Bloomberg BNA

Tax Management
Transfer Pricing Report™

Former GE Tax Counsel Peter Barnes Gives Views On BEPS, Country–by-Country Reporting, Documentation

Peter Barnes, former chief tax counsel at General Electric, reflects on his 23 years with the company Dec. 13, 2013, sharing his views on documentation, country-by-country reporting, tax competition, formulary apportionment, and the Organization for Economic Cooperation and Development's project on base erosion in general. Barnes, who has long advocated simplifying documentation requirements, describes the data companies would need to supply to tax authorities ''in a perfect world.'' He also warns that country-by-country reporting likely will lead to public disclosure of information about companies' tax payments to different countries despite reassuring statements from the OECD on the subject. The former GE official is now a senior fellow at Duke University and recently joined the Washington, D.C., firm Caplin & Drysdale as ''of counsel.''

BLOOMBERG BNA: First, congratulations on the new job. I think readers would be interested in what you're doing now, and how your experience at General Electric prepared you for it.

BARNES: I had a wonderful 23 years at GE. I retired Oct. 1, and had the great fortune to get a teaching job at Duke University. I'm a senior fellow at the Duke Center for International Development and also a senior teaching fellow at the law school. Duke has a small international tax program that takes mid-career professionals from foreign countries and gives them a one- or two-year master's degree, and of course there are also a significant number of law students who are interested in tax. This is a great opportunity for me to pursue the teaching career that I always considered.

In addition, my friends at Caplin & Drysdale invited me to join the firm as 'of counsel.' That gives me an opportunity to work with great people and keep my hand in active cases, which is interesting and will help my teaching.

The 23 years at GE were a fabulous training ground; I had a chance to learn every single day. I was able to see literally hundreds of transactions across dozens of countries—real-world cases with facts that spanned a range of industries. In addition, throughout my time at GE, I had a chance to work extensively with foreign governments, particularly in Asia, in developing their tax laws. The past two decades have been an active time for these governments to develop their tax rules and they generally welcome thoughtful input from taxpayers. All of these experiences helped build a foundation for my new career.

BLOOMBERG BNA: Your name has appeared regularly in the pages of *Transfer Pricing Report* ever since we started publishing in 1992. Obviously, much has happened in the international tax area since that time. What events would you say have been most responsible for changing the practice of transfer pricing for large multinationals over the last 20-plus years? What have been the most significant positive and negative changes?

BARNES: The big change in 20 years is the extraordinary focus now on transfer pricing documentation. Everyone is familiar with the history. The U.S. started things by introducing documentation purely as penalty protection. Other countries jumped on the idea and made it mandatory. In the past 15 years, there has been an explosion of these documentation requirements across countries. So, while 20 years ago we would consider documentation for truly high-risk transactions, now a multinational corporation is required to prepare documentation annually for hundreds of legal entities. I'm not sure that's been a good development, but it's been a major, major development for transfer pricing.

Another development is simply the increase in the volume of audits. Twenty years ago, the U.S. competent

 ISSN 1063-2069

authority's case load was primarily U.S.-initiated adjustments; now its case load is primarily foreign-initiated adjustments. There are countries where almost every major legal entity is audited every year and transfer pricing is questioned almost every year. Twenty years ago there were transfer pricing audits, but they were few and far between and they focused on big-dollar transactions. Now, every single cross-border transaction is a likely candidate for an audit and an adjustment.

Financial Reporting, Penalties

BLOOMBERG BNA: How have financial reporting requirements changed the game of transfer pricing? For example, how much has the concern, for public companies, shifted away from the Section 6662 transfer pricing penalty and toward what they are required to disclose on their financial statements?

BARNES: I'm not sure financial reporting has had a big impact in and of itself. All multinational companies are in multiple audits all the time, and no matter what you do, you can't stop that. You're always going to have reserves for pending audits and for risks that have not yet been audited but that you expect to be audited in the future. I think the changes for transfer pricing are really driven by the transfer pricing environment more than by financial reporting.

BLOOMBERG BNA: Do you think companies are as worried about getting a Section 6662(e) or (h) penalty currently as they were in past years?

BARNES: There certainly is a concern about U.S. penalties, or, more properly, about full compliance with U.S. law. But, the bigger worry—and, frankly, frustration—is about foreign governments. There are a lot of jurisdictions where the penalties are automatic—where if you have an adjustment, it is subject to penalties and interest, and the penalty cannot be waived. That's probably not a good policy, but it is the rule in a lot of countries—if you get an adjustment, you get a penalty, often scaled to the size of the adjustment.

I think the focus for most multinationals is not the U.S. penalties. Those are important, and we all seek to comply, but in the U.S. you can have a reasonable discussion about your transfer pricing. In foreign jurisdictions, the approach is often more revenue-driven, and the penalties and interest are automatic.

One point about the U.S. is important, though. Over the last few years, the IRS has increased the breadth of its inquiry into transfer pricing adjustments. That's understandable; they are simply following the international norm and examining a broader range of transactions. But the change does mean that transfer pricing is a larger portion of the audit for many US multinationals.

IRS Transfer Pricing Practice

BLOOMBERG BNA: Is that an outcome of the Transfer Pricing Practice that started as a pilot program under IRS Deputy Commissioner (International) Michael Danilack in 2010, and continues under Samuel Maruca, who was hired to run the practice in 2011?

BARNES: Mike Danilack and Sam Maruca said, correctly, that we need to have a coherent and structured approach to transfer pricing audits. The whole field process has benefited from their leadership.

BLOOMBERG BNA: Have you noticed a change in the way audits are conducted under the Transfer Pricing Practice as opposed to earlier, under the tiered issue program introduced in 2007 that ranked various types of issues according to their risk?

BARNES: I don't have enough experience with a breadth of companies to allow me to comment on that. I think Mike and Sam are properly focused on the cases that matter. Whether a markup should be cost plus five or cost plus 10 is not the right focus. Their focus is on intangibles, and their thinking appears to be that they want to put their resources there, where it matters.

Public Scrutiny

BLOOMBERG BNA: Nowadays, companies are coming under a lot of scrutiny from the public about their tax planning—witness the Senate hearings on Microsoft, Hewlett-Packard and Apple. Would you say this has caused many of them to actually change their operations?

BARNES: There's no question there's more public scrutiny, and that will continue, I'm sure. Big companies always worried about the newspaper test. That was true 20 years ago and it's true today. I think big companies have always assumed that their tax planning would be on the front page of the newspaper and have always wanted to be comfortable that they explain what they're doing and why they're doing it.

Yes, multinational companies talk more internally and with other companies now about the issue of public scrutiny. And, the NGOs are playing a role they never played in the past. The scrutiny and the involvement of third party commentators, including NGOs, will get bigger if country-by-country reporting results in public reporting of companies' tax payments.

BLOOMBERG BNA: That's not what's contemplated, according to Joe Andrus of the Organization for Economic Cooperation and Development. He said at the consultation in November that the country-by-country reporting mechanism being developed to fight base erosion and profit shifting is aimed at tax officials, not the public (22 *Transfer Pricing Report* 863, 11/14/13).

BARNES: The thinking now is that it would all be solely within the governments. But I, and a lot of other tax professionals, think limited disclosure is unlikely to be sustained. It may start off as government-only, something in the nature of an information exchange, but I think it's unlikely to stay that way. Either there will be leaks, or some government somewhere will require that it be made public. Country-by-country reporting may start off as an information exchange matter but it won't stop there.

BLOOMBERG BNA: One aspect of the NGO scrutiny and the Senate hearings—and the hearings in U.K. Parliament and legislatures around the world—is that transfer pricing has now become a household word.

BARNES: Along with that, there is some misunderstanding that is very unfortunate. People are accused of 'engaging in transfer pricing.' Of course they're engaging in transfer pricing! There's no other way to establish intercompany prices and transact business between affiliated companies. We have to get away from the idea that engaging in transfer pricing is itself evil.

Companies have come to the realization that their transfer pricing will be audited often and extensively.

   ISSN 1063-2069

We must be able to explain our methodologies for establishing transfer prices. That part is fine. But governments and NGOs, likewise, have to realize that transfer pricing is a core part of international business and is not, by itself, wrongdoing.

Tax Competition

BLOOMBERG BNA: While companies are being criticized for their tax planning, one could argue that governments enable this planning by offering incentives for investment—something that leads to tax competition among countries.

BARNES: It is interesting—and, I would argue, significant—that the United States has enormous state-to-state tax competition. The experience of Boeing in deciding where to locate production for its new version of the 777 has been in the headlines recently. The federal government does not step in and say the states can't compete against each other in offering tax incentives. But, for some reason, when tax competition occurs among national governments it is viewed as abhorrent. Critics of tax competition need to explain why competition is OK between the states but not between national governments.

But, it is important to add another point: tax is only one of many factors in deciding how a company goes to market, and taxes are generally a small factor. Those of us who spend our lives in the tax business sometimes forget that we are only a small piece of the business puzzle.

BEPS

BLOOMBERG BNA: What are your thoughts generally about the OECD's action plan to combat base erosion and profit shifting? What actions will be the easiest and hardest to implement, and which will potentially have the greatest impact?

BARNES: The BEPS discussion and exercise is very good. It is much better for these issues to be put on the table and openly discussed by lots of smart people grappling with what to do, what's a problem, what's not a problem, than to have governments and critics grumble in the dark. I much prefer that to a general gripe session around the world about how multinational companies are engaging in transfer pricing and not paying their fair share. I wholeheartedly salute the OECD for undertaking the BEPS project and I think it's great that the OECD stepped up to lead this effort. They have the right players and the right focus.

None of the action items are easy, and country-by-country reporting illustrates that. You would think, on the surface, that country-by-country reporting was perhaps the easiest agenda item; countries would just report the tax they pay and the income they earn in each country. But as everyone who has looked at this quickly recognizes, there are huge issues—in how to develop the information, what information is truly available, and how it should be presented. We'll all be very interested in February when the first template comes out from the OECD.

I think the hardest question is the action item around base erosion—Action 4 is to 'limit base erosion via interest deductions and other financial payments'—because we don't even know what base erosion is. Countries have plenty of tools. They've got thin capitalization rules, debt-equity restrictions. What is not working about those rules today? What should BEPS propose for companies and countries to change? I don't know what will come out of the base erosion discussion, but I hope there is intellectual rigor about what we mean when we say 'base erosion.' If a company is wholly compliant with a country's thin cap debt-equity rules, if there's a withholding tax on royalties that are paid cross-border, then somebody needs to explain what improper base erosion is occurring.

Withholding

BLOOMBERG BNA: Have attitudes changed about withholding? In the past, it was criticized as a treaty provision that often caused double taxation. Has that changed under the BEPS project?

BARNES: Clearly, the push from source countries to take a larger share of the total tax revenues is a trend that's not going to stop, and withholding taxes are a useful way to put more revenue into source countries. The problem with withholding tax is that even a fairly low rate—5 percent, for example—can be an enormous tax on net income. At a 25 percent income tax rate, 5 percent withholding tax suggests a 20 percent profit margin, and a 20 percent profit margin is fairly rare. So you have to be careful with withholding taxes or they quickly become more than 100 percent of the real net income on a particular flow of interest royalties. There are usually significant expenses incurred in generating a flow of interest or royalties, so withholding taxes can be excessive.

BLOOMBERG BNA: And that would create a disincentive to invest in the country.

BARNES: Absolutely. Or, at a minimum, the withholding taxes would shift a disproportionate share of the tax revenue to the source countries. It is certainly true that withholding taxes are a bigger part of the international discussion than before, and that is likely to continue because of the source countries' desire to get a bigger share of the tax pie.

Documentation in a 'Perfect World'

BLOOMBERG BNA: You have long been a proponent of simplifying transfer pricing documentation requirements. At one time, you described how GE went from producing about 10 documentation studies per year in the early 1990s to 2,000 separate studies (15 *Transfer Pricing Report* 851, 4/4/07).

Does anything in the OECD's current project on documentation offer hope of a more globally coordinated, less burdensome regime? Is there an approach that you think would work better?

BARNES: I despair of any near-term change in the documentation requirements. Most of the proposals, such as the master file approach, are not really simplification; in my view, the master file is just a different way of organizing the same burdensome level of documentation. What's worse is that more and more countries are seeking to segment each legal entity's businesses and are requiring three, four or five analyses as they break down the legal entity into separate lines of business.

What's always confused me is that we take one approach when a company is seeking an [advance pricing agreement] and a completely different approach if the company does not have an APA. If you want an APA, you discuss with the tax authorities a methodology: 'Here's how I think about my transfer pricing, here is my method, here are the data sources that I use to determine actual transaction prices.' Then, the company and the government try to agree on whether that's a reasonable approach to determining the transfer price.

Outside the APA program, in an actual audit, governments fundamentally don't care how you determined your transfer prices. They don't care whether you were reasonable or not in establishing a methodology. The governments initiate a war on comparables—my comparables versus your comparables. What's worse is that I establish my transfer prices for 2014 right now based on data from 2012 and part of 2013, but when those prices are tested in an audit in 2016 or 2017, they're tested against data from 2014 that doesn't exist today.

In a perfect world, transfer pricing audits would look more like an APA program, and taxpayers would be questioned on their methodology for determining their transaction prices. If the methodology made sense, the government and the taxpayer would agree that the taxpayer would keep it for a period of years. This would get away from the silly war of comparables, where each side tries to discredit the other sides's choice of comparables.

In the perfect world I envision, the taxpayer would be asked, and would have to disclose, how it went from its raw financial data to the prices at which it engages in transactions—not in great detail, but in general terms. If that methodology made sense, there would not be grounds for a transfer pricing adjustment. And, during this audit process, the taxpayer and the government could discuss changes in the methodology that should be used prospectively in order to ensure that prices continue to be at arm's length.

BLOOMBERG BNA: Don't the taxpayer and the government fight over comparables in an APA as well?

BARNES: They do, but at the end of the day you come up with an agreed approach. The taxpayer and the government have a shared interest in reaching agreement on a methodology. By contrast, in an audit, you know what's going to happen: I come in with my comparables; you throw out three of mine and add three of yours; you question my segmentation and come up with your own segmentation. It's a ballet. It's a dance—and it leads to a lot more controversy than there needs to be. It's not a good use of resources from either side.

Formulary Apportionment

BLOOMBERG BNA: An article you wrote for us in June of 1992 was a critique of provisions in the Rostenkowski/Gradison bill (HR 5270) that would have required some foreign-owned U.S. businesses to report a minimum amount of taxable U.S. income, based on a formula. At the time, you said it would be difficult to apply such a rule fairly (1 *Transfer Pricing Report* 86, 6/10/92).

Do you still think that's true?

BARNES: That bill dealt with U.S. branches of foreign insurance companies, and you are probably the only person who remembers I wrote that article.

I am absolutely not a fan of formulary apportionment on a unitary, global basis. I think when people look at it closely, they realize it has huge problems and is not simpler. You may use a formulary method at a narrow transaction level to figure out a transfer price for a specific transaction; formulary methods can work at a very low level, where you're doing safe harbors or simplified methods. I think there's a huge opportunity for good safe harbors and good simplified methods, but that's at a very narrow, transactional level.

BLOOMBERG BNA: Profit split arguably is a formulary approach. How do you feel about that?

BARNES: I think you can do profit split, again, at a very low level. If you have two or three legal entities in a big multinational group, and those two or three legal entities are inherently connected, working 24/7 with each other, then a profit split for those three entities may make sense. That's very, very different from a global profit split.

BLOOMBERG BNA: Is the arm's-length standard still an adequate framework today, when so many companies deal with their affiliates in ways that they don't deal with unrelated parties? How do you apply it now?

BARNES: I do believe the arm's-length standard is still the right approach. But let me broaden the question. Today, we use separate-entity accounting in applying the transfer pricing rules, rather than a unitary approach that looks at an enterprise on some consolidated basis without regard to separate legal entities. We try to determine the right amount of income earned by each separate legal entity, and then we divide that income among the two or more countries in which that legal entity has operations. I think this approach is still sensible.

Some critics of transfer pricing confuse these issues. When a critic says, 'The arm's-length standard does not work,' what they may be saying is that it is not sensible to use separate-entity accounting in determining the amount of income that should be taxed by each country; instead, there should be a unitary approach. Or, the critic may be saying that separate-entity accounting is reasonable, but there are transactions that occur between related parties that rarely occur between unrelated parties and for these transactions it is difficult to determine an arm's-length price. These are two separate criticisms, and they require separate responses.

Yes, there are some transactions that companies engage in with related parties that never—or at least rarely—occur between unrelated parties. For instance, it is rare (though not unprecedented) for a company to sell valuable intangibles to an unrelated company for a lump sum amount. It is rare for companies to give long-term licenses when the value of the underlying IP is hard to determine. But I don't think these concerns mean the arm's-length standard needs to be abandoned, and I certainly don't believe these concerns lead us to conclude that separate-entity accounting is the wrong approach.

We need some humility on the part of both taxpayers and governments to recognize that determining arm's-length prices for transactions that rarely occur between unrelated parties is very hard. Taxpayers need to explain their approaches fully, especially on intangibles transfers. And, governments need to respect the fact that they are entitled to tax only those transactions that actually occur within their jurisdictions.

Again, I would come back to Mike Danilack and Sam Maruca. They have brought a focus on exactly the right issues: What are related-party transactions for which there is no real-world analogy? But, even if you acknowledge that there are some difficult transactions, I

   ISSN 1063-2069

don't think you have to throw out the arm's-length method or the use of separate-entity accounting.

BLOOMBERG BNA: Christopher Bello, chief of Branch 6 at the IRS Office of Associate Chief Counsel (International), said recently that other governments have expressed an interest in the commensurate-with-income approach as one way to price a transaction in the absence of comparables or projections. (See the related story in this issue.)

BARNES: The U.S. has worked with commensurate-with-income for almost 30 years and we're not quite sure what it means, but it's not a nasty concept. There are no real-world cases where people take a company's crown jewels and fix a price today and sell those crown jewels with no idea of what will happen in the future. I would argue that the commensurate-with-income requirement is fully compatible with arm's-length transfer pricing.

Beyond Arm's-Length

BLOOMBERG BNA: How do you interpret the OECD language calling for 'special measures' beyond the arm's-length standard for hard-to-value intangibles?

BARNES: I frankly don't know what 'special measures' means. I do think it probably means we need to give special scrutiny to some kinds of transactions, but I don't think that means we are moving away from the arm's-length standard. It may simply be that we can't find real-world parallels for a specific transactions and so we have to create a constructed price that makes sense to both the taxpayer and the government.

BLOOMBERG BNA: The first item on the OECD's BEPS plan is addressing the challenges of the digital economy. The OECD and the business community are debating whether the existing transfer pricing framework is adequate to address electronic commerce transactions. (See the related story.)

This is not the first time the issue has arisen. You said in 2006, in the context of a discussion on restructuring, that stakeholders, after months of debate, reached consensus that existing concepts would work for e-commerce (15 *Transfer Pricing Report* 615, 12/20/06).

Have digital transactions now reached the point where a new framework is needed?

BARNES: We have transactions now where the source of income is much more mobile than it was before. For example, the 'Internet of Things' connects machines to monitoring stations all over the world. There are redundancies built in, so you're never sure in advance whether the monitoring will occur in, for example, the U.K., Germany, Japan, or the U.S., because all of those locations can tap into the Internet of Things. I don't think we need new principles, but we have to recognize that there are fact patterns now in which commerce is conducted in multiple locations simultaneously and we have to figure out what that means for sourcing income and expenses.

BLOOMBERG BNA: Have you seen changes in the arguments on both sides of this debate since it was raised in prior years?

BARNES: The dollars at stake in digital commerce continue to rise, so the emotions around the tax rules continue to rise. I think BEPS is a great framework for looking at these issues in a thoughtful, conscientious way. But I don't know that there's a change in overall character; I think there has just been an increase in the volume of transactions.

Looking Ahead

BLOOMBERG BNA: Are there any other thoughts you'd like to share with readers before we conclude?

BARNES: One of the delights of my new role is that I get to explore topics that don't have an immediate taxpayer interest. I'm very interested in the tax rules that apply to sharia-compliant financial instruments. I think Islamic finance is a huge area of growth with a lot of tough intellectual questions for the tax community. In my new life, I get a chance to dig into issues like that, and that's a great privilege.

BLOOMBERG BNA: What's the biggest thing on the horizon for 2014?

BARNES: Country-by-country reporting. We're going to have a template out in February; companies are going to have to figure out how to respond, how to gather the data. The debate over whether this exercise will be strictly within governments, or whether the information will be made publicly available, is keenly important. If you ask what's the immediate pressure point, it's going to be finding a way to make country-by-country reporting work.