

Global View

Preparing the Form 8975 to Defend Transfer Pricing

By Robert J. Misey, Jr.*

Although the OECD's Base Erosion and Profit Shifting project ("BEPS") has produced 15 action plans, the only OECD recommendation that the IRS has implemented is country-by-country ("C-by-C") reporting. The IRS promulgated regulations regarding C-by-C reporting¹ and finally published Form 8975 this summer.

The IRS purportedly implemented C-by-C reporting to conduct high-level transfer pricing risk assessments, but little of the information on Form 8975 comports with the functions performed, risks assumed, or resources employed to determine an appropriate transfer price.² The recent publication of Form 8975 is important because the first required reporting period is for years beginning on or after June 30, 2016.³ Accordingly, a U.S. parent with a fiscal year ending on June 30, 2017, has to file Form 8975 with its U.S. Form 1120 corporate income tax return as long as its group has combined revenue of \$850 million or more.⁴

Form 8975 has two parts and a Schedule A that contains three parts.

Part I of Form 8975 requires identification information with respect to the filer. The filer is the U.S. parent of a U.S.-based multinational enterprise group. Part I also requires the ultimate U.S. parent to provide a reporting role code, which will typically be code "ULT."⁵

Case Study

USCo has a sales office in Canada and owns an Irish holding company that owns an Irish operating company. The Irish operating company earns royalty income from a license to an unrelated third party in Japan. Finally, USCo owns a U.S. subsidiary that is incorporated in the United States but is managed and has all of its operations in Cyprus (*see* Figure 1).

In this case study, USCo is the filer and will provide the appropriate information in Part I of Form 8975, including the reporting role code of "ULT" as the ultimate U.S. parent. Part II provides a page and a half of space for a filer to provide "Additional Information" related to USCo's group.

Schedule A contains three parts and requires the combined information for all the constituent entities in a particular jurisdiction. A constituent entity includes a corporation resident in a jurisdiction and a permanent establishment in

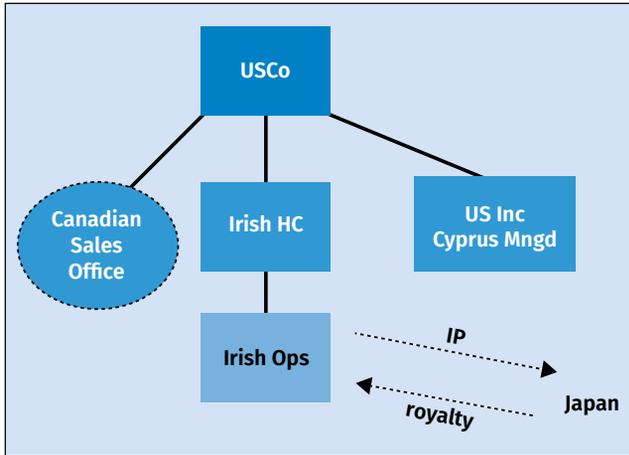


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FIGURE 1



a jurisdiction.⁶ If a constituent entity is resident in more than one jurisdiction and there is not an applicable income tax treaty, the constituent entity's jurisdiction of residence is its place of effective management.⁷ The information for all stateless entities is combined in a single Schedule A.⁸

In this case study, USCo would file four Schedule As. USCo will file its first Schedule A for itself, the only constituent entity in the United States. The second Schedule A would include the constituent entity information for both the Irish holding company and the Irish operating company. The third Schedule A would be for the permanent establishment in Canada resulting from the sales office. The fourth Schedule A would be for the U.S.-incorporated subsidiary that is managed in Cyprus (because the company's effective place of management is in Cyprus). There is not a constituent entity in Japan and, therefore, USCo does not have to file a Schedule A for Japan because merely receiving a gross item of income subject to withholding tax does not create a permanent establishment.⁹

For each constituent entity listed on a Schedule A, the U.S. parent must provide a code for its main business activity. The codes relate to each of the following brief descriptions:

- Research and development;
- Holding or managing intellectual property;
- Purchasing or procurement;
- Manufacturing or production;
- Sales, marketing, or distribution;
- Administrative, management, or support services;
- Provision of services to unrelated parties;
- Internal group finance;
- Regulated financial services;
- Insurance;
- Holding shares or other equity instruments;
- Dormant; and
- Other.

Neither the instructions to Form 8975 nor the regulations provide guidance with respect to determining the main business activity. For example, which code should USCo choose for a constituent entity that has multiple activities?

Schedule A's line 1 details revenue from unrelated parties and related parties, as well as total revenue.¹⁰ Although revenue includes both operating revenue and passive types of income such as interest, rents and royalties, dividends are not included.¹¹ As a result, USCo would not include any dividends received from either the Irish holding company or the U.S./Cyprus company.

In line 2, profit or loss before income tax is essentially taxable income.¹²

Line 3 requests the income tax paid on a cash basis and Line 4 requests income tax accrued.¹³ These require inclusion of taxes paid or accrued to countries outside the constituent entity's jurisdiction.¹⁴ For example, if, in addition to paying Irish taxes, the Irish operating company incurred a withholding tax on the royalty received from the Japanese licensee, the Japanese withholding taxes would be included on the Schedule A for Ireland.

A jurisdiction's Schedule A must report stated capital on line 5 and accumulated earnings on line 6. However, the Schedule A for the jurisdiction of the legal entity—not the jurisdiction of the permanent establishment—reports the stated capital and accumulated earnings of a permanent establishment.¹⁵ As a result, lines 5 and 6 of the Schedule A for the Canadian permanent establishment should list 0s, with any stated capital and accumulated earnings appearing on the Schedule A for USCo.

Line 7 requests the number of full-time equivalent employees, which includes independent contractors.¹⁶ Although neither the regulations nor the instructions to Form 8975 provide any meaningful guidance as to when an independent contractor is a full-time equivalent employee, the regulations focus on consistency with respect to this determination from year-to-year.

In line 8, the preparer must include the value of tangible assets other than cash, cash equivalents, or financial assets.¹⁷ Again, neither the regulations nor the instructions provide a definition or distinction between cash equivalents and financial assets.

Although most of the aforementioned items are objective in nature, Part II of the Form 8975 and Part III of its Schedule A provide more than two pages for "Additional Information," which the filer does not have to provide. What kind of additional information might USCo want to include? For Form 8975, the instructions suggest "... a narrative description of the overall business operations and structure of your group or an overall assumption or

convention used which might have an effect on your report.” The instructions for Part III of Schedule A suggest providing information “... to explain the tax jurisdiction financial and employee information in Part I ...” Both of these instructions look for information that is subjective.

It is always a concern that taxpayers who include additional information may be unnecessarily informing the IRS of potential issues. However, if significant revenue (line 2 of Part I of the Schedule A) comes from a tax jurisdiction with a small number of employees (line 7 of Part I of the Schedule A), the U.S. parent may want to include a concise and defensible statement to explain the disparity. For example, the explanation may simply state that the jurisdiction owns valuable intangibles that are not listed (intangibles are not listed on the Schedule A) or that the few employees within that jurisdiction perform high value services. Anything that USCo writes as additional information must be consistent with its transfer pricing documentation.¹⁸

Form 8975 and its Schedule A require objective information regarding related parties, but filers should carefully draft any subjective “Additional Information.” Whether the IRS abides with its stated objective of a high-level risk

analysis of transfer pricing remains to be seen.

ENDNOTES

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¹ Reg. §1.6038-4.

² Reg. §1.482-1(d)(3).

³ Reg. §1.6038-4(k).

⁴ Reg. §1.6038-4(h). This is consistent with the OECD threshold of EUR 750 million.

⁵ The only other alternative would be the filing designation of “SUR” for a U.S. territory corporation that is a surrogate of a U.S. parent.

⁶ The definition of permanent establishment includes the traditional treaty definition of a permanent establishment and a trade on business in a non-treaty country.

⁷ Reg. §1.6038-4(b)(8).

⁸ Reg. §1.6038-4(d)(3)(i).

⁹ Reg. §1.6038-4(b)(8).

¹⁰ Reg. §1.6038-4(d)(2)(i) and (ii).

¹¹ Reg. §1.6038-4(d)(3)(ii). It is not clear whether an inclusion from either Subpart F or a Qualified Electing Fund is similarly excluded.

¹² Reg. §1.6038-4(d)(2)(iii).

¹³ Reg. §1.6038-4(d)(2)(iv) and (v).

¹⁴ Reg. §1.6038-4(d)(3)(iv).

¹⁵ Reg. §1.6038-4(d)(2)(vi) and (vii).

¹⁶ Reg. §1.6038-4(d)(2)(vii) and -4(d)(3)(iii).

¹⁷ Reg. §1.6038-4(d)(2)(viii).

¹⁸ Code Sec. 6662(e).

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