative to the arm's length approach is the profit split method. The profit split method can be used in the absence of comparable arm's length prices to allocate profits for certain transactions between two related parties by reference to the relative value of each party's contribution to the combined profit of the parties. The profit split method allows for greater flexibility by taking into account specific, possibly unique, facts and circumstances of the related parties that are not present with unrelated parties. However, the profit split method also can be used to allocate profits to lower tax jurisdictions. A division of profits based on easily measureable factors like the share of expenditures may not, in every case, reflect where value is created. Profit splits that are more complex and reflect a variety of contributing functions, such as research and development (R&D), advertising, use of another intangible

[1] GAO/GGD-92-89.

assets, and formulas may better measure the actual contribution to value of the different parties.

To illustrate how the profit split method can be used to shift profits from high tax to low tax jurisdictions, we return of the example of the Chockolet. As before, Chockolet has developed an intangible asset in terms of its trademarked brand "Chockolet" that allows the company to sell its product at a higher price than a generic. In this case, Chockolet does not have a comparable arm's length price for the trademark license that can be used to allocate profits. In the absence of such a price, Chockolet adopts the profit split method to allocate profits between the parent company and its distributing subsidiary. Under this method, the profits in excess of the normal mark-up (what a generic would get), which are the profits that reflect the value of the trademark, are split according to the relative contribution of the two parties.) In this simple example shown in table 2, relative contributions are measured as their share of total expenditures.

Table 2: Profit Split from the Transfer of an Intangible Asset (per case of chocolate bars)

	Chockolet Parent	Distributing sub	Total
Development and distribution costs	100	30	**130**
Share of Total Costs	77%	23%	**-**
Revenues Associated with a Generic Product (Cost Mark-up: 5%)	105	32	**137**
Revenues From Selling Chockolet Product (Cost Mark-up: 60%)	160	32	**192**
Chockolet Revenues Allocated by Share of Costs (Profit split according to relative contribution)	147	44	**-**
Net Profit (allocated revenues less costs)	47	14	**62**
Country Tax Rate	30%	15%	**-**
Tax Liability (net profit multiplied by the tax rate)	14	2	**16**
MNE group's effective tax rate	**-**	**-**	**27%**

Legend: - =not applicable, MNE=Multinational enterprise

Source: GAO analysis. | GAO-17-103

Note: Numbers may not add due to rounding

As table 2 illustrates, Chockolet's product receives a 60 percent (or $160) mark-up—higher than what a generic would earn. Its subsidiary earns a 5 percent mark-up of $32 on its expenditures, which are routine in nature.

In this case, the total profit in excess of the generic return is $55 ($192 - $137) and is split by multiplying it by each party's share of expenditures giving Chockolet $47 (its 77 percent share) and the subsidiary $14 (its 23 percent share). As tables 1 and 2 show, the profit split method results in a lower overall effective tax rate for the MNE group than the effective tax rate of 29.6 percent, which would be achieved by using a price based on the arm's length principle, were it available. This profit split method, which is based on relative expenditures by the two related parties, assigns too much profit to the distributing subsidiary. Because the subsidiary performs routine distribution functions that did not contribute to creating the intangible asset, the contributions of the distributing subsidiary should only earn a normal return. But, under this method, the subsidiary is allocated some of the profits that reflect the value of the intangible. More complex profit split methods could alleviate this misallocation, but would reduce the simplicity that is often a key attraction of profit split methods. For example, an adjustment to the expenditure method shown in table 2 that distinguished between the type of expenditures and whether those expenditures earn a normal return, or contribute to the value of the intangible asset may result in an arms' length pricing outcome, but would require being able to determine the types of expenditures that contribute to the value of the intangible.

OECD's final report issued in October 2015 did not provide guidance on the profit split method but instead provided a plan for future guidance. This plan raised concerns about whether the future revisions will ensure that the application of this method is not subjective or arbitrary. In July 2016, OECD issued a discussion draft for public comment to clarify and strengthen its guidance on the profit split method. The additional guidance includes, for example, the recognition that profit split methods may enable tax authorities and MNEs to better align creation of value with profits than relying on the ALP in situations where related parties both contribute intangible assets. Additionally, the draft provides guidance on potential limitations in the use of some common profit splitting factors. For example, cost-based profit splitting factors should be used when there is a strong correlation between expenses incurred and relative value contributed. The discussion draft also cautions that cost-based profit splitting factors can be sensitive to country variations such as price levels or wages, which could distort the relative contribution and final profit allocation.

In addition to providing more guidance for applying profit splits, the OECD final report and discussion draft introduced a new distinction between the types of profits to which a profit split method would apply. That new distinction is based on risk by recognizing two different types of profits that could be split—actual or anticipated profits. In a profit split of actual profits, the profits of the parties to the transaction are combined and the actual profits are split based on the relative contributions of each party. While the basis (i.e., formula or share) of the split of combined profits is established before profits are realized, the split is applied to actual, combined profits resulting from the transaction. Alternatively, the combined profits may be split based on the anticipated profits according to the contributions of each party. In the latter case, one party to the transaction receives a fixed payment for tax purposes based on its share of anticipated profits regardless of what actual profits are, while the other party receives whatever actual profit remains after the payment is made. The actual profit split method results in a greater sharing of the uncertain profit allocations than under a profit split of anticipated profits

To illustrate how these methods could be applied, we consider again the example of the Chockolet where, in this case, the expected mark-up over costs for Chockolet is 60 percent. Under a profit split based on anticipated profits, the expected Chockolet profits of $55 ($192-$137) would be split according to the relative shares of expenditures, resulting in a fixed payment of $44 (and a net profit of $14) to the distributing subsidiary. The Chockolet parent would be assigned the residual Chockolet profits from actual final sales of $117 ($162-$44) resulting in a net profit of $17. In this type of profit split, the distributing subsidiary is assigned a guaranteed payment while the transfer pricing outcome for Chockolet depends on actual outcomes of the business activities and risks. However, under a profit split based on actual profits in this example, the actual total profits from the producer and the subsidiary are combined and split according to the relevant share of expenditures between them. In this case, the transfer pricing outcome for the distributing subsidiary would also depend on factors influencing the final realized profits and could be assigned less profit, as in the case below where profits were less than expected.

Table 3: Change in Effective Tax Rates from Profit Split Based on Anticipated Profits and That Are Based on Actual Profits (per case of bars)

	Chockolet Parent	Distributing sub	MNE Group
Total Costs	100	30	130
Share of Total Costs	77%	23%	-
Revenues Associated with a Generic Product (Cost Mark-up: 5%)	105	32	137

	Chockolet Parent	Distributing sub	MNE Group
Expected Revenues from Selling Chockolet Product (Expected Cost Mark-up: 60%)	160	32	192
Anticipated Chockolet Revenues Allocated by Share of Costs to Subsidiary	-	44	-
Remaining Actual Chockolet Revenues Allocated to Parent (Actual Revenues minus the Subsidiary's Revenues)	117	-	-
Net Profit	17	14	32
Country tax rate	30%	15%	-
Tax liability (net profit multiplied by the tax rate)	5	2	7
MNE group's effective tax rate (anticipated profit split)	**-**	**-**	**23%**
Actual Chockolet Revenues Allocated by Share of Costs (Actual Cost Mark-up: 30%)	124	37	162
Net profit	24	7	32
Country tax rate	30%	15%	-
Tax liability (net profit multiplied by the tax rate)	7	1	8
MNE group's effective tax rate (actual profit split)	**-**	**-**	**27%**

Legend: - = not applicable, MNE=Multinational enterprise

Source: GAO analysis. | GAO-17-103.

Note: Numbers may not add due to rounding.

The choice of splitting actual or anticipated profits could be manipulated to shift profits to lower-tax jurisdictions. For example, if the Chockolet parent in table 3 suspected that profits might end up lower than the anticipated profits specified in a contract, a profit split based on anticipated profits would be preferable as a way to shift profits to its lower-taxed distributing subsidiary. This information asymmetry could happen when the parent corporation knows more about the likely profit outcomes than tax authorities. For example, the expected profits could be the result of a high probability of slightly lower profits combined with a low probability of very high profit. If the parent knows about the likely outcomes, while tax authorities only know the expected profit, the parent corporation would have an incentive to pursue the anticipated profit split as the appropriate method for allocating profits so that it will have a higher chance of shifting profits to a low-tax subsidiary.

The OECD discussion draft recommends that a profit split based on actual profits (one that "shares risk") require a higher level of integration of activities. OECD asserts that MNEs that are highly integrated share risk, and therefore a profit split method that facilitates the ability to allocate (or share) risk across parties is the more appropriate method. However, as discussed previously, related parties cannot be treated the same as unrelated parties. The more closely related the parties are, such as a parent and its wholly owned subsidiary, the less likely the parent is able to export or share risk. Thus, care should be taken in using risk as an implicit factor for splitting profits.

The United States does not differentiate between actual or anticipated profits as the OECD discussion draft has put forth. According to Department of Treasury regulations, profits splits must be based on two methods — (1) the comparable profit split or (2) the residual profit split.[2] The comparable profit splits allocates profits based on the division of profits of unrelated parties whose transactions and activities are similar to those of the related parties in question. The residual profit split allocates profit or loss from the relevant business activity following a two-step process. The first step allocates operating income to each party to provide a market return for its routine contributions. In the second step, any residual profit associated with intangible assets is divided among the parties based on the relative value of their contributions of intangible property that were not accounted for as a routine contribution. The value of these contributions may be determined by factors such as market benchmarks, capitalized values of R&D, or other expenditures.

Specialists have also expressed concerns that OECD's discussion draft may signal an additional reliance on profit split methods. They are concerned that if the guidance is not explicit on when a profit split method is appropriate, what factors should be used to allocate the profit, and how it can be applied, countries may increasingly rely on profit split methods as a way of moving away from arm's length pricing and toward adopting formula apportionment. Formula apportionment is a factor based tax system that would allocate an MNE's global profits based on the share of their business factors, such as sales, employment, or physical capital, located in a given country. Profit split methods can have features of formulary apportionment. The concern is that, to the extent that a country relies on profit split methods over arm's length pricing, the allocation of profits based on some kind of functional analysis becomes more routine, making the adoption of a tax system that effectively taxed MNE's profits

[2]26 C.F.R. §§ 1.482-6(c).

based on formulary apportionment more likely. While it is uncertain whether an increased use of profit split methods would lead to the adoption of a formulary apportionment tax system, adopting formulary apportionment in an uncoordinated fashion, as we have reported in the past, would increase the probability of double taxation.[3]

[3] GAO/GGD-92-89.

Appendix III: Comments from the Commissioner of Internal Revenue

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DEPUTY COMMISSIONER

January 9, 2017

Mr. James R. McTigue
Director, Tax Issues
Strategic Issues Team
U.S. Government Accountability Office
441 G Street N.W.
Washington, DC 20548

Dear Mr. McTigue:

Thank you for providing your draft report, *Information on the Potential Impact on IRS and U.S. Multinationals of Revised International Guidance on Transfer Pricing* (GAO-17-103), for our review and comments. We appreciate the time your GAO team spent reviewing the impact on U.S. transfer pricing guidance and administration resulting from revisions made by the Organization for Economic Co-Operation and Development (OECD) to its transfer pricing guidelines as part of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project.

The GAO's report properly highlights the importance of taking into account allocations of risk in transactions between entities within the same multinational group. The final reports under Actions 8-10 of the BEPS project contain a detailed discussion of risk. The IRS recognizes the importance of working with U.S. treaty partners to understand and follow this guidance in order to resolve transfer pricing disputes under U.S. tax treaties.

If you have any questions, please contact me or a member of your staff may contact, Sharon R. Porter, Director, Large Business and International Division, Treaty and Transfer Pricing Operations, at (502) 912-5236.

Sincerely,

John M. Dalrymple

John M. Dalrymple
Deputy Commissioner for
Services and Enforcement

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

James R. McTigue, Jr. (202) 512-9110 or mctiguej@gao.gov.

Staff Acknowledgments

In addition to the above named contact, Kevin Daly (Assistant Director), Ann Czapiewski, Bertha Dong, Edward Nannenhorn, Cynthia Saunders, Andrew J. Stephens, and Jennifer G. Stratton made key contributions to this report.

Appendix V: Accessible Data

Agency Comment Letter

Text of Appendix III: Comments from the Commissioner of Internal Revenue

Mr. James R. McTigue Director,

Tax Issues Strategic Issues Team

U.S. Government Accountability Office

441 G Street N.W.

Washington, DC 20548

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Sincerely,

John M. Dalrymple

Deputy Commissioner for Services and Enforcement

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