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Transfer Pricing

BEAT's Impact on Transfer Pricing Alternative Dispute Resolution

Mark Martin, Sean Foley, and Thomas Bettge of KPMG discuss the new base erosion and anti-abuse tax (BEAT), which focuses on cross-border related party payments, bringing groups with international operations and transfer pricing arrangements into its sights. The authors examine the options for groups bound by now-unfavorable advance pricing agreements (APAs) with the U.S. and for other taxpayers subject to tax treaties with mutual agreement procedure (MAP) articles.

By Mark Martin, Sean Foley, and Thomas Bettge

Introduction

U.S. tax reform has brought with it a number of provisions that promise to reshape not only the U.S. transfer pricing landscape, but also the alternative dispute resolution mechanisms that allow taxpayers to navigate that landscape and forestall controversy. At the same time as the new territorial based tax U.S. tax system removes many of the constraints of the former deferral system, new anti-base erosion measures require extreme care. In particular, tax code Section 59A's new base erosion and anti-abuse tax, commonly referred to as BEAT, will affect many multinational enterprises.

Although it is possible to speak of BEAT as affecting a taxpayer's deductions, mechanically it is closer to the U.K.'s diverted profits tax or the corporate alternative minimum tax, which was repealed as part of the U.S. tax reform. BEAT imposes a potential additional tax on taxpayers with a large share of base erosion payments, defined as deductible payments (and certain other payments that reduce a taxpayer's gross income or receipts) to related foreign parties, using a low 25 percent vote or value threshold to determine relatedness. Taxpayers belonging to controlled groups with fewer than $500 million in average gross receipts over the past three years or with a base erosion percentage of less than 3 percent avoid imposition of the tax. Certain related party payments, most prominently cost of goods sold and services that qualify for the services cost method under Treasury Regulation Section 1.482-9, are exempt from treatment as base erosion payments.

Because BEAT targets cross-border related party payments for adverse tax treatment, it has significant consequences for most groups with substantial international transfer pricing arrangements that include U.S. taxpayers. Troublingly, some groups that have entered into one or more APAs with the U.S. may find that they have in effect locked themselves into what has now become an unfavorable tax treatment. Those groups need to consider carefully, based on their particular circumstances, whether the advent of BEAT will allow them to obtain relief from the imposition of APAs. Other taxpayers with significant international operations are wondering whether invoking the mutual agreement procedure (MAP) article of an applicable tax treaty will cause the consulting competent authorities to refrain from applying BEAT.

Addressing the Impact of BEAT on APAs in Force

APAs may be unilateral, bilateral, or multilateral. While unilateral APAs are negotiated between a taxpayer and the Internal Revenue Service, bilateral and multilateral APAs are negotiated between multiple competent authorities and agreed to by the taxpayer. Revenue Procedure 2015-41 (the Revenue Procedure) governs the negotiation and administration of APAs. The APA program, which began in 1991 and is administered by the Advance Pricing and Mutual Agreement Program (APMA), has seen over 2,000 applications filed and 1597 APAs executed, with 98 filed and 86 executed in 2016, the most recent year for which APA data is available, according to Announcement 2017-03. In contrast, only 11 APAs have been revoked or canceled—and only 224 applications have been withdrawn—since the inception of the program, with none revoked or canceled in 2016. Pursuant to the Revenue Procedure, the IRS revokes APAs only for wrongdoing, disregard, or lack of good faith compliance on the part of the taxpayer, and revocations are retroactive to the first day of the first year covered by the APA. Cancellations, on the other hand, may occur either because of taxpayer wrongdoing or because of the failure of a critical assumption or a material change in law. When a change in law results in a cancellation, the cancellation will ordinarily be effective as of the beginning of the year the change in law entered into force. Similarly, when cancellation is due to the failure of a critical assumption, the cancellation is effective as of the beginning of the year during which the critical assumption was not satisfied.

The scarcity of cancellations suggests that taxpayers that have entered into APAs have historically seen the certainty associated with them as significantly more desirable than a return to the normal regime of transfer pricing enforcement by exam. While critical assumptions will sometimes cease to be satisfied, the low figure for cancellations suggests that taxpayers and the IRS have seen value in revising APAs to account for changed circumstances, as permitted by the Revenue Procedure, rather than electing cancellation. However, the low number of cancellations may in part also be ascribable to the difficulty of showing that a critical assumption has not been met, or that a change in law is material with respect to the APA.

The Revenue Procedure provides that, ''[i]f controlling U.S. case law, statutes, regulations, or treaties change the federal income tax treatment of any matter covered by the APA, the new case law, statute, regulation, or treaty provision supersedes any inconsistent terms and conditions of the APA.'' BEAT's impact on the treatment initially contemplated by completed and proposed APAs may significantly alter the cost-benefit analysis involved. Faced with an additional U.S. tax targeted at related party payments that disturbs the calculus on which APAs rest, many taxpayers may now be considering how to get out of—or at least modify—an APA rather than how to preserve it.

Revising an APA could alter the applicability of BEAT to the transactions involved. Although making determinations as to whether payments are base erosion payments subject to BEAT likely falls outside the scope of APMA's authority as provided under the Revenue Procedure, it is well within APMA's competence to determine the characterization of payments, e.g., as cost of goods sold or as services eligible for the services cost method, in negotiating an APA. If APMA is unwilling to revise, canceling an APA would allow the taxpayer to assert its own characterization of relevant transactions without the strictures of the previously agreed upon APA treatment.

The procedure for revising an APA is not complicated. In the authors' experience, an amendment to an APA can be relatively quick compared with the negotiation of the APA itself, e.g., a matter of months as compared with 18 months to two years. However, this time frame might be extended if the BEAT-related amendment requires a substantial revision of the transfer pricing methodology.

The Revenue Procedure provides the common sense rule that ''[a]n APA may be revised by agreement of the parties.'' For bilateral or multilateral APAs, this would require the consent of the other competent authorities as well as the IRS and the taxpayer. In some circumstances in which the other tax authority does not consent to a revision, the IRS may agree to revise or cancel a bilateral APA for domestic purposes only. Thus proposing a revision is always an option for taxpayers whose APA arrangements are adversely affected by BEAT. Of course, the IRS will ordinarily have no incentive to agree to revisions designed to reduce U.S. tax liability, meaning that most interested taxpayers would need to force cancellation or revision by showing that BEAT effected a material change in the governing law or that a critical assumption has not been met.

While the Revenue Procedure specifies that a ''material change'' in governing law will result in cancellation unless the parties can agree on appropriate revisions, it does not define material change. It is evident, however, that the materiality requirement does not refer to the scope of the change to U.S. tax law in a vacuum. Rather, it means materiality with respect to the APA, paralleling other grounds for cancellation, ''mistake with respect to a material fact'' and ''failure to state a material fact.''

Because the materiality standard is APA-dependent, it is clear that whether the imposition of BEAT provides grounds for cancellation is a determination that must be made on the basis of the facts of the APA. The IRS may argue that BEAT cannot constitute a material change because it effectively operates as a change in the effective tax rate, which ordinarily is not the subject of APA negotiations. On the other hand, taxpayers will point to BEAT's practical consequence of denying what would otherwise have been allowable deductions for related party payments. The success of both arguments must ultimately depend on the materiality of the impact on the particular APA, and whether APMA will agree that this impact affects the APA's underlying framework.

While identifying a material change in law may pose a challenge, the critical assumptions are explicitly laid out in the APA. The Revenue Procedure defines ''critical assumption'' as a ''fact whose continued existence is identified in an APA as being material to the reliability of the APA's covered methods; such fact may be related to the taxpayer, a third party, an industry, or business and economic conditions.'' Critical assumptions will vary depending on the taxpayer and the method employed, but should generally state that the taxpayer's relevant activities, functions, and risks with respect to the transactions covered by the APA remain materially the same.

It is expected that many taxpayers will restructure their business operations during coming years, either to reduce or avoid BEAT liability or on account of other aspects of U.S. tax reform or the Organization for Economic Cooperation and Development's base erosion and profit shifting initiative. When a restructuring causes a significant change in the parties' respective risks and functions, one or more critical assumptions of an APA may fail to be met, triggering revision or cancellation of the APA. However, to be respected, it is imperative that the restructuring have an appropriate business purpose. In addition to existing anti-abuse authority that would allow the IRS to ignore a putative restructuring designed to avoid negative APA treatment, Section 59A(i)(1) provides a grant of specific authority to create regulations that ''provid[e] for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section.'' For taxpayers looking to escape adverse treatment under an APA, a restructuring with a bona fide business purpose may prove more viable than arguing over whether BEAT was a material change in governing law.

Possibilities for Avoiding BEAT in MAP Proceedings

Another unresolved issue is whether BEAT violates U.S. income tax treaties, and if so, whether MAP proceedings can be used to avoid its application. Article 25 of the U.S. Model Income Tax Convention (Model Convention) provides that, if a taxpayer believes that one or both of the contracting states is taxing it contrary to the terms of the convention, the taxpayer may invoke the MAP by calling upon either competent authority. The competent authorities will then, if necessary, attempt to resolve the issue by mutual agreement. When the competent authorities cannot reach an agreement, arbitration may be available. MAP provisions are included in all U.S. income tax treaties except the treaty with Bermuda.

Whether BEAT is inconsistent with tax treaties is unclear. There is a plausible argument that it may run afoul of non-discrimination provisions. Article 24, paragraph 4 of the Model Convention provides that ''interest, royalties, and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned Contracting State.'' All U.S. income tax treaties contain some form of non-discrimination article.

BEAT targets payments specifically because of the recipient's foreignness. If BEAT is conceived of as a provision that effectively disallows or otherwise modifies deductions, it would appear that it violates U.S. treaties: Payments to related foreign parties would not be ''deductible under the same conditions'' as payments to domestic payees, because the deductions with respect to the former would be partially or wholly clawed back by BEAT. On the other hand, the competent authority may contend that BEAT only affects the applicable tax rate. If this is the case, it has no effect on the deductibility of the payments as such, and thus should not violate non-discrimination provisions. It is not yet clear which characterization of BEAT will prevail.

Even if there is an inconsistency, invoking MAP may not supply the desired outcome. Ordinarily, the U.S. competent authority has latitude to move away from U.S. law in order to reach a reasonable settlement of the issues in a MAP proceeding. However, under U.S. law, statutes and treaties have equal status, and conflicts between them are resolved by applying the one that was enacted or entered into later in time. Whether there is a conflict depends on whether BEAT was intended to override U.S. tax treaties, which remains to be determined. If the Treasury Department determines that Congress intended BEAT to override treaties, then the competent authority will be much more constrained and may not be able to reach a settlement that ignores BEAT.

Substantial uncertainty remains surrounding how BEAT issues will play out in MAP proceedings. While tax treaties give those attempting to avoid BEAT liability some valuable arguments, ultimately, taxpayers cannot count on treaties to make BEAT vanish.