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IRS issues final regs on BEPS country-by-country reporting

The IRS issued final regulations (TD 9773) on June 29 that will require U.S. multinationals with more than $850 million in revenue to report specific information on a country-by-country basis for the first time.

The regulations were drafted to comply with new country-by-country reporting (CbCR) standards created by the base erosion and profit shifting (BEPS) project of the Organisation for Economic Co-operation and Development (OECD).

The new reporting will be performed on Form 8975, *Country-by-Country Report,* and applies to "multination enterprise groups" with a U.S. parent (U.S. MNEs) that have annual revenue for the preceding annual accounting period of 850 million USD or more. Form 8975 will require, on a jurisdictional basis, information on a U.S. MNE group's revenues, taxes paid, number of employees, functions performed and certain other indicators of profit allocation within the group.

The final regs largely adopt the proposed regulations (REG-109822-15), but with important changes to address a number of technical issues and clarify the rules. Many of these changes to the proposed regulations were also made to be consistent with OECD minimum standards. The final regs are generally effective starting with the tax year of the MNE's ultimate U.S. parent that begins on or after June 30, 2016. Treasury is working on a voluntary reporting option for tax years beginning prior to June 30, 2016, and on or after Jan. 1, 2016, but such procedures will be provided in forthcoming guidance.

CbCR at a glance

The reporting is required of the ultimate parent entity (UPE) of a U.S. MNE meeting the $850 million threshold. A UPE is defined as a U.S. business entity that meets both of the following conditions:

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- Owns directly or indirectly a sufficient interest in one or more non-U.S. business entities such that it is required to consolidate the accounts of the other business entities with its own accounts under U.S. GAAP
- Is not owned directly or indirectly by another business entity that consolidates the accounts of the U.S. business entity with its own accounts under U.S. GAAP.

The above rules also apply if the U.S. business entity would be required to consolidate the accounts, or its accounts would be consolidated, if equity interests in the U.S. business entity were publicly traded on a U.S. securities exchange.

A "U.S. business entity" is defined as a business entity that is organized or has its tax jurisdiction of residence in the United States. The term "business entity" is broadly defined and includes partnerships, permanent establishments and disregarded entities (DREs).

If a UPE of a U.S. MNE is required to comply with CbCR, it must file Form 8975 by the extended due date of its U.S. federal income tax return. Although a draft of Form 8975 has not been released, it is expected to be largely based on the template provided in the preamble to the proposed regs, which was developed by the OECD. Accordingly, Form 8975 will likely have three sections including the following:

- Constituent entity information
- Financial and employee information aggregated by tax jurisdiction
- A space to provide additional information

Final regs

The final regs amend the proposed regs to address a number of technical issues and associated divergence from the BEPS standards. Some of the most important changes are discussed below.

U.S. territories and fiscal autonomy

The proposed regs defined "tax jurisdiction" as a country or a jurisdiction that is not a country but that has "fiscal autonomy." Several commentators pointed out that the term "fiscal autonomy" was ambiguous and requested it be further defined. Treasury declined to define the term without "international consensus," in an effort to prevent a departure from the BEPS standards. However, the final regs clarify that a U.S. territory or possession of the United States--defined as American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands--is considered to have fiscal autonomy for purposes of CbCR.

Surrogate parent entity filings

The preamble to the final regs states that the IRS will not permit surrogate parent entity filing in the United States by foreign corporations because of resource constraints.

However, the final regs say that a U.S. territory UPE may designate a U.S. business entity that it controls to file Form 8975 on behalf of the U.S. territory UPE.

Business entities

The final regs modify the term "business entity" in several key ways. Generally, the modifications were made to provide greater clarity and consistency with the intended meaning of the final BEPS report.

The first modification is to the reference to a permanent establishment in the definition of business entity. The final regs provide that the term "permanent establishment" includes any of the following:

- A branch or business establishment of a constituent entity in a tax jurisdiction that is treated as a permanent establishment under an income tax convention to which that tax jurisdiction is a party
- A branch or business establishment of a constituent entity that is liable to tax in the tax jurisdiction in which the branch or business establishment is located pursuant to the domestic law of such tax jurisdiction
- A branch or business establishment of a constituent entity that is treated in the same manner for tax purposes as an entity separate from its owner by the owner's tax jurisdiction of residence

This approach is intended to prevent a U.S. MNE group that has already determined under applicable law whether it has a permanent establishment or a taxable business presence in a particular jurisdiction from needing to make another determination under the OECD Model Tax Convention solely for purposes of completing Form 8975.

The term "business entity" was also modified to exclude decedents' estates, individuals' bankruptcy estates and grantor trusts within the meaning of Section 671, the owners of which are individuals. This change was made due to the close connection to individual grantors, decedents, and individual debtors, all of which would not be business entities under the final regs, and thus not subject to the rules themselves.

Finally, the final regs expressly provide that foreign insurance companies that elect to be treated as domestic corporations under Section 953(d) are U.S. business entities that have their tax jurisdiction of residence in the United States.

The final regs do not redefine constituent entity in the proposed regs, reaffirming that reporting isn't required for foreign corporations or foreign partnerships for which the ultimate parent entity isn't required to furnish information under Section 6038(a) (i.e., Form 5471 or Form 8865).

Stateless Income

The proposed regs were unclear regarding whether a country with a purely territorial tax regime--for example, Hong Kong--could be a tax jurisdiction of residence. Such ambiguity

left uncertainty over whether the rules should be interpreted to treat all entities in tax jurisdictions with territorial tax regimes as stateless entities. Treasury stated in the preamble to the final regs that the language in question was intended to indicate that a business entity will not have a tax jurisdiction of residence in a jurisdiction solely by being liable to tax in the jurisdiction on fixed, determinable, annual or periodical income from sources or capital situated in the jurisdiction. Accordingly, the final regs were updated to unambiguously include purely territorial tax regimes as tax jurisdictions of residences.

Effective date and gap year

The final Regs generally apply beginning with the UPE tax year that begins on or after June 30, 2016. Consistent with the proposed regs, the final regs do not apply for taxable years before June 30, 2016. Accordingly, calendar year taxpayers are not required to comply until the 2017 calendar tax year.

This raised concerns for many taxpayers, because the OECD set standards recommending that jurisdictions implement requirements starting in 2016, and for most taxpayers the final regs would not be effective until 2017. Because legislation in many of these jurisdictions includes secondary mechanisms that require local reporting if the parent entity's jurisdiction doesn't require country-by-country reporting, this created what's been referred to as the "gap year." Without a voluntary submission alternative, many U.S. multinationals would be forced to comply with country-by-country requirements at various local levels during this so-called gap year.

The final regs did not provide the "gap year" relief many taxpayers had hoped for, but the IRS stated in the preamble that it intends to allow U.S. MNEs to voluntarily file Form 8975 for reporting periods that begin on or after Jan. 1, 2016, but before the applicability date of the final regs. The preamble to the final regs states that Treasury is working to ensure that foreign jurisdictions implementing CbCR requirements won't require foreign subsidiaries of U.S. MNEs to comply with foreign jurisdictions' secondary mechanisms if the U.S. MNE voluntary files Form 8975 with the IRS. The final regs note that the procedures for this voluntary filing are to be provided in separate, forthcoming guidance.

Next steps

The final regs include much-needed clarifications, but omit many anticipated changes, including national security exemptions, voluntary early filing options and modifications for variable interest entities. Taxpayers should carefully review the final regs and consider whether they will be subject to the CbCR requirements. Failure to comply could result in civil and criminal penalties and an extended statute of limitation period for the income tax return filed by the UPE and for all related returns. In addition to the U.S. consequences, failure to comply could result in various reporting requirements under secondary mechanisms enforced by foreign jurisdictions that may also carry penalties and other consequences.

Complying with the final regs may be a significant burden. Preparation could include changes or upgrades to ERP systems, identifying data sources, capturing data by permanent establishments as well as legal entity and analysis to determine entities included in the U.S. MNE group and respective jurisdictions in which such entities are subject to income tax. Overlaying the complexities of stateless income, partnership aggregation and other requirements under the final regs could prove to be a daunting task for many U.S. MNEs.

Complying with CbCR may also spotlight other pre-existing issues. The reporting could expose inadequate transfer pricing policies. On the other hand, collecting this data may greatly expand a U.S. MNE's ability to perform analytics, reduce risk and drive value from within the tax function.

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