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Managing Multilateral Controversy

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Multilateral tax issues are on the rise, and not just in headline-grabbing Base Erosion and Profit Shifting (BEPS) 2.0 developments. Changes in how businesses and tax authorities operate have led to an increased reliance on, and scrutiny of, operating models in which ostensibly bilateral transactions in fact implicate more than two jurisdictions. Such operating models are common, although the issues they raise are not always framed as multilateral issues by tax authorities. This article lays out a number of common scenarios and describes the strategies and best practices we have found successful in approaching tax controversies with multilateral dimensions. Multilateral controversies will increase significantly in the coming years, and it will be important for taxpayers to understand how to effectively engage with these issues.

I. INCREASING CONTROVERSY

Innovations from the initial BEPS project have fueled controversy in recent years. Country-by-country reports have been used as the basis for transfer pricing adjustments, notwithstanding the clear direction of BEPS Action 13 that these reports should only be used for risk assessment.[1] Guidance on the relevance of functions related to the development, enhancement, maintenance, protection, and exploitation of intangible property — better known by the acronym DEMPE — has led to disputes based on the location and movement of key employees, an issue which the Covid-19 pandemic threatens to exacerbate.

Recent developments are poised to build upon the growth from the BEPS project. The Biden Administration has proposed significantly increasing the IRS's enforcement budget, eliminating longstanding resource constraints that have forced IRS audit activity to record lows in many areas. The Trump Administration already increased the IRS budgets for fiscal years 2020 and 2021, and the Biden proposal would go much further, providing the IRS an additional $79 billion for enforcement activities over the next decade. The General Explanations of the Administrations Fiscal Year 2022 Revenue Proposals, commonly referred to as the Green Book, estimates the revenue associated with this additional funding at almost $266 billion over fiscal years 2022 through 2031.

The United States is not alone in cracking down on enforcement. In Mexico, the ever-changing legal land-

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[1] Paul Glunt, Sean Foley, John DerOhanesian, and Josh McConkey, "The Misalignment of CbC Reporting and Value in Modern Business," 171 Tax Notes Federal 1183 (May 24, 2021).

scape has raised new tax challenges. Mexican President Andrés Manuel López Obrador recently publicly touted large tax settlements with multinational companies,[2] suggesting the perceived noncompliance by multinational taxpayers is a key political issue. In Saudi Arabia, where there was historically little or no transfer pricing enforcement, we are now directly aware of several examinations.

Even Her Majesty's Revenue and Customs (HRMC) in the UK, traditionally regarded as a tax authority that was willing to accept principled taxpayer-favorable resolutions, has become more aggressive. As of November 2020, the diverted profits tax (DPT), which applies a heightened 25% rate to profits that are regarded as having been artificially diverted from the United Kingdom, have netted over £6 billion by HMRC's estimate.[3] Supplementing the DPT is HMRC's profit diversion compliance facility (PDCF), a program which allows companies with potential compliance issues to reach a settlement with HMRC. The PDCF has been implemented via a campaign of "nudge letters," which offer targeted taxpayers the choice between participating in the PDCF or facing an audit.

Other HMRC developments may also spell trouble for taxpayers. A recent consultation has been launched to consider bolstering the U.K. transfer pricing documentation rules, potentially increasing the compliance burden on taxpayers. More problematic is evidence that, in some cases, HMRC is seeking to characterize transfer pricing issues as domestic law issues in order to render them ineligible for competent authority resolution, thereby subjecting taxpayers to unnecessary double tax. These developments speak to a rigidity and an aggressiveness that was not there historically.

II. MULTILATERAL DEVELOPMENTS

The rise in multilateral controversies has been driven in large part by increasing complexity in businesses' value chains. While global operating models have been common for decades, few companies today rely on a simple hub and spoke structure in which each foreign affiliate transacts directly with a central headquarters entity. Multiple principal structures have become common, and even in structures with a single principal, transactions that implicate the interests of several entities and jurisdictions are commonplace.

At the same time, the mutual agreement procedure (MAP) and advance pricing agreements (APAs) under bilateral tax treaties are increasingly available to address controversies. Foreign counterparties, especially those with regional principal or cost sharing participants, are generally located in jurisdictions, like Ireland and Switzerland, that have tax treaties with the United States and other key developed economies. MAP itself has become more viable as a dispute resolution tool, as peer reviews and statistical reporting under BEPS Action 14 push tax authorities around the world to take their treaty obligations seriously.[4]

Yet the historical paradigm of unilateral (i.e., domestic) or bilateral (i.e., treaty-based) dispute resolution is ill equipped to deal with the rising number of controversies that implicate more than two jurisdictions, and approaching these controversies through that paradigm creates double tax risk.

This year saw the launch of the OECD's International Compliance Assurance Programme (ICAP) as a permanent program after two rounds of pilots. Although not a dispute resolution process per se, ICAP provides a voluntary multilateral forum in which multiple tax authorities come together to review and evaluate a participant's tax positions, particularly with respect to transfer pricing and permanent establishment issues. ICAP does not provide certainty as such, but it does provide multinational enterprises with valuable comfort for the issues that have been reviewed and addressed.

The OECD's October 2020 blueprint on Pillar One of the BEPS 2.0 project laid out an intriguing proposal for multilateral dispute prevention, which would involve a consensus-based review process backstopped by a quasi-arbitral determination panel.[5]

The July 2021 Inclusive Framework statement outlining agreement on Pillars One and Two provided that mandatory binding dispute prevention and resolution would be available for Amount A and related disputes, but did not provide technical details. Although it remains unclear whether a final BEPS 2.0 solution will be implemented and, if so, how dispute prevention and resolution will be addressed, it is clear that there is strong political will, at least among some countries, to move to a multilateral resolution paradigm. Even if Pillar One is not ultimately successful, the blueprint's dispute prevention proposal may prove influential going forward.

Yet one need not wait for a multilateral framework to be agreed and implemented to effectively address controversies that implicate more than two jurisdic-

[2] William Hoke, "Mexican President Says IBM Settled Tax Dispute for $30.6 Million," 2020 TNTI 108-7 (Oct. 23, 2020).

[3] Ryan Finley, "Diverted Profits Tax Has Raised £6 Billion Since 2015, HMRC Says," 100 Tax Notes Int'l 1093 (Nov. 23, 2020).

[4] *See* Mark Martin, Sharon Katz-Pearlman, Sean Foley, and Thomas Bettge, "MAP: Past, Present, and Future," 171 Tax Notes Federal 219 (Apr. 12, 2021).

[5] For additional details, see Mark Martin and Thomas Bettge, "Off the MAP: Dispute Resolution in the BEPS 2.0 Blueprints," 170 Tax Notes Federal 259 (Jan. 11, 2021).

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tions. Below, we summarize a number of common multilateral fact patterns, and share lessons learned from our experience handling such controversies.

III. MULTILATERAL CONTROVERSY: COMMENTS AND BEST PRACTICES

The common thread woven throughout many of the most complex fact patterns is the need for multilateral engagement by the tax authorities. Unfortunately, outside of a few contexts and jurisdictions, the procedures and history of multilateral controversies is fraught with uncertainty, confusion, inefficiency, and even bad outcomes. We have set forth below some best practices which, in our experience, will reduce the likelihood for a bad experience.

While fact patterns raise different concerns and issues, and some of these specific examples are discussed in more detail below, there are some general best practices which cut across most situations. At the very least, understanding the potential pitfalls should reduce some of the uncertainty on what lies ahead. One important note — this area is moving fast, both generally and due to BEPS 2.0 dispute resolution on the horizon, so the experiences and recommendations set forth below may change rapidly in the years ahead.

a. Is There Typically a 'Multilateral' Option?

The short answer is ''Maybe.'' Although many tax authorities are trying to change this, and true multilateral procedures do certainly occur, for the most part tax treaties and associated procedures are set up to accommodate bilateral or unilateral cases. For example, in most countries, there is no formal multilateral Advance Pricing Agreement (APA) or MAP process. For example, the current U.S. revenue procedures governing APAs and MAP cases are generally set up for bilateral matters, as well as unilateral APAs.

As a practical matter, ''multilateral'' APAs and MAP cases are often operated by the tax authorities as merely a web of two, three, or more bilateral cases which the tax authorities attempt to coordinate.

The lack of clear procedures is complicated by the use of intermediary countries, either for tax planning reasons or for business reasons, which may have no direct treaty relationships with all the countries implicated in the multilateral controversy, or with any of them. Sometimes this may include low-tax jurisdictions.

What is a company to do when faced with these headwinds? There are various techniques that have been proven to achieve the objectives of taxpayers, which we will summarize here, followed by comments on particular fact patterns.

b. Multiple Bilateral Approach

As noted above, many ''multilateral'' cases are in fact as a practical matter a series of bilaterals where the tax authorities assist the taxpayer in coordinating the positions and resolutions with the aim of achieving no or minimal double taxation. Historically, one of the best ways to address a multilateral controversy is through one or more bilateral cases. For example, one vital strategy to address ongoing controversies is the use of APAs with rollback. One advantage of APAs with rollback is the ability to address many years (both prospective and past) at a time, making them an efficient way to address all years which the controversy touches. In the multilateral context, one main advantage of APAs is the possibility to use critical assumptions to address the profit allocated to a third country.

Similarly, in a MAP case, the two parties to the case must deal with the profitability allocated to one or more third-country entities. While the critical assumption concept is not present in MAP cases, the objective is the same: to have the tax authorities who are actually at the table reach an agreement with respect to the profitability of the entities in their jurisdiction, as well as the profitability of the entity in the third country.

For both APAs and MAP cases, the ability to coordinate the multiple bilateral cases and ensure consistency and avoid double taxation is an art rather than a science, but taxpayers should expect that two coordinated cases will be more expensive, time consuming, and take longer to ultimately resolve than two standalone cases.

c. Informal Competent Authority

If a multilateral issue arises, but adding one or more bilateral APAs or MAP cases is either too expensive, not feasible, or not even possible due to lack of effective treaty access, another strategy can be employed — a single bilateral APA or MAP case with informal involvement of the ''other'' country.

That is, the taxpayer's advisors can coordinate with the third country tax authority closely regarding the progress of the case, and hopefully ensure that the resolution in the MAP case does not result in double taxation. This involvement is often a best practice in any case involving a third country where there is a sophisticated tax authority and treaty relationships with the other parties.

The key here is that the tax authority not directly implicated in the case should be involved ''early and often.'' The more frequent the involvement of the other tax authority, and the more information that can be provided, the better. This is often antithetical to the desires of the taxpayer, which may wish to avoid the

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complexity of getting another tax authority involved and potentially ''messing up'' the case. If there are tax attributes that can absorb the impact of an adjustment, or due to tax efficient structuring there is not much risk of double taxation, then this view may be justified. In contrast, double taxation is such a disastrous outcome that if it is a potential result then the involvement of another tax authority and a certain level of disclosure to them is often a risk worth taking.

One note here is the role of unilateral APAs and unilateral Competent Authority relief. While unilateral APAs are typically frowned upon, and unilateral Competent Authority relief is still relatively unusual outside of a few fact patterns, they are also approaches which are often key to dealing with multilateral controversy, as discussed in more detail below.

d. Specific Best Practice Recommendations

While the principles above should be followed as best practices, they can be distilled into a number of discrete recommendations:

- Communication and coordination:
  - Taxpayers should engage early and often (including any informal tax authority involvement).
  - Taxpayers should proactively coordinate all related proceedings to ensure consistency and avoid misunderstandings. In appropriate cases, this can include joint meetings and joint fact-finding in which all relevant tax authorities participate.
  - Regardless, best practice is for taxpayers to ensure that all tax authorities have the same information and all the critical information necessary to resolve the case.
- Forward-looking engagement at the examination level:
  - While taxpayers will of course be invested in defending their positions and achieving the best possible result from an examination, it is also important to look forward to the next stage of a dispute.
  - It is rarely too early to engage in high-level thinking about available procedural options, including consulting with outside advisors.
  - Informal discussions at the examination level regarding the implications of a potential adjustment should begin when there is a significant possibility of an adjustment.
  - When it is clear that a material adjustment with multilateral implications will be issued by a tax authority, the taxpayer should engage with the exam team to determine the allocation of the adjustment among all affected counterparties. For example, the IRS is tasked with issuing pattern letters that identify any treaty countries affected by an adjustment and allocate the adjustment among countries. However, the IRS sometimes does not send these letters without a taxpayer request.

In addition, there are a number of general best practices that are particularly salient in multilateral contexts:

- Early action to avoid procedural issues:
  - While many treaties specify presentation timeframes (e.g., three years from first notification of the adjustment) during which a MAP case must be brought, some treaties, such as the U.S. treaties with Canada and Mexico (among others), impose notification deadlines. Failure to comply with these notification requirements can foreclose effective MAP relief.
  - Unlike presentation timeframes, these notification timeframes generally run from the tax year (or tax return filing date) at issue. As a result, long and contentious examinations may result in the issuance of an adjustment after the deadline has expired. For this reason, best practice is to provide the required notification as soon as it appears that an adjustment may result from an examination.
  - Not all treaties provide that MAP outcomes can be implemented notwithstanding domestic limitations (such as statutes of limitations for the payment of refunds). Where appropriate, it is important to follow domestic procedures (such as the filing of a protective claim in the United States) to keep refund statutes open.
  - Taxpayers do not always consider the secondary adjustments that result from a resolution, which can have significant consequences. Early modeling is recommended to understand the tax consequences of secondary adjustments, and how best to structure those adjustments while taking into account the rules of all relevant jurisdictions.

IV. EXAMPLES OF COMMON MULTILATERAL CONTROVERSIES

The following discussion outlines a number of common situations where multilateral tax issues tend to occur.

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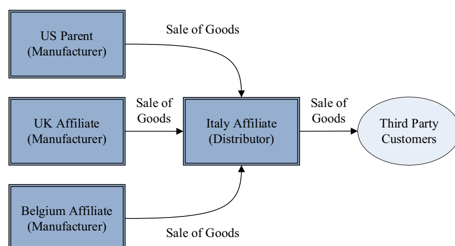
a. Multiple Principal Structures

Multinational enterprises with multiple principal structures span all industries and are designed to bring efficiencies to the exploitation of intellectual property (IP), capital, or other value drivers. These structures take different forms depending on the industry, the value driver, and the requirements of the market jurisdictions, which will affect the roles of the principals.

For example, financial services entities with global trading operations often have dual booking locations, often the United States and the United Kingdom. Traders in remote locations, for example in Japan or Australia, will book client trades in either booking location depending on the client agreements. The booking location may move the initial trade to the other location in a back to back arrangement depending on how market risk is managed, though dual locations may be maintained for certain books. Additionally, credit risk may be segregated from the market risk and be consolidated in a location that is not the booking location. Financial institutions often use a profit split to address the multi-jurisdictional value drivers and have used multilateral advance pricing agreements to ensure that the tax authorities across the jurisdictions are in agreement with the allocations. However, multilateral APAs are less common outside of global trading.

Transfer pricing adjustments made by a tax authority to a subsidiary that purchases goods from multiple principals would have a direct impact on the remuneration from other affiliates. One common example of this situation involves companies that have numerous manufacturing and distribution entities in different countries. For example, US Parent is involved in the manufacture and sale of electronic goods. The group's products are manufactured by entities throughout the world that own the IP for their products, and are sold to local affiliates that in turn distribute to third-party customers in their markets. In the example below, US Parent, UK Affiliate, and Belgium Affiliate all manufacture products which are then sold to Italy Affiliate for distribution to third-party customers.

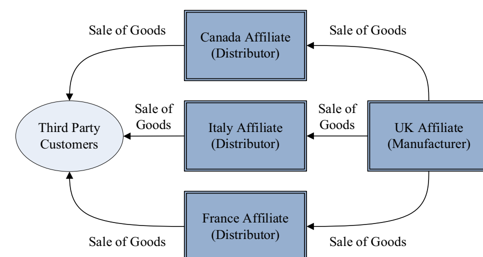
Figure 1: Multiple Principal Structure Scenario 1



Now, if the Italian tax authority were to make a transfer pricing adjustment increasing the profit margin of Italy Affiliate, this would necessarily imply an adjustment to the intercompany price paid by Italy Affiliate for some or all of the products purchased by Italy Affiliate from the related manufacturers. In reality, tax authorities often focus on the profitability of the local affiliate and do not bother to consider whether any particular product is mispriced, which can make it challenging to determine how much of the adjustment relates to each of the affiliated manufacturers. Although it would be necessary to address this allocation point, the adjustment would give rise to double taxation, and the competent authorities of the United States, United Kingdom, and Belgium would have a vested interest in determining the proper intercompany price, thus leading to the need for a multilateral solution.

The same issue may arise from a manufacturer's standpoint. In an alternative scenario, UK Affiliate sells its manufactured products to Italy Affiliate, France Affiliate, and Canada Affiliate, which each distribute the products to third parties in their respective local markets.

Figure 2: Multiple Principal Structure Scenario 2



If the U.K. tax authority were to propose an adjustment increasing the intercompany price on the grounds that the UK Affiliate is being undercompensated for its manufacturing activities, the competent authorities of Canada, Italy, and France would each have a vested interest in determining the proper intercompany price. An additional issue arising from this situation is that each of the distributors is selling products to end users in different markets, and thus at different prices, which may have a direct impact on the intercompany price. The Canadian competent authority, for example, would not want Canada Affiliate paying a higher price for the same products as Italy Affiliate or France Affiliate, and would therefore benefit from a multilateral solution.

Comments and Thoughts

As noted above, either a formal multilateral with all parties at the table, or a series of coordinated bilateral cases is the safest approach here. The latter approach is sometimes referred to as a synthetic multilateral case. Here, the synthetic multilateral case would involve three bilateral APAs with rollback or MAP cases, all with mirrored terms: Canada-U.K.; Italy-U.K.; and France-U.K.

We have also been successful in this context with a combined bilateral/unilateral approach. For the juris-

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diction where an adjustment has been proposed, we have obtained a bilateral APA with rollback or MAP relief followed by an APA. Another option would be to seek a bilateral APA for the jurisdiction with the greatest intercompany flows.

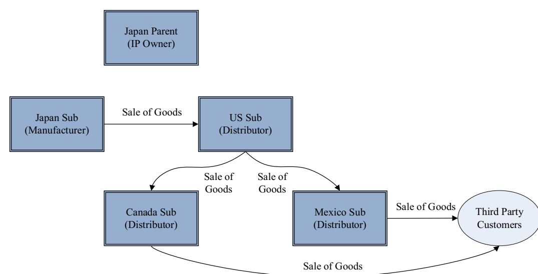
For the other countries not covered by the bilateral proceeding, in the example above one could seek a unilateral APA/ruling to address prospective risk. There is a bit more risk to this approach, which depends on the particular facts and risks involved.

b. Sandwich Transactions

In many cases, a company's supply chain is not nearly as simple as the basic paradigm in which Affiliate A sells directly to Affiliate B which sells to third-party customers. Oftentimes the supply chain involves additional companies, which add value along the way in an integrated supply chain. These supply/value chains give rise to so called ''sandwich'' transactions involving multiple related parties. The intercompany transactions are arranged based on the functions, assets, risks of the various entities in the value chains. These sandwich structures can cause issues regarding which entity should bear what portion of any transfer pricing adjustment that may arise. The following sections describe two common sandwich transaction scenarios where multilateral dispute resolution may be necessary.

In this scenario, Japan Parent is involved in the manufacture and sale of industrial equipment. Japan Parent's products are manufactured in Japan by Japan Sub and sold to US Sub, which both distributes products locally in the United States, and also on-sells certain products to Canada Sub and Mexico Sub.

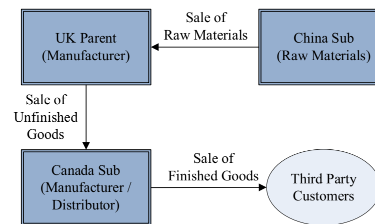
Figure 3: Sandwich Transaction Scenario One



If the Canadian taxing authority disagrees with the purchase price between Canada Sub and US Sub, and proposes a transfer pricing adjustment, the appropriate amount of profit between Japan Parent and US Sub may also be an issue. For instance, if the Canadian adjustment is large enough, it could cause the US Sub to earn minimal profit or even suffer losses. To determine the proper remuneration for all entities involved, a multilateral solution may be necessary to determine whether the amount of the adjustment is appropriate, and to what extent it should be borne by US Sub, Japan Sub, and/or Japan Parent.

Alternatively, the supply chain may be even more complex in that the distributor in the middle of the sandwich transaction may also perform additional value-added activities. For example, UK Parent manufactures tangible goods for sale to consumers. The manufacturing process is completed in stages, with certain stages completed in different countries. At the beginning of the supply chain, raw materials are harvested by China Sub and sold to UK Parent, which performs the initial steps of the manufacturing process. After completing these initial steps, UK Parent sells the unfinished goods to Canada Sub, which completes the remaining steps in the manufacturing process and distributes the products in North America.

Figure 4: Sandwich Transaction Scenario Two



Here, UK Sub is performing multiple functions, further complicating the supply chain. Thus, if a taxing authority were to adjust any portion of the supply chain, each entity involved (i.e., UK Parent, China Sub, and Canada Sub) could be affected, and a multilateral solution could be necessary for a proper resolution.

Comments and Thoughts

Due to the complexity of the sandwich structures set forth above, more than one of the techniques described above may need to be employed (local or unilateral rulings/APAs, multiple bilateral matters, fighting adjustments domestically, etc.). There is no one-size-fits-all solution, but rather general principles as described in our general comments and best practices above.

However, there are a few approaches to note that have worked in the past, including proactively addressing these issues through a bilateral APA. For example, in any value chain where there is a ''sandwich'' issue, such that the controversy involves entities in jurisdictions with one or more entities or steps in the value chain between such entities, there can be a critical assumption inserted in a bilateral APA with respect to the profitability of the entities that transact between the parties to the APA. An example of this would be a CPM/TNMM range of the profitability of such entities, which if the actual results are outside the range would violate a critical assumption, thus triggering renewed negotiations. In the local jurisdiction, a document-and-defend approach can be taken, with bilateral relief available to the extent of any adjustments.

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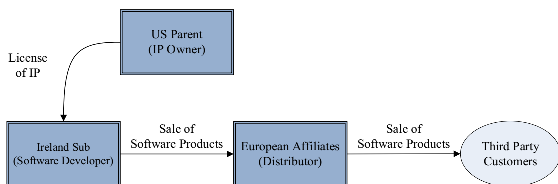
c. IP Licensing/Cost Sharing Arrangement

In another scenario, US Parent develops software which it distributes globally through its affiliates. The group's software is developed by Ireland Sub with the use of IP licensed from US Parent. After the software is fully developed, Ireland Sub sells the software to US Parent's other European affiliates for distribution in the local markets. Ireland Sub then pays a royalty to US Parent for the license of IP based on Ireland Sub's residual profit. The European affiliates are compensated by Ireland Sub for their distribution functions.

Figure 5: Development of Software IP Scenario



Upon reviewing the intercompany transactions with Ireland Sub, the French taxing authority may determine that France Sub is overpaying on the intercompany purchase of products. As a result of a proposed transfer pricing adjustment, Ireland Sub's residual profit would be decreased, meaning that the royalty it pays to US Parent for the use of IP may also need to be subsequently decreased. As a result, US Parent has a vested interest in the arm's length pricing of intercompany transactions between France Sub and Ireland Sub.

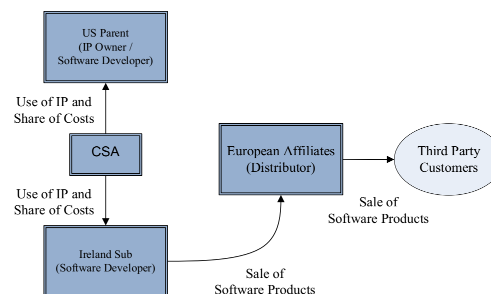
Alternatively, instead of entering into an IP licensing agreement, US Parent and Ireland Sub may enter into a cost sharing arrangement (''CSA'') under which the parties agree to share the intangible development costs associated with their software products in accordance with their share of the reasonably anticipated benefits (''RAB'') from the intercompany IP. In this arrangement, Ireland Sub still sells the finished products to other European affiliates for distribution in the local markets.

Comments and Thoughts

The software development base case scenario raises concerns and issues which are quite similar to the supply chain ''sandwich'' structure set forth above, namely how and whether the impact of any adjustments can or should flow through from the intermediary entity to the ultimate principal. The CSA example raises the issues discussed immediately below.

Similar to the prior fact pattern, if the French taxing authority were to propose an adjustment for intercompany transactions between France Sub and Ireland Sub, Ireland Sub's reasonably anticipated benefits from use of the intangible property would decrease and a smaller portion of the total intangible

Figure 6: Cost Sharing Arrangement Scenario



development costs related to the development of the software products should be allocated to Ireland Sub. US Parent, in turn, may experience a corresponding increase in the intangible development costs it should bear based on its increased RAB share, which would decrease the amount of taxable income in the United States. Again, similar to the IP licensing scenario, this CSA situation would result in US Parent having a vested interest in the arm's length pricing of intercompany transactions between France Sub and Ireland Sub, which may necessitate a multilateral MAP resolution.

Comments and Thoughts

As discussed in more detail above, the CSA structure is susceptible to a resolution through APA or MAP with coordinated bilateral cases, a combination of bilateral and unilateral/domestic controversy, or a full multilateral approach. If the CSA in question involves low-tax jurisdictions with no effective MAP relief, the full multilateral approach would not be available, but if the particular structure involves all treaty countries a multilateral approach may be advisable due to the complexity of coordinating multiple bilateral CSA APAs or MAP cases.

d. Exit Charge

Over time, companies adjust their strategy and enter restructurings to adapt to market trends and maximize synergies. In essence, a business restructuring can involve any substantive change to a company's structure or functions, including changes to the nature or scope of its intercompany transactions; a shift in the allocation of functions or risks. Importantly, the mere fact that an operational change qualifies as a ''restructuring'' under Chapter IX of the OECD's Transfer Pricing Guidelines does not imply that compensation is required.[6]

However, when a restructuring has cross-border implications, many countries seek to impose an ''exit charge'' as compensation for the loss of future profit

[6] *E.g.*, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017) ¶¶ 9.29, 9.39, 9.78.

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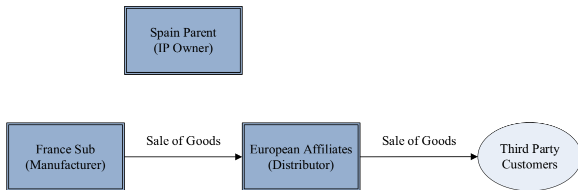
either under domestic law or Chapter IX of the OECD Guidelines.[7] Often, exit charges are implemented by requiring an explicit payment from the legal entity that is considered to have benefited from the restructuring to the legal entity that is thought to have surrendered its functions, assets, or risks.

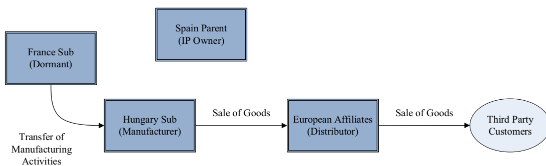
As an example of how an exit charge may trigger the use of a multilateral solution, consider Spain Parent, which functions as a manufacturer of tangible goods, which it sells throughout Europe via local subsidiaries that function as routine, limited-risk distributors. Historically, the group's manufacturing activities have been carried out by France Sub, under the guidance and management of Spain Parent.

Figure 7: Exit Charge Scenario – Pre-Movement of Activities



Spain Parent decided to restructure the group's manufacturing activities and organized a new subsidiary in Hungary. After Hungary Sub was organized, Spain Parent transferred the manufacturing activities from France Sub to Hungary Sub. This movement of functions left France Sub as a dormant entity.

Figure 8: Exit Charge Scenario – Post-Movement of Activities



The France taxing authority may determine that France Sub is owed an exit charge due to the loss of functionality from the restructuring.

Comments and Thoughts

There is an issue in determining which entity should pay the proposed exit charge. While Hungary Sub received the direct benefit from the transfer of manufacturing activities, the Hungary competent authority is likely to argue that Spain Parent, which made the ultimate decisions for the group, had control over the restructuring and should thus pay the exit charge. However, if the France taxing authority were to propose that the exit charge be paid by the Spain Parent, the Spain competent authority may argue that since Hungary Sub received the benefit, it should pay the exit charge. Therefore, in order to determine the proper payor as well as amount (if any) of the exit charge, the competent authorities in both Spain and Hungary may need to be consulted.

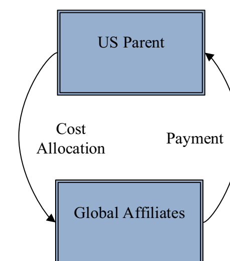
There is no technical rule that requires a country to assess an exit tax with respect to a particular counterparty country, or to where the ultimate principal will be impacted. However, as with the sandwich structures with respect to tangible goods, there is typically an effect upon the ultimate principal. The bad news (that exam teams often have discretion to determine to which country the exit tax relates) may sometimes be the good news — it is possible that the exam team can be convinced that the exit tax adjustment should be made with respect to the ultimate principal entity, thus turning what appeared to be a complicated multilateral case into a less complicated bilateral one. If successful, this can also avoid the significant timing and taxpayer-initiated adjustment issues that these cases raise. Negotiating this issue with exam is therefore crucial to avoiding potential multilateral complexity.

e. Cost Allocations: Direct Charge to Multiple Countries

In our increasingly digital economy, global companies are finding it more efficient to centralize certain administrative tasks such as bookkeeping, information technology, and human resources. Due to the ease in communication and the transfer of information, functions that were once localized can now be performed for each entity under a corporate umbrella at a singular location. When this situation occurs, the service provider must charge out a portion of its costs to each affiliate receiving a benefit. Yet, this can create certain problem that potentially give rise to a multilateral solution. Generally, there are two main fact patterns under which this situation can occur, which are described below.

US Parent partners with third-party companies through its local subsidiaries to design and execute incentive programs. To reduce costs, US Parent provides certain administrative services to each subsidiary. The costs associated with the administrative services beneficial to a specific entity are then charged to that entity based on its revenue and headcount.

Figure 9: Direct Charge Scenario



While reviewing the cost allocation, the IRS disallowed deductions related to a percentage of US Parent's claimed shareholder expenses, arguing that these need to be allocated to each of US Parent's global

[7] *Id.* ¶¶ 9.1–9.3, 9.11.

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subsidiaries. Any adjustment made by the IRS to US Parent's cost allocation would thus affect each of the global subsidiaries. Instead of negotiating the proper allocation metric with each individual company, it could prove beneficial to utilize a multilateral solution in this scenario.

Comments and Thoughts

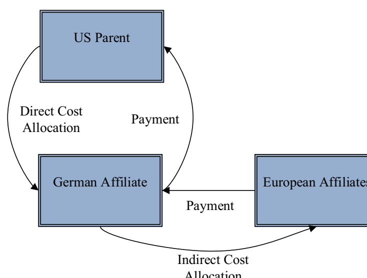
The biggest issue with a resolution in a direct charge scenario is efficiency in terms of resolution. For example, we have had many cases where the examiners do not focus on how many countries are recipients of the cost allocations, and sometimes situations where the adjustment does not even specify a breakdown in the cost allocations among countries. That is, the IRS would adjust a taxpayer's management and administrative services charges by $200 million, but not specify to which service recipients this reduction in charges relates.

In these situations, a cost-benefit analysis needs to be undertaken, and the answer will determine how to address the adjustments for each country. Note that Competent Authority offices often undertake such an analysis themselves in order to prioritize their time, and thus one of the situations where unilateral relief is most frequent is an administrative services cost allocation. As an example, if 80% of the adjustment can be shown to relate to two countries/entities, but then the remaining 20% of the adjustment relates to ten other countries/entities, unilateral relief is often granted to eliminate the latter portion of the adjustment rather than prosecute twelve different MAP cases.

f. Cost Allocations: Direct and Indirect Charges

However, not all intercompany administrative service providers directly charge each affiliate that receives a benefit. This is shown in a situation in which Germany Affiliate acts as the group's principal entity in Europe and has responsibility for the group's European operations. As such, Germany Affiliate pays US Parent for all administrative services performed by US Parent on behalf of all of the European affiliates. Germany Affiliate would then on-charge the portion of US Parent's costs to the European affiliate receiving the benefit.

Figure 10: Indirect Charge Scenario



If the French taxing authority were to examine the allocation of costs to France Affiliate, it may only propose adjustments to the allocation from Germany Affiliate. This adjustment would then have a direct impact on the cost allocation from US Parent to Germany Affiliate, and depending on the significance of the adjustment, all other cost allocations from Germany Affiliate to the other European Affiliates. Therefore, a multilateral resolution may be needed.

V. THE FUTURE OF MULTILATERAL CONTROVERSY

Many Competent Authority offices, including the U.S. IRS APMA office, have expressed the desire to do more multilateral cases and work them more efficiently. In fact, it appears based on public statements that IRS APMA has become more open to addressing Competent Authority issues either unilaterally or bilaterally when it is not directly involved but is ultimately impacted — which can perhaps mitigate the need for a multilateral case.

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