Notes

Cleaning Up After *Chevron*: A Proposed Cross-border Pipeline for the Transfer Pricing of Intra-group Debt Transactions

Columbia Journal of Transnational Law Student Writing Prize in Comparative and International Law, Best Note Award

The use of cross-border intra-group debt transactions to facilitate corporate tax planning faces heightened scrutiny by taxing authorities in light of the G20/Organization for Economic Cooperation and Development's Base Erosion and Profit Shifting Project. This Note examines risks presented by the puzzling legal regime applicable to the transfer pricing of intra-group loans, using the recent Australian Chevron case as an illustrative vehicle, and proposes a solution through the Internal Revenue Service's ("IRS") Advance Pricing and Mutual Agreement ("APMA") Program. The APMA Program facilitates the negotiation of binding contracts through which a taxpayer and at least one taxing authority delineate sanctioned transfer pricing methodologies applicable to specified transactions over a fixed term that generally spans at least five prospective years. IRS data suggests that taxpayers have not commonly leveraged the APMA Program to price intra-group loans, presumably owing in part to the bespoke nature of loans, the time and cost required to strike a deal with taxing authorities, and the difficulty of predicting financing needs years in advance. Nevertheless, this Note argues that the APMA Program is fundamentally a process that allows parties to agree on pricing methodologies—not *standalone prices. Therefore, this Note suggests that certain multinational enterprises with high-volume or high-risk internal financing arrangements could benefit from locking in the underlying methodologies used to price their intra-group loans, thereby limiting the risks demonstrated by Chevron and the fluctuating regulatory environment. This Note also explores the possibility of establishing "mandatory" participation in the APMA Program where a taxpayer has already demonstrated a lack of compliance with arm's length debt pricing.*

INTRODUCTION

Transfer pricing focuses on the pricing of cross-border intercompany transactions that take place among a multinational enterprise's ("MNE") related party affiliates. Strategic transfer pricing uses these intercompany transactions to create tax efficiencies for the MNE by allocating related party income and expense among tax jurisdictions in a manner that reduces the MNE's worldwide tax liability. Because of the perception that transfer pricing enables abusive corporate tax practices, the accounting mechanism is subject to a complex body of evolving rules and regulations aimed at ensuring that transactions between related parties are consistent with the "arm's length principle."[1] This cornerstone of transfer pricing law commands that related party transactions must be analyzed with reference to "the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances."[2]

Earnings stripping, the use of intra-group loans—and resulting interest deductions—to generate tax benefits, has faced heightened scrutiny by taxing authorities in recent years owing in part to its inclusion in the G20/Organization for Economic Cooperation and Development's ("OECD") Base Erosion and Profit Shifting ("BEPS") Package.[3] Australia's recent *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation*[4] case, which dissected the pricing and structure of a U.S. dollar ("USD") 2.5 billion loan involving Chevron subsidiaries in the United States (the lender) and Australia (the borrower), provides a particularly pertinent example.[5] The lawsuit resulted in a five-week trial and 206-page opinion in favor of the Australian Taxation Office ("ATO"), which argued that the loan's

1. *See* OECD, OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (July 2017) [hereinafter OECD GUIDELINES]. *See also* I.R.C. § 482 (2012) and associated regulations.

2. OECD GUIDELINES, *supra* note 1, ¶ 1.6.

3. OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING, at 17 (2013), https://www.oecd.org/ctp/BEPSActionPlan.pdf, [https://perma.cc/XV5W-79EL].

4. *Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n [No. 4]* (2015) FCA 1092 (Austl.).

5. *See generally Deconstructing the Chevron Transfer Pricing Case*, TAX INSIGHTS (Deloitte Austl.), Nov. 3, 2015, https://www2.deloitte.com/content/dam/Deloitte/au/Documents/tax/deloitte-au-tax-insight-deconstructing-chevron-transfer-pricing-case-041115.pdf, [https://perma.cc/DND2-BYR7]. *See also* Richard Vann & Graeme Cooper, *Transfer Pricing Money – the Chevron Case* 1 (Sydney Law Sch. Legal Studies Research Paper No. 16/72, 2016).

high interest rate artificially shifted income out of Australia.[6] The *Chevron* case is a testament to the complexity of global transfer pricing and demonstrates the risks inherent in seeking litigated judgments in the intra-group debt space.

This Note examines key risks presented by the puzzling legal regime applicable to the transfer pricing of intra-group loans, using *Chevron* as an illustrative vehicle, and proposes a solution through the Internal Revenue Service's ("IRS") Advance Pricing and Mutual Agreement ("APMA") Program. The APMA Program facilitates the negotiation of unilateral, bilateral, and multilateral Advance Pricing Agreements ("APAs"), which are contracts between a taxpayer and at least one taxing authority that delineate sanctioned transfer pricing methodologies applicable to certain "Covered Transactions" over a fixed "APA Term" (most commonly the next five years, and an average of six years, for APAs executed in 2016).[7] According to data published by the IRS, taxpayers have not generally leveraged the APMA Program to price their intra-group loans,[8] presumably owing in part to (i) the bespoke nature of loans, (ii) the time necessary to arrive at negotiated agreement with the IRS (on average, it took 48.7 months to complete new APAs ultimately executed in 2016),[9] and (iii) the difficulty of predicting financing needs years in advance. Nevertheless, this Note argues that the APMA Program is fundamentally a process that allows parties to agree on pricing *methodologies*—not standalone *prices*. Therefore, this Note suggests that certain MNEs (e.g., banks with active central treasuries and capital-intensive companies that rely on intra-group loans to fund their investments and operations) could benefit from negotiating APAs with taxing authorities to pre-arrange the underlying methodologies used to price their intra-group loans, thereby limiting the risks demonstrated by *Chevron* and the fluctuating regulatory environment. This Note also explores the possibility of establishing "mandatory" participation in the APMA Program where a company has already demonstrated a lack of compliance with arm's length debt pricing.

Part I provides an overview of key global transfer pricing concepts and introduces the strategies that taxpayers use to shift income to no-tax or low-tax jurisdictions within the existing global

6. *Deconstructing the Chevron Transfer Pricing Case*, *supra* note 5; Vann & Cooper, *supra* note 5, at 1.

7. INTERNAL REVENUE SERV., ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS 11 (Mar. 27, 2017), https://www.irs.gov/pub/irs-utl/2016_apma_statutory_report.pdf, [https://perma.cc/XHA6-YRN4].

8. *Id*. at 8.

9. *Id*. at 12.

transfer pricing framework. Part II surveys the evolving legal regime applicable to intra-group loans, highlighting the uncertainty and complexity of the current regulatory architecture. Part III delves into the *Chevron* case as an illustration of the risks that taxpayers relying on intra-group loans may encounter while interfacing with this system. Part IV proposes the use of the APMA Program as a mechanism to help certain taxpayers mitigate growing transfer pricing risk.

I. Overview of Global Transfer Pricing

A. The Mechanics: Transacting at "Arm's Length"

Broadly speaking, global transfer pricing refers to the pricing of transactions between controlled taxpayers in different tax jurisdictions.[10] "Controlled taxpayers" are taxpayers "owned or controlled directly or indirectly by the same interests,"[11] which generally means they are part of the same MNE.[12] "Transactions" are defined broadly to comprise services performed for the benefit of another taxpayer as well as the "sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in a right to use any property (whether tangible or intangible, real or personal) or money . . . ."[13]

For illustrative purposes, let's assume that a U.S.-based automotive MNE, Mammoth Motorcars Company ("MMC-Parent"), has a subsidiary in Mexico that engages in manufacturing activities ("MMC-Mexico") and a subsidiary in Ireland that engages in distribution activities ("MMC-Ireland"). To sell cars in Ireland, MMC-Ireland purchases fully manufactured cars from MMC-Mexico. MMC-Ireland and MMC-Mexico are controlled taxpayers, and the price at which that transaction occurs is the transfer price. If MMC-Parent provides head office services (e.g., human resources, information technology, or public relations) on behalf of its subsidiaries, licenses certain manufacturing intangibles to MMC-Mexico, or provides the subsidiaries with intra-group loans, such transactions also

10. Treas. Reg. § 1.482-1 (2015).

11. Treas. Reg. § 1.482-1(i)(5) (2015).

12. More generally, the definition of "controlled" covers "any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted." Treas. Reg. § 1.482-1(i)(4) (1972).

13. Treas. Reg. § 1.482-1(i)(7) (1972).

fall under the global transfer pricing umbrella.

The United States, through Internal Revenue Code ("I.R.C.") § 482 and U.S. Treasury Regulation ("Treas. Reg.") § 1.482 (as well as many other countries, through the adoption of the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines") or local transfer pricing legislation), specifies that controlled transactions must be priced in accordance with the arm's length standard (or principle). Treas. Reg. § 1.482-1(b)(1) summarizes the arm's length standard as follows:

> In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. *A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances* (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.[14]

In theory, the transfer price at which MMC-Ireland should buy manufactured cars from MMC-Mexico is the market price at which independent manufacturers and distributors with similar functional, risk, and asset profiles would transact with one another.

To calculate an arm's length result, taxpayers must follow the "best method rule" as outlined in Treas. Reg. § 1.482-1(c).[15] Under the best method rule, an arm's length result "must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result."[16] Treas. Reg. §§ 1.482-2 through 1.482-7 and 1.482-9 outline the numerous methods

14. Treas. Reg. § 1.482-1(b)(1) (2015) (emphasis added). Similarly, the OECD Guidelines set forth the arm's length principle as follows: Where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly." OECD GUIDELINES, *supra* note 1, ¶ 1.6.

15. Analogously, the "most appropriate method rule" under the OECD Guidelines. OECD GUIDELINES, *supra* note 1, ¶ 2.2.

16. Treas. Reg. § 1.482-1(c)(1) (2015).

that taxpayers may apply under the best method rule.[17] While a technical voyage through the transfer pricing methods is beyond the scope of this introduction, it is analytically helpful to note that most methods can be sorted into one of three general buckets: (i) transaction-based methods; (ii) profit-based methods; (iii) and unspecified methods.[18] Transaction-based methods utilize data on comparable uncontrolled transactions to assess the arm's length nature of controlled transactions.[19] Profit-based methods compare the profitability of a "tested party" with the profitability of comparable companies.[20] Unspecified methods are methods not identified in the first two groups that are nevertheless consistent with Treas. Reg. § 1.482-1 and "the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it."[21]

In choosing among these methods, Treas. Reg. § 1.482-1(c)(2) advises taxpayers to consider two primary factors. First, the taxpayer should assess the *comparability* of the controlled and uncontrolled transactions by analyzing functions, contractual terms, risks, economic conditions, and the nature of the property or services transferred.[22] Second, the taxpayer should assess the quality of the *data and assumptions* used in the analysis by analyzing the completeness and accuracy of data, the reliability of assumptions, and the sensitivity of results to deficiencies in data and assumptions.[23]

After selecting the best method, an "arm's length range" of reliable results is ordinarily derived by applying the selected method to two or more uncontrolled "comparables" (these might be comparable companies, transactions, or other data, depending on the method applied) selected on the basis of relevant comparability criteria.[24]

17. Treas. Reg. §§ 1.482-2 (2011), 1.482-3 (1995), 1.482-4 (2011), 1.482-5 (2011), 1.482-6 (2009), 1.482-7 (2013), 1.482-9 (2011). The methods set forth in the OECD Guidelines are largely analogous to the methods set forth in the U.S. transfer pricing regulations. *See* OECD GUIDELINES, *supra* note 1, ch. II.

18. For a helpful description of the differences between transaction-based methods (referred to as "traditional transaction methods" under the OECD Guidelines) and profit-based methods (referred to as "transactional profit methods" under the OECD Guidelines), see OECD GUIDELINES, *supra* note 1, ch. II.

19. *Id*.

20. *Id*.

21. Treas. Reg. § 1.482-9(h) (2011).

22. Treas. Reg. § 1.482-1(d)(1) (2015).

23. Treas. Reg. § 1.482-1(c)(2)(ii) (2015).

24. Treas. Reg. § 1.482-1(e) (2015).

Comparability adjustments may be made to the results of the uncontrolled comparables "if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results."[25] If possible, statistical methods that account for central tendency are generally applied to narrow the range and increase the reliability of the comparison.[26] In many cases, the analysis is focused on the interquartile range, representing the middle fifty percent of the uncontrolled comparable results.[27]

Finally, the controlled taxpayer's financial results are compared to the arm's length range established by the comparable companies.[28] If the controlled taxpayer prices its controlled transactions such that its results fall within the arm's length range established by the uncontrolled comparables, the taxpayer's results will not be subject to adjustment provided that the IRS (or other relevant taxing authority acting pursuant to the OECD Guidelines or local regulations) agrees with the choice of, and application of, the best method.[29] However, I.R.C. § 482 also warns taxpayers that the IRS may perform its own economic analysis and make adjustments to better reflect the taxpayer's "true taxable income" under the following circumstances:

> In any case of two or more . . . businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such . . . businesses, if he determines that such distribution, apportionment, or allocation is *necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such . . . businesses*.[30]

Thus, if the controlled taxpayer's results are outside the arm's length range such that the IRS believes that income is being inappropriately shifted out of the United States, or if the IRS recalculates the arm's length range in a manner that triggers such an outcome, the IRS may adjust the controlled taxpayer's result to any point within the range.[31] Generally, the IRS adjusts the result to the median of the interquartile

25. Treas. Reg. § 1.482-1(d)(2) (2015).

26. OECD GUIDELINES, *supra* note 1, ¶ 3.57.

27. Treas. Reg. §§ 1.482-1(e)(2)(iii)(B)–(C) (2015).

28. Treas. Reg. §§ 1.482-1(d)–(e) (2015).

29. Treas. Reg. § 1.482-1(e) (2015).

30. I.R.C. § 482 (2012) (emphasis added); Treas. Reg. § 1.482-1 (2015).

31. Treas. Reg. § 1.482-1(e)(3) (2015).

range or to the arithmetic mean of all results.[32]

In summary, the global transfer pricing system seeks to place transactions between related parties on equal footing with transactions between unrelated parties, and grants taxing authorities the power to adjust the income and expenses of controlled taxpayers if they fail to transact at arm's length.

B. The Significance: The Multi-Front War Against "Base Erosion and Profit Shifting"

Having introduced the underlying mechanics of a transfer pricing analysis, this Note now turns more generally to the significance of global transfer pricing as an instrument to facilitate international tax planning. There is robust evidence that market competition incentivizes MNEs to engage in a range of tax avoidance activities.[33] To this end, MNEs have capitalized on the globalization of supply chains, capital markets, and customer bases by erecting "legal arrangements that make profits disappear for tax purposes or allow profits to be artificially shifted to low or no-tax locations." [34] Such tactics tend to attract the attention of taxing authorities when there is little to no "economic substance"[35] in the jurisdiction that receives a MNE's profits through a transfer pricing arrangement. In such cases, taxing authorities commonly aver that corporate profit shifting activities cause the attrition of their national tax bases.[36] The OECD, a forum comprised of member countries striving to address the challeng-

32. *Id.*

33. *See, e.g.*, Hongbin Cai & Qiao Liu, *Competition and Corporate Tax Avoidance: Evidence from Chinese Industrial Firms*, 119 ECON. J. 764 (2009).

34. *Policy Brief: BEPS Update No. 3*, OECD (Oct. 2015), https://www.oecd.org/ctp/policy-brief-beps-2015.pdf, [https://perma.cc/4NS5-VB5G]. *See generally About the Inclusive Framework on BEPS*, OECD, http://www.oecd.org/tax/beps/beps-about.htm (last visited Jan. 12, 2017), [https://perma.cc/E242-FRJK]; Vito Tanzi, *Globalization, Tax Competition and the Future of Tax Systems* (IMF, Working Paper No. 96/141, 1996), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=883038, [https://perma.cc/W3ZX-PH5Q].

35. The "Economic Substance Doctrine" is codified in I.R.C. § 7701(o) and states that a transaction must change a taxpayer's economic position in a meaningful way and must have a substantial purpose apart from the reduction of a taxpayer's tax burden in order to be respected. I.R.C. § 7701(o) (2012). A jurisdiction lacking economic substance is one in which a taxpayer violates the economic substance doctrine, such as a tax shelter.

36. Patrick Love, *BEPS: Why You're Taxed More Than a Multinational*, OECD INSIGHTS BLOG (Feb. 13, 2013), http://oecdinsights.org/2013/02/13/beps-why-youre-taxed-more-than-a-multinational/, [https://perma.cc/7NW4-MX2R].

es of globalization,[37] aptly refers to these tax avoidance tactics as Base Erosion and Profit Shifting, or "BEPS."[38]

Returning to the simplified MMC example, *supra*, suppose that the transfer pricing policy applied to MMC-Ireland's distribution function is tested using a profit-based method that assesses MMC-Ireland's operating margin with respect to its distribution activities against the operating margins established by the financial results of comparable European distributors over a similar period (e.g., the last three taxable years). Hypothetically, suppose that the resulting benchmarking set of comparable European distributors produces an interquartile range of operating margins between two and seven percent. If MMC-Ireland earned an operating margin of thirty percent, suggesting it is more profitable than comparable distribution companies with similar function, risk, and asset profiles, the Mexican taxing authority might assert that MMC-Mexico was underpaid for vehicles purchased by MMC-Ireland, which earned disproportionately high profits on this trade flow. To address this perceived deficiency, the Mexican taxing authority might impose an upward adjustment on MMC-Mexico's taxable income. Because the evidence of MMC's economic substance in Ireland (i.e., distribution services) does not appear to align with the substantial profits accruing there, one might inquire into whether MMC is inappropriately shifting profits out of countries with relatively higher corporate tax rates (e.g., Mexico) and into Ireland, notorious for its low corporate tax rate, in order to reduce its overall corporate tax burden.

The OECD "conservatively" estimates that tax revenue losses from BEPS fall between USD 100 billion and USD 240 billion annually, or between four and ten percent of global corporate income tax revenues.[39] In addition to enabling tax revenue losses, the OECD argues that BEPS undermines the tax system by:

- providing unfair tax advantages to MNEs that exploit gaps and mismatches in the tax system to gain competitive advantages over solely domestic companies;
- depressing confidence in the fairness of the tax system;
- raising monitoring costs incurred by taxing authorities to identify non-compliant MNEs;

37. OECD GUIDELINES, *supra* note 1, at 608.

38. *Policy Brief: BEPS Update No. 3*, *supra* note 34.

39. *Id. See also OECD/G20 BEPS Project 2015 Final Reports: Information Brief* 3, OECD (2015), http://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf, [https://perma.cc/D448-2L5E].

- unduly burdening individual taxpayers who must pay a greater portion of the country's tax burden; and
- harming the MNEs themselves if they face reputational damage as public perception of their aggressive tax planning sours.[40]

The G20 and OECD kicked off the BEPS Project in 2013 as a multilateral effort to close the legal gaps that permit aggressive tax planning, with the aim of achieving international tax rules and results that are coherent across jurisdictions, transparent, and driven by economic substance (i.e., such that "MNEs report profits where economic activities are carried out and value is created").[41] In October 2015, the G20 and OECD released a consolidated "BEPS Package" including final reports covering the fifteen Actions initially identified as part of the *Action Plan on Base Erosion and Profit Shifting* in 2013.[42] Adoption and implementation of these non-binding "soft law legal instruments"[43] is underway, at various stages across the Actions and across countries, with no clear path toward "swift and consistent"[44] implementation or monitoring in sight.[45] As succinctly highlighted in the 2016 BDO Tax Outlook Survey:

BEPS is one of the most ambitious reform initiatives

40. *OECD/G20 BEPS Project 2015 Final Reports: Information Brief*, *supra* note 39, at 3; *Policy Brief: BEPS Update No. 3*, *supra* note 34; Interview by Richard Collier with Pascal Saint-Amans, (Feb. 2014), https://www.pwc.com/gx/en/tax/tax-policy-administration/beps/assets/pwc-tax-interview-transcript.pdf, [https://perma.cc/G86J-7L8X].

41. *OECD/G20 BEPS Project 2015 Final Reports: Information Brief*, *supra* note 39; *Policy Brief: BEPS Update No. 3*, *supra* note 34.

42. *OECD/G20 BEPS Project 2015 Final Reports: Information Brief*, *supra* note 39. In broad strokes, the 15 BEPS Actions are as follows: Digital Economy (Action 1); Hybrids (Action 2); CFC Rules (Action 3); Interest Deductions (Action 4); Harmful Tax Practices (Action 5); Treaty Abuse (Action 6); Permanent Establishment Status (Action 7); Transfer Pricing – Intangibles (Action 8); Transfer Pricing – Risk & Capital (Action 9); Transfer Pricing – High-Risk Transactions (Action 10); BEPS Data Analysis (Action 11); Disclosure of Aggressive Tax Planning (Action 12); Transfer Pricing Documentation (Action 13); Dispute Resolution (Action 14); and Multilateral Instrument (Action 15). *See BEPS Actions*, OECD, http://www.oecd.org/tax/beps/beps-actions.htm (last visited Jan. 11, 2017), [https://perma.cc/DAK6-MUWK].

43. *OECD/G20 BEPS Project 2015 Final Reports: Frequently Asked Questions* 5, OECD (2015), http://www.oecd.org/ctp/beps-frequently-asked-questions.pdf, [https://perma.cc/HT2V-NSB7].

44. *OECD/G20 BEPS Project 2015 Final Reports: Information Brief*, *supra* note 39, at 6.

45. *BEPS Implementation Matrices*, DELOITTE, https://www2.deloitte.com/global/en/pages/tax/articles/beps-action-implementation-matrices.html (last visited Jan. 11, 2017), [https://perma.cc/L5PD-R39Z].

> ever undertaken on an international scale . . . [T]he tax regulatory and reporting environment is in a state of major flux. The BEPS recommendations may be applied differently by different countries, which is creating more uncertainty and confusion for multinational businesses.[46]

Notably, rather than blaming opportunistic corporate taxpayers for the leeching effects of BEPS, the OECD has fairly asserted that BEPS is caused by "domestic laws and rules which are not coordinated across borders, international standards which have not always kept pace with the changing global business environment, and an endemic and worrying lack of data and information."[47] Notwithstanding the OECD's charitable placement of blame for BEPS with the *system*—and not the corporate *taxpayer* using the system to its advantage—corporate taxpayers are ultimately punished for the lack of transparency in the international tax system through adjustments,[48] penalties,[49] and double taxation[50] imposed by aggressive taxing authorities who can capitalize on this lack of certainty when defining what is "arm's length" under their narration of the facts and circumstances. Indeed, where taxing authorities rely on presumptive estimations of transfer prices, some have suggested that the corporate income tax is no longer a genuine income tax at all.[51] This controversial feature of the global transfer pricing system, namely, the theoretical tug-of-war between taxing authorities and corporate taxpayers over the assumptions underpinning the hazy arm's length standard, echoes throughout this Note and its conclusion that negotiated agreement between these parties represents the "best method" to address the challenges of pricing intra-group loans.

46. *2016 BDO Tax Outlook Survey*, BDO 3 (2016), https://www.bdo.com/getattachment/af796075-7626-45b3-bb05-2d0e8a8c0103/attachment.aspx?2016TaxOutlookSurvey.pdf, [https://perma.cc/J8Q8-G9AE].

47. *OECD/G20 BEPS Project 2015 Final Reports: Information Brief*, *supra* note 39, at 3.

48. I.R.C. § 482 (2012).

49. See I.R.C. § 6662 (2012), which imposes accuracy-related penalties on underpayment due to substantial or gross valuation misstatements.

50. James M. Hill, *Dealing with the Secondary U.S. Tax Consequences of Transfer-Pricing Adjustments*, TAX ADVISER (June 1, 2013), https://www.thetaxadviser.com/issues/2013/jun/hill-june2013.html (explaining that transfer pricing adjustments may result in double taxation where no competent authority relief is available), [https://perma.cc/PLE3-TLK5].

51. Tanzi, *supra* note 34, at 8.

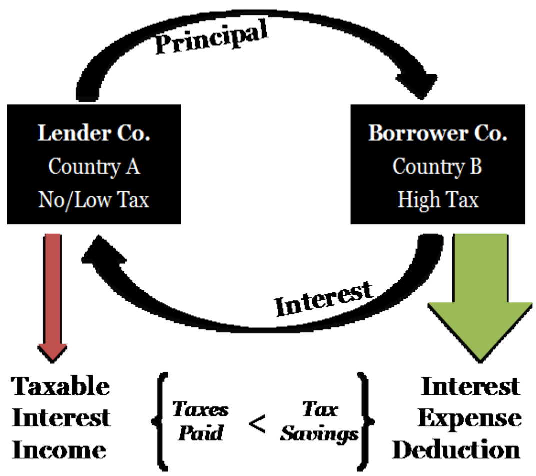
With the backdrop of the contemporary transfer pricing landscape now firmly established through this introduction, the remainder of this Note grapples with the unique problem of applying these complex principles to intra-group loans executed between controlled taxpayers.

II. STRUCTURE & REGULATION OF INTRA-GROUP DEBT TRANSACTIONS

A. Designing Intra-group Debt Transactions

MNEs regularly utilize intra-group debt transactions to more efficiently allocate group resources among their various legal entities, simultaneously funding global business operations and maximizing shareholder value.[52] Of the five core forms of remittance to and from a parent company (i.e., equity injections, loans, dividends, royalties, and fees or charges), intra-group loans notably represent the only means of temporarily moving funds between a parent and subsidiary.[53]

Figure 1: Simplified Intra-group Loan



Meanwhile, the OECD acknowledges that "[t]he use of third party and related party interest is one of the most simple of the profit-shifting techniques available in international tax planning."[54] The tax motivations and mechanics underpinning such earnings stripping transactions are straightforward. As most countries treat debt and

52. Ass'n of Corp. Treasurers, *Seeking a Perfect Structure: Inter-company Funding and Alternative Funding Solutions*, TREASURER 14, 15 (Spring 2009), http://www.treasurers.org/ACTmedia/Spring09TTCMSCertICM14-16.pdf, [https://perma.cc/52AB-YBCB].

53. *Id*. at 16.

54. *OECD/G20 BEPS Project 2015 Final Report: Frequently Asked Questions*, *supra* note 43, at 10. *See also* Jennifer Blouin et al., *Thin Capitalization Rules and Multinational Firm Capital Structure* (IMF, Working Paper No. 14/12, 2014), http://www.imf.org/external/pubs/ft/wp/2014/wp1412.pdf, [https://perma.cc/QLT8-KL9J].

equity differently for corporate tax purposes, permitting the deduction of interest on debt from taxable income, MNEs are incentivized to use debt financing if they are able to offset income that would otherwise be taxable at a rate higher than the rate applied to associated interest income.[55] Thus, as illustrated in Figure 1, MNEs that borrow (and therefore take interest deductions) in high-tax countries and pay interest to affiliates in zero-tax or no-tax countries (frequently where the MNE has low levels of actual business activity) are able to unlock significant tax benefits.[56] Moreover, because a MNE controls the magnitude of its intra-group lending, it can cunningly structure networks of tax-motivated loans between controlled entities that produce interest deductions far greater than the MNE's third party interest expense.[57] From a U.S. perspective, such tactics may inappropriately erode the U.S. corporate tax base.

We can generalize about two lenses through which intra-group debt transactions might be viewed. First, BEPS-critics (i.e., advocates for less onerous regulation) might argue that reasonable interest payments are a fundamental cost of business used to appropriately compensate lenders for the use of their capital.[58] Rather than starting from the premise that selectively sourcing intra-group debt is an outright abuse, they begin with the premise that informed governments have already considered the effects that their corporate tax rates will have on resident businesses when developing their respective tax policies.[59] As one commentator observed, "[t]he [BEPS] drafters are clearly bothered by the existence of tax rate differences across countries . . . The seeming premise of the drafters that finance cost should be incurred in the lowest tax location is radical indeed."[60] Proponents of this view might be more likely to support the traditional arm's length standard of intra-group loan pricing.

Alternatively, BEPS-supporters (i.e., advocates for more

55. *OECD/G20 BEPS Project 2015 Final Reports: Frequently Asked Questions*, *supra* note 43, at 10. *See also* MICHAEL J. GRAETZ, FOLLOW THE MONEY 233 (2016).

56. Michael C. Durst, *The Tax Policy Outlook for Developing Countries: Reflections on International Formulary Apportionment* 6 (ICTD, Working Paper No. 32, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2587860&download=yes, [https://perma.cc/3K78-KK7G].

57. *OECD/G20 BEPS Project 2015 Final Reports: Frequently Asked Questions*, *supra* note 43, at 10.

58. James J. Tobin, Esq., *BEPS and Interest: A Bad Formula*, BLOOMBERG BNA (Mar. 18, 2015), http://www.bna.com/beps-interest-bad-n17179924145/, [https://perma.cc/L26E-DQ5U].

59. *Id.*

60. *Id.*

stringent regulation) might suggest that intra-group interest payments and deductions form the center of an aggressive tax avoidance strategy used to improperly further BEPS and earnings stripping. The academic commentary surrounding global transfer pricing has lurched in this direction under G20 and OECD leadership.[61] Proponents of this view might be more willing to support a movement to a global formulary apportionment standard.[62]

The next two sections of this Note provide (i) an overview of the traditional arm's length standard-based regulatory architecture applicable to intra-group debt transactions, with a focus on the U.S. transfer pricing regulations, as well as (ii) an exploration of certain new developments (i.e., BEPS and I.R.C. § 385) and the ambiguities that they introduce with respect to the transfer pricing of related party loans.

B. Traditional Regulatory Architecture Applicable to Intra-group Debt Transactions

In contrast to the simplicity of *arranging* tax-driven intra-group debt transactions, *assessing* the tax treatment of resulting interest payment flows "is now one of the most complex aspects of income tax law."[63] In their critical discussion of the *Chevron* case, Richard J. Vann and Graeme S. Cooper of The University of Sydney Law School suggest four methods through which a government might challenge an intra-group loan that it suspects of furthering BEPS. While each of these methods is introduced below to give a more complete picture of a taxing authority's enforcement toolkit, the transfer pricing rules (i.e., the fourth method) are the central concern of this Note.[64]

1. General Anti-Avoidance Rules

First, if the country has enacted such a rule, the government

61. *See, e.g.*, GRAETZ, *supra* note 55, at 232 (suggesting that the ability to secure deductions in higher-tax countries for borrowing to invest in lower-tax countries creates incentives for bad investments that decrease worldwide welfare).

62. In general, under the formulary apportionment method, "the income of a group is measured on an aggregate international basis, and is then divided among the different group members according to measures of their relative levels of economic activity, such as perhaps their relative level of sales." Durst, *supra* note 56, at 6.

63. GRAETZ, *supra* note 55, at 224.

64. Vann & Cooper, *supra* note 5, at 4.

could invoke its General Anti-Avoidance Rule ("GAAR"). These broad statutory rules generally allow a taxing authority to deny the benefits of an arrangement that a taxpayer has entered for an "impermissible tax-related purpose."[65] For example, in the Australian *Orica*[66] case, a U.S. subsidiary of an Australian company lent certain funds to the Australian parent, generating deductions in Australia and a stream of interest income in the U.S., where the subsidiary had large tax losses that sheltered the income.[67] The Federal Court of Australia upheld the ATO's application of the GAAR and its assessment of administrative penalties against the Australian parent, concluding that the transaction had no commercial purpose from the perspective of the borrower and was fashioned for the dominant purpose of tax avoidance in Australia.[68]

2. Controlled Foreign Corporation Rules

Second, it might be possible to invoke a country's controlled foreign corporation rules, which require that taxpayers include income generated by certain foreign affiliates to prevent artificial deferral of taxes. For example, in the United States, the complex Subpart F rules exist to deny tax deferral for movable income (e.g., dividends, interest, rent, and royalties) earned through a controlled foreign corporation located in a low-tax or no-tax country.[69] Similarly, in Australia, the controlled foreign corporation rules aim to tax passive income and income that has been stripped out of Australian entities and into foreign companies that are not residents of comparable tax jurisdictions.[70]

65. *General Anti-Avoidance Rules: What Are the Key Elements to a Balanced Approach?* 1, PwC (June 4, 2012), https://www.pwc.com.au/tax/assets/tax-controversy-06jun12.pdf, [https://perma.cc/DKH4-35CJ].

66. *Orica Ltd v Comm'r of Tax'n* [2015] FCA 1399 (Austl.).

67. *The Orica Decision and its Implications* 1, GREENWOODS & HEBERT SMITH FREEHILLS (Dec. 14, 2015), http://www.greenwoods.com.au/media/1727/tb-re-orica-decision-dated-14-december-2015.pdf, [https://perma.cc/9BPV-XC3X].

68. *Id.* at 2.

69. INTERNAL REVENUE SERV., LB&I INT'L PRACTICE SERVICE CONCEPT UNIT: SUBPART F OVERVIEW (Sept. 3, 2014), https://www.irs.gov/pub/int_practice_units/DPLCUV_2_01.PDF, [https://perma.cc/W9Z8-C4N4].

70. Vann & Cooper, *supra* note 5, at 4–6.

3. Thin Capitalization Rules

Third, the government could invoke its thin capitalization rules, which function to limit the total interest deductions that a company may take on its debt.[71] Thin capitalization analyses typically compare a company's debt relative to its assets or equity and cap deductible interest at a certain threshold—treating the excess as taxable dividends—if the company's capital structure reflects too much debt.[72] In the context of intra-group loans, a taxing authority might successfully seek to attack a company's internal leverage ratio (i.e., the ratio of debt from related parties to equity).[73]

4. Transfer Pricing Rules

Finally, the government could challenge the choice or application of the transfer pricing methodology applied to determine an individual loan's interest rate. In doing so, the government could seek to adjust the amount of interest income or deductible interest expense that each loan generates.[74] In the scenario presented in Table 1, we might expect to see a transfer pricing dispute in Country B if the government believes that the transfer price (i.e., the interest rate) is too high. Traditionally, analyses based on the arm's length principle have not been centrally concerned with scrutinizing the business purpose underlying in-

Table 1: Mock Transfer Pricing Dispute

	Country A Low Tax (*Location of Lending*)	Country B High Tax (*Location of Borrowing*)
Government	Wants **High** Interest Rate (to maximize taxable income)	Wants **Low** Interest Rate (to minimize deductions) <u>Argument</u>: interest rate is **above** the arm's length range.
MNE	Wants **High** Interest Rate (to maximize deductions) <u>Argument</u>: interest rate is **within** the arm's length range.	

71. Blouin et al., *supra* note 54, at 7.

72. *Id.* at 8; Ass'n of Corp. Treasurers, *supra* note 52, at 15.

73. Blouin et al., *supra* note 54, at 4.

74. Vann & Cooper, *supra* note 5, at 7–8.

tra-group financing transactions. Instead, the transfer pricing rules have generally focused on a more detached comparison between the interest rate charged between controlled borrowers and lenders and the market rate that would be charged between uncontrolled parties transacting under comparable conditions.[75]

Under the traditional U.S. transfer pricing regulations, introduced in Part I in their general form, intra-group debt arrangements receive special treatment. Specifically, controlled taxpayers have three choices with respect to the method by which they set and/or defend the interest rates payable on their bona fide[76] related party loans: (i) the safe haven rule; (ii) the situs rule; and (iii) a general comparability analysis supported by a transfer pricing study. Outside of the safe haven and situs rules, the regulations governing comparability are vague and provide little guidance to taxpayers.[77]

a. Safe Haven Analysis

Pursuant to Treas. Reg. § 1.482-2(a)(2)(iii), taxpayers (with certain exceptions)[78] have the option to comply with a "safe haven" provision based on the applicable federal rate ("AFR"). Under that provision, a U.S. dollar denominated interest rate is considered arm's length if it is "[n]ot less than 100 percent of the [AFR] (lower limit)" and "[n]ot greater than 130 percent of the [AFR] (upper limit)."[79] Where the actual interest rate charged falls below the lower limit, the IRS considers the lower limit to be the arm's length interest rate and

75. Durst, *supra* note 56, at 15.

76. Treas. Reg. § 1.482-2(a)(1)(ii)(B) (2011) excludes various instances of "alleged indebtedness" from the protections afforded by compliance with the U.S. transfer pricing regulations, even if the stated interest rate falls within the safe haven rates. For example, where alleged indebtedness is in reality a capital contribution to a corporation, a corporate distribution with respect to its shares, or a lease of property, such payments are treated according to their substance and not their form.

77. Matt C. Courtnage, *Important Considerations in the Pricing of Intercompany Loans and Financial Guarantees*, INSIGHTS 19, 19 (Winter 2015), http://www.willamette.com/insights_journal/15/winter_2015_3.pdf ("The existing guidance from the [Internal Revenue] Service and the Organization for Economic Co-operation and Development (OECD) for pricing intercompany loans and financial guarantees is somewhat vague and open to interpretation."), [https://perma.cc/V47Q-YPEW].

78. The safe haven interest rates do not apply to (i) lenders that are engaged in the trade or business of making loans or advances to unrelated parties or (ii) loans or advances expressed in a currency other than U.S. dollars. Treas. Reg. §§ 1.482-2(a)(2)(iii)(D) and (E) (2011).

79. Treas. Reg. § 1.482-2(a)(2)(iii)(B)(1) (2011). AFRs are defined in Treas. Reg. § 1.482(a)(2)(iii)(C) (2011) based on the tenor of the loan.

compounds it semiannually.[80] Where the interest rate charged falls above the upper limit, the IRS generally (with complexities not considered in this Note) determines that the upper limit is the arm's length interest rate and compounds it semiannually.[81]

The safe haven provision is taxpayer-elective, and is frequently disregarded because the AFRs do not account for many of the nuances of bespoke loan agreements and therefore do not capture the true credit risk of individual transactions. For example, the AFR covers only three maturity "buckets": loans with maturities of 0–3 years reference the "short-term rate," loans with maturities of 3–9 years reference the "mid-term rate," and loans with maturities of greater than 9 years reference the "long-term rate."[82] Additionally, the AFRs are not adjusted for (i) influential counterparty characteristics such as size, industry, or line of business, or (ii) relevant environmental factors such as political, economic, or currency risk.[83] Moreover, the AFRs are not applicable to foreign currency loans.[84] Finally, foreign taxing authorities are likely to contest the AFRs in transfer pricing disputes where local-country lenders transact with U.S. borrowers because the AFRs, which are made up of U.S. Treasury rates, tend to be rather low.[85]

b. The Situs Rule

If a lender obtains third-party funds at the situs of the borrower, which it then uses to make a loan to the borrower, the interest rate should generally be the "rate actually paid by the lender increased by an amount which reflects the costs or deductions incurred by the lender in borrowing such amounts and making such loans," unless the taxpayer supports a more appropriate rate.[86] For example, if a foreign parent company uses the proceeds of a loan that it borrowed in the United States to finance a loan to a U.S. subsidiary, the arm's length interest rate is the rate that the foreign parent paid to borrow the funds in the United States plus any other costs or deductions incurred in the borrowing and subsequent lending.[87]

---

80. Treas. Reg. § 1.482-2(a)(2)(iii)(B)(2) (2011).

81. Treas. Reg. § 1.482-2(a)(2)(iii)(B)(3) (2011).

82. Courtnage, *supra* note 77, at 21.

83. *Id*.

84. *Id*.

85. *Id*.

86. Treas. Reg. § 1.482-2(a)(2)(ii) (2011).

87. INTERNAL REVENUE SERV., LB&I INT'L PRACTICE SERVICE TRANSACTION UNIT:

c. Arm's Length Comparability Analysis

If taxpayers elect not to charge the safe haven interest rates, and if the situs rule does not apply, they must determine a "true" arm's length interest rate based on the loose comparability guidelines provided in Treas. Reg. § 1.482-2(a)(2)(i).[88] Instead of identifying a particular transfer pricing method (or methods) for application in the specific context of intra-group loan pricing, the U.S. transfer pricing regulations broadly call for "a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances."[89] In calculating such rate, the regulations state that taxpayers should consider "all relevant factors," including the following comparability criteria: (i) the principal amount of the loan; (ii) the duration of the loan;[90] (iii) the security involved; (iv) the credit standing of the borrower;[91] and (v) the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties.[92] Applying the best method rule, as is required by the U.S. transfer pricing regulations, the imprecise comparability guidance outlined above is probably best labeled an "unspecified method"[93] because (apart from advising the taxpayer to consider all relevant factors in setting an arm's length price) the regulations do not clearly identify a list of methods to be applied with respect to intra-group debt analyses[94] the way that they do for services[95] transactions and

INTERCOMPANY INTEREST RATES UNDER THE SITUS RULE OF IRC SECTION 482, 3 (Jan. 8, 2016), https://www.irs.gov/pub/int_practice_units/ISI9422_08_01.pdf, [https://perma.cc/K6EP-Z8D2].

88. Treas. Reg. § 1.482-2(a)(2)(i) (2011).

89. *Id*.

90. On a normal yield curve, the interest rate increases as the time to maturity lengthens. Gregg Fisher, *What the Yield Curve is Telling Investors*, FORBES (June 8, 2010), http://www.forbes.com/2010/06/08/yield-curve-predictor-personal-finance-indicator.html, [https://perma.cc/6NNK-QT6A].

91. The interest rate that a lender demands increases as the borrower's credit rating, which approximates its "capacity and willingness to meet its financial commitments as they come due," declines. *S&P Global Ratings Definitions*, STANDARD & POOR'S (Aug. 18, 2016), https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352, [https://perma.cc/X6UU-PUTQ].

92. Treas. Reg. § 1.482-2(a)(2)(i) (2011).

93. *See* Treas. Reg. § 1.6662-6(d)(3)(ii)(C) (2011).

94. Courtnage, *supra* note 77, at 20.

95. *See* Treas. Reg. § 1.482-9 (2011).

transfers of tangible[96] or intangible[97] property.

In many countries, the transfer pricing regulations do not individually discuss intra-group loans in the way that Treas. Reg. § 1.482-2(a) attempts to give separate treatment to "[l]oans or advances."[98] For example, the OECD Guidelines consider debt and financial services transactions to be "intra-group services" transactions subject to the OECD's specified transfer pricing methods.[99] According to a 2013 study conducted by PricewaterhouseCoopers, the most commonly accepted method to evaluate arm's length interest rates (chosen by eighty-four percent of survey respondents across forty countries) was the external comparable uncontrolled price ("CUP") method.[100] The external CUP method, which is the preferred method under the OECD Guidelines where applicable,[101] also exists as a specified method under the U.S. transfer pricing regulations.[102] This method directly "evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction,"[103] with comparability adjustments made to the third party data as necessary. The comparable uncontrolled transactions can take place between a controlled entity and an uncontrolled party (an "internal" CUP) or between two uncontrolled parties (an "external" CUP).

The choice of the external CUP is not surprising given the availability of external third-party loan data (and other market data). For example, databases such as Bloomberg and LoanConnector contain data that can be sorted and analyzed using the comparability cri-

96. *See* Treas. Reg. § 1.482-3 (1995).

97. *See* Treas. Reg. § 1.482-4 (2011).

98. *Progress, but No Guarantees for the Consistent Treatment of Intercompany Financing Transactions* 4, PwC (2013), https://www.pwc.com/gx/en/tax/publications/transfer-pricing/perspectives/assets/tpp-progressbutnoguarantees.pdf, [https://perma.cc/GU7T-DKB5]. Treas. Reg. § 1.482-2(a).

99. Courtnage, *supra* note 77, at 22. OECD GUIDELINES, *supra* note 1, ch. VII.

100. *Progress, but No Guarantees for the Consistent Treatment of Intercompany Financing Transactions*, *supra* note 98, at 4. Less commonly used methods include reliance on bank quotes, insurance pricing models, standby letters of credit, credit default swaps, and put options. *See also* Courtnage, *supra* note 77, at 23. Given the dominance of the external CUP, these methods are not given further consideration in this Note.

101. OECD GUIDELINES, *supra* note 1, ¶ 2.15 ("Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP method is preferable over all other methods.").

102. *See* Treas. Reg. § 1.482-3(b) (1995).

103. *See* Treas. Reg. § 1.482-3(b)(1) (1995).

teria suggested by the U.S. transfer pricing regulations. The application of an "unspecified method" similar to an external CUP will be detailed, *infra*, because it is the primary transfer pricing methodology that this Note recommends for implementation under intra-group debt APAs.

As with other transfer pricing arrangements, the IRS has the authority to "make appropriate allocations to reflect an arm's length rate of interest" for the use of an intra-group loan or advance if a controlled entity "either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest."[104] In other words, if a loan is originated in the United States and the IRS's application of the external CUP method suggests that the controlled U.S. lender should be charging a controlled foreign borrower more than it is presently charging, the IRS might attempt to make an adjustment.

While the transfer pricing regulatory system described to this point has operated in the United States and countries that have adopted the OECD Guidelines for many years, critics suggest that it has fueled a growing corporate appetite for strategic transactions that further BEPS.[105] For example, a U.S. borrower formulating its own transfer pricing policies might devise a database search strategy that allows it to cherry-pick the uncontrolled loans establishing the arm's length range in its external CUP analysis, creating an artificially high range that inflates its interest expense deductions. Alternatively, transfer pricing economists performing tax planning services on behalf of a U.S. lender might advise their client to shift its pricing to the very bottom of the arm's length range, extracting tax savings beyond which the company would otherwise have realized by charging a higher interest rate. In light of these and other criticisms of the broader regulatory environment surrounding intra-group debt transactions, numerous proposals and changes have rattled the regulatory

104. Treas. Reg. § 1.482-2(a)(1)(i) (2011).

105. OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments—Action 4: 2015 Final Report*, at 3 (2015), http://www.oecd-ilibrary.org/docserver/download/2315311e.pdf?expires=1484256758&id=id&accname=guest&checksum=8B757ABF4417FEEC3258C37B32BA797A [hereinafter *BEPS Action 4 Final Report*] ("Weaknesses in the current rules create opportunities for [BEPS], requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created."), [https://perma.cc/J8BN-SQGW]. More dramatically, Nobel Prize-winning economist Joseph Stiglitz has argued that eliminating the arm's length principle altogether is a necessary step in the battle against MNEs that use tax planning to inappropriately shift income out of the United States. Alex Parker, *Another Voice for Formulary Apportionment*, BLOOMBERG BNA (June 9, 2014), https://www.bna.com/voice-formulary-apportionment-b17179891148/, [https://perma.cc/TGY3-U2V5].

environment in recent years. The next section of this Note considers these upheavals and the new uncertainties that they create for taxpayers.

C. Regulatory Uncertainty in a Post-BEPS World[106]

In large part because of BEPS, the norms governing the pricing and allocation of intra-group funding costs are in flux in many important respects. MNEs face unprecedented regulatory uncertainty in the charting of their international tax footprints as each country determines whether it will implement, and how it will interpret, the new BEPS guidance. This Note presents a cursory tour of these changes, beginning with a discussion of certain BEPS Actions directly related to transfer pricing. Next, it briefly mentions several other BEPS Actions related to intra-group loans (e.g., interest deductibility). Finally, it introduces the new I.R.C. § 385 regulations and their potential impact on transfer pricing.

1. BEPS

a. Actions 8–10: Aligning Transfer Pricing Outcomes with Value Creation

BEPS Actions 8–10, which focus on various aspects of global transfer pricing, are substantially consistent with the traditional U.S. transfer pricing regulations described above. The Treasury Department suggests that harmonizing the rules will not require "substantial" changes to existing U.S. rules.[107] Notably, however, the Actions specifically advise that taxing authorities are empowered to address transactions on the basis of their economic substance over their form, suggesting greater authority to re-characterize or disregard critical aspects of transactions if, for example, the taxing authority does not believe that the transaction would have been adopted by uncontrolled entities "behaving in a commercially rational manner."[108]

106. This overview is not intended to be comprehensive, and is meant to give a brief flavor for the changing regulatory environment induced by BEPS. For a more thorough analysis of the regulatory impact of BEPS on intra-group lending, see Vikram Chand, *Transfer Pricing Aspects of Intra-Group Loans in Light of the Base Erosion and Profit Shifting Action Plan*, 44 INTERTAX 885, 885 (2016).

107. *BEPS Implementation by Country: United States* 3, DELOITTE (Mar. 2017), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-beps-actions-implementation-united-states.pdf, [https://perma.cc/T984-XC73].

108. Chand, *supra* note 106, at 887–88. OECD, *Aligning Transfer Pricing Outcomes with Value Creation—Action 8–10: 2015 Final Report* ¶ 1.122 (2015), http://www.oecd-

b. Action 13: Transfer Pricing Documentation & Country-by-Country Reporting

BEPS Action 13, which proposes a three-tiered structure (including a Local File,[109] Master File, and Country-by-Country Report) to transfer pricing documentation, aims to promote transparency and consistent reporting that will make it easier for taxing authorities to identify BEPS.[110] The Master File, a new requirement introduced by Action 13, presents a high-level outline of a MNE's global operations, its transfer pricing policies, and the global allocation of its income and economic activity.[111] The Master File guidance specifically requires that taxpayers disclose information about their intercompany financial transactions, including: (i) a description of the MNE's financing, including both related and important unrelated lenders; (ii) identification of controlled entities that perform central financing functions; and (iii) a description of the MNE's intercompany financing transfer pricing policies.[112]

While the United States has not yet legislatively required the creation of a Master File, Deloitte posits that the IRS will likely ask for a taxpayer's Master File during an audit if such report already exists.[113] Because many countries (including Spain, Australia, and Japan) already require the Master File, the IRS is likely to gain access to this audit roadmap even without a U.S. reporting requirement.[114]

The Country-by-Country Report, which requires disclosure of a MNE's key financial and operational data (e.g., unrelated and related party revenues, income tax paid, number of employees, stated cap-

ilibrary.org/docserver/download/2315351e.pdf?expires=1484257798&id=id&accname=guest&checksum=1F8077E16233BD406717EEC5DCD026D1 [hereinafter *BEPS Action 8–10 Final Report*], [https://perma.cc/XSN8-K6RJ].

109. The local file requirement is a country-specific transaction-based reporting requirement satisfied by the U.S. contemporaneous transfer pricing documentation requirement.

110. OECD, *Transfer Pricing Documentation and Country-by-Country Reporting—Action 13: 2015 Final Report* 9 (2015), http://www.oecd-ilibrary.org/docserver/download/2315381e.pdf?expires=1484258076&id=id&accname=guest&checksum=634071AD71D600266562C1319BC4CB55 [hereinafter *BEPS Action 13 Final Report*], [https://perma.cc/V3KT-ZKY2].

111. *Id.* at 9, 14–15.

112. *Id*. at 26.

113. *BEPS Implementation by Country: United States*, *supra* note 107, at 34.

114. *BEPS Action 13: Country Implementation Summary* 1, KPMG (Jan. 6, 2017), https://home.kpmg.com/content/dam/kpmg/xx/pdf/2017/01/tnf-beps-action-13-january6-2017.pdf, [https://perma.cc/L9KV-E5GS].

ital, and tangible assets) in addition to its primary business functions (e.g., internal group finance), has been adopted in the United States as Form 8975 and will provide the IRS with a convenient litmus test against which to test its BEPS suspicions.[115]

c. Action 4: Limiting Base Erosion Involving Interest Deductions

BEPS Action 4, which establishes a common approach to preventing BEPS through artificial interest deductions, sets forth two domestic law solutions. First, it recommends a "fixed ratio rule" that would permit an entity to take interest deductions of between ten and thirty percent of its earnings before interest, taxes, depreciation, and amortization ("EBITDA").[116] Second, it recommends an optional "group ratio rule" permitting certain entities with net interest expense above the fixed ratio to deduct interest up to the level of its worldwide group's ratio of net interest over EBITDA.[117] Although any disallowed interest expense may be carried back or forward, the key implication of Action 4 is that an entity's aggregate interest deductions might be limited even if individual transactions are conducted at arm's length transfer prices, thereby increasing the risk of double taxation.[118] The G20/OECD countries are "expected to converge over time through the implementation of the agreed common approaches;"[119] however, no legislative proposals on Action 4 were active in the United States as of March 2017.[120]

Other BEPS Actions affecting intra-group debt, such as those regarding hybrid mismatch arrangements (Action 2), controlled foreign corporation rules (Action 3), the denial of treaty benefits (Action 6), and counteracting harmful tax competition (Action 5) are not discussed herein. Having introduced the complexity and breadth of the BEPS Project, a more specific discussion of its murky impact is best left to another day.

115. *BEPS Implementation by Country: United States*, *supra* note 107, at 4.

116. *BEPS Action 4 Final Report*, *supra* note 105, at 11.

117. *Id*.

118. Chand, *supra* note 106, at 899.

119. *OECD/G20 BEPS Project 2015 Final Reports: Frequently Asked Questions*, *supra* note 43, at 5.

120. *BEPS Implementation by Country: United States*, *supra* note 107, at 2.

2. I.R.C. § 385

Thin capitalization rules, alluded to *infra*, are arguably inseparable from the transfer pricing rules for intra-group debt. As an initial matter, a transaction must be characterized as debt (and not equity) in order to necessitate the payment of an arm's length amount of interest. The U.S. transfer pricing regulations accomplish this by requiring that debt is "bona fide."[121] If a loan is re-characterized or non-recognized by the taxing authority in the borrower's country, the MNE loses its intended tax benefit.[122]

In October 2016, the Treasury Department and IRS released a 518 page regulatory package under I.R.C. § 385, which addresses the debt versus equity treatment of certain related party transactions.[123] The proposed regulations faced significant criticism from Congress and taxpayers alike, generating over 200 comment letters.[124] The final regulations are narrower in scope than the proposed regulations in that they focus on certain related party debt instruments that the IRS believes have the potential to erode the U.S. tax base, but significant uncertainty remains.[125]

The international tax system is currently lost in the dust of its own reconstruction. As each country is working with a different political and economic blueprint, the developing regulatory architecture is on course for a wobbly future. If corporations don't take action to protect their optimal structures, they should be prepared for increased exposure to disruptive tax risks such as double taxation and costly cross-border disputes.[126]

III. THE *CHEVRON* CASE

In light of increasing international attention on the transfer pricing space, it may be expected that taxing authorities will be eager to flex their strengthened enforcement muscles in the coming

121. Treas. Reg. 1.482-2(a)(1) (2011).

122. Chand, *supra* note 106, at 886.

123. *New Section 385 Regulations Significantly Limit Scope* 1, PwC Tax Insights (Oct. 14, 2016), http://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-new-section-385-regulations-significantly-limit-scope.pdf, [https://perma.cc/LF9L-GERQ].

124. *Id*.

125. *Id*.

126. *10 Minutes on the OECD's BEPS Project* 1, PwC 10Minutes (Dec. 2015), http://www.pwc.com/us/en/10minutes/pwc-10minutes-oecd-beps-global-tax-reform.pdf, [https://perma.cc/YZ99-SDSG].

years.[127] At a certain point, disputes might become so costly that MNEs elect to change their business strategies in certain countries.[128] Because MNEs ultimately pass on the costs of such disputes to their shareholders or customers,[129] it is vital to understand and control these costs. The Australian *Chevron* case helps highlight the risks that MNEs might face when taxing authorities sink their teeth into the economics underlying even a *single* intra-group loan.

A. Facts

Chevron Corporation (previously known as Chevron U.S.A. Inc.) ("CVX") is a U.S.-based MNE engaged in exploration, production, and distribution activities in nearly all facets of the energy industry, including crude oil, natural gas, transportation fuels and lubricants, petrochemicals and additives, and geothermal energy.[130] CVX conducts business in thirty-six countries[131] and operates its significant Australian operations through an indirect wholly-owned subsidiary, Chevron Australia Holdings Pty Ltd ("CAHPL"). CAHPL has the dominant stake in the massive Gorgon and Wheatstone natural gas projects, and is an equal one-sixth foundation participant in the North West Shelf Project, Australia's largest oil and gas development.[132]

1. Intercompany Funding Structure

127. Monique van Herksen et al., *The Impact of BEPS on Tax Controversy*, EY TAX INSIGHTS (Apr. 25, 2016), http://taxinsights.ey.com/archive/archive-articles/the-impact-of-beps-on-tax-controversy.aspx, [https://perma.cc/UK56-55GE].

128. *Id*.

129. *Id*.

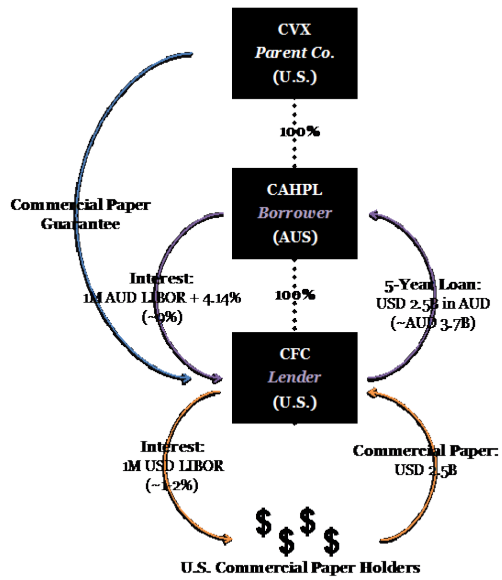
130. CHEVRON CORP., 2015 ANNUAL REPORT 6 (2015), https://www.chevron.com/-/media/chevron/annual-report/2015/2015-Annual-Report.pdf, [https://perma.cc/6ZXK-EFBS].

131. *About Chevron Australia*, CHEVRON AUSTRALIA, https://www.chevronaustralia.com/aboutchevronaustralia (last visited Sept. 22, 2017), [https://perma.cc/C7GC-2K28].

132. *North West Shelf Project*, CHEVRON AUSTRALIA, https://www.chevronaustralia.com/our-businesses/north-west-shelf-project (last visited Sept. 22, 2017), [https://perma.cc/5EF9-969R]; *Gorgon Project*, CHEVRON AUSTRALIA, https://www.chevronaustralia.com/our-businesses/gorgon (last visited Sept. 22, 2017), [https://perma.cc/SH84-LZMD]; *Wheatstone Project*, CHEVRON AUSTRALIA, https://www.chevronaustralia.com/our-businesses/wheatstone (last visited Sept. 22, 2017), [https://perma.cc/HP6T-F3KC].

In 2003, CAHPL entered a five-year Credit Facility Agreement with ChevronTexaco Funding Corporation ("CFC") (now Chevron Funding Corporation), an indirect wholly-owned subsidiary of CAHPL incorporated under the laws of Delaware to provide CAHPL with funding for general corporate purposes.[133] CAHPL claimed that the purpose of the challenged loan was to refinance preexisting debt and to fund its Australian exploration activities (e.g., Gorgon).[134] The terms of the borrowing were as follows: (i) CFC lent CAHPL the Australian dollar ("AUD") equivalent of USD 2.5 billion (approximately AUD 3.7 billion) on an unsecured basis for five years (ultimately extended until 2010); and (ii) CAHPL paid monthly interest at a rate of one month ("1M") AUD LIBOR plus 4.14% (approximately nine percent) and had the option of early principal repayment.[135] CVX did not guarantee CAHPL's performance under the intercompany loan agreement.[136] Moreover, the intercompany loan agreement contained no financial or operational covenants that might have had the effect of reinforcing CAHPL's creditworthiness as a borrower.[137] Given the lack of parental guarantee or covenants, evidence presented at trial suggested that this loan would have received a non-investment grade rating.[138] Under these terms, Goldman Sachs and Deutsche

Figure 2: CFC/CAHPL U.S.-Australian Funding Structure



133. ChevronTexaco Funding Corp., Registration Statement (Form S-3) (Nov. 14, 2003), https://www.sec.gov/Archives/edgar/data/93410/000119312503081167/ds3.txt, [https://perma.cc/XE4L-ENLC]; Vann & Cooper, *supra* note 5, at 2.

134. Chand, *supra* note 106, at 894; Vann & Cooper, *supra* note 5, at 2; *Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n [No. 4]*, at ¶ 113.

135. Chand, *supra* note 106, at 894; Vann & Cooper, *supra* note 5, at 2.

136. Chand, *supra* note 106, at 894.

137. *Id*.

138. Vann & Cooper, *supra* note 5, at 2.

Bank advised that a high interest rate would be appropriate.[139]

CFC sourced and on-lent the funds to CAHPL by accessing the U.S. commercial paper market under the following terms: (i) U.S. commercial paper holders lent CFC USD 2.5 billion from the U.S. commercial paper market; and (ii) CFC paid interest at or near USD LIBOR (approximately one to two percent).[140] CVX guaranteed CFC's performance to its unrelated lenders, triggering a high investment grade rating and lower interest rate.

2. Tax Structure

Chevron's CFC-CAHPL funding structure generated significant tax benefits for CAHPL. First, CAHPL claimed a deduction in Australia for all interest expense paid to CFC at around nine percent.[141] Second, CFC secured an exemption from Australia's ten percent withholding tax through a 2003 ATO Private Ruling covering interest paid by CAHPL to CFC.[142] Third, although it made a substantial profit (around AUD 1.1 billion) owing to the interest spread of around seven percent, CFC's resulting interest income was disregarded under the U.S. check-the-box rules, which allow certain eligible entities to elect their classification for U.S. federal tax purposes (and accordingly provide significant U.S. tax planning opportunities).[143] Finally, CFC would periodically return the profits it made on the loan to CAHPL as non-assessable dividends pursuant to Australia's participation exemption, which exempts certain shareholders from taxation of dividends received from foreign companies.[144] In

139. *Transfer Pricing Under Attack—State Aid* 40:50–42:50, 5th Annual IBA Tax Conference, INT'L BAR ASS'N (Feb. 9, 2016), http://www.ibanet.org/Conferences/tax_conf_2016_7.aspx#, [https://perma.cc/NWN8-HKXW].

140. Geoff Gill et al., *Australian Court Rules in Favor of Tax Authorities in Chevron Transfer Pricing Case*, ARM'S LENGTH STANDARD 1 (Dec. 2015), http://newsletters.usdbriefs.com/2015/Tax/ALS/151214_1.pdf, [https://perma.cc/T9HR-B372]; Chand, *supra* note 106, at 894.

141. *Transfer Pricing Under Attack—State Aid*, *supra* note 139.

142. *Id. See also* Vann & Cooper, *supra* note 5, at 3.

143. *Australia and US: Federal Court of Australia Rules Against Chevron in Transfer Pricing Case*, EY TAX INSIGHTS (May 9, 2017), http://taxinsights.ey.com/archive/archive-news/australia-and-us--federal-court-of-australia-rules-against-chevron-in-transfer-pricing-case.aspx, [https://perma.cc/KN3F-QUDV]. *But see* Vann & Cooper, *supra* note 5, at 3 (suggesting that U.S. tax treatment of CFC is unclear from the record).

144. *Transfer Pricing Under Attack—State Aid*, *supra* note 139. *See also* Vann & Cooper, *supra* note 5, at 3.

this regard, Chevron established an incredibly efficient intra-group funding structure that continued to lower the group's overall funding cost as CAHPL paid more interest.[145] Ultimately, the tax deduction pulled the group's interest cost below USD LIBOR.[146]

B. Dispute

Like Country B in the mock dispute modeled in Table 1, *supra*, Australia's ATO challenged the high interest rate charged on the CFC-CAHPL loan for the taxable years ending December 31, 2003, through December 31, 2007 ("Covered Period"), grounding its opposition in domestic transfer pricing law and disallowing more than fifty percent of CAHPL's interest expense deductions.[147] In addition to making an upward adjustment to CAHPL's taxable income for the Covered Period, the ATO assessed a twenty-five percent scheme shortfall penalty because, without the transfer pricing "scheme benefit" obtained by the controlled taxpayers, it was reasonable to believe that CAHPL would have borrowed from a third party at a lower, arm's length interest rate.[148]

At trial, the central question was whether or not the transfer pricing policy resulted in an arm's length allocation of income and expense between the United States and Australia under the circumstances of the loan. In other words, was the intercompany interest rate paid by CAHPL to CFC too high? Did it inappropriately reduce CAHPL's Australian taxable income?

On October 23, 2015, after a five-week trial that sorted through nineteen expert witnesses, additional lay witnesses, and forty-five expert reports, the Federal Court of Australia released a 206-page opinion upholding the transfer pricing adjustments and penalties assessed by the ATO.[149] Holding that CAHPL had not sufficiently shown that the interest rate was within or below the arm's length range,[150] Justice Robertson explained:

> I find that but for the conditions operating between

145. *Transfer Pricing Under Attack—State Aid*, *supra* note 139.

146. *Id*.

147. Vann & Cooper, *supra* note 5, at 3; *Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n [No. 4]*, at ¶ 5.

148. *Deconstructing the Chevron Transfer Pricing Case*, *supra* note 5, at 7; *Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n [No. 4]*, at ¶ 5.

149. Vann & Cooper, *supra* note 5, at 7; *Deconstructing the Chevron Transfer Pricing Case*, *supra* note 5, at 1.

150. *Deconstructing the Chevron Transfer Pricing Case*, *supra* note 5, at 1.

> CAHPL and CFC which differ from those which might be expected to operate between independent parties dealing wholly independently with one another an amount of profits might be expected to have accrued but has not so accrued.[151]

Specifically, the court took issue with the absence of security or operational and financial covenants provided by CAHPL:

> If the property had been acquired under an agreement between independent parties dealing at arm's length with each other, I find that the borrower would have given such security and operational and financial covenants and the interest rate, as a consequence, would have been lower. The limited scope of the consideration given or agreed to be given by CAHPL resulted in the consideration which CAHPL did give, the promise to pay the interest rate, exceeding the arm's length consideration in respect of the acquisition.[152]

Agreeing with the ATO's determination that the dominant purpose of the loan was to obtain a tax benefit (and not to refinance existing AUD-denominated debt, as Chevron contended), the court explained:

> [R]efinancing was not the dominant purpose of the scheme as refinancing could be achieved by borrowing at an arm's length interest rate which CAHPL did not. . . . [I]t is reasonable to conclude that CAHPL entered into the Credit Facility Agreement for the dominant purpose of obtaining a "scheme benefit."[153]

On April 21, 2017, the Full Court of the Federal Court of Australia dismissed Chevron's appeal of the October 23, 2015 decision.[154] In this opinion, Chief Justice Allsop diverted the focus of the economic analysis away from CAHPL's own security or covenants as "[t]here may have been a question, on the evidence, whether CAHPL was in a position to give security."[155] Instead, the court emphasized that "the reasonable expectation would be that Chevron or a company in Chevron's position would give a guarantee; and so security and any covenants given by CAHPL or the company in its position would be of no

151. *Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n [No. 4]*, at ¶ 614.

152. *Id.* ¶ 87.

153. *Id.* ¶ 628–29.

154. *Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n* [2017] FCAFC 62 ¶ 159 (Austl.).

155. *Id.* ¶ 60.

relevant consequence."[156] The Chief Justice explained his invocation of the implicit guarantee as follows:

> Part of the assessment of what consideration is reasonably to be expected to be given [by CAHPL] are the facts that are likely or reasonably to be expected to attend such a transaction with an independent third party. If the evidence reveals (as it did here) that the borrower is part of a group that has a policy to borrow externally at the lowest cost and that has a policy that the parent will generally provide a third party guarantee for a subsidiary that is borrowing externally, there is no reason to ignore those essential facts in order to assess the hypothetical consideration to be given.[157]

Put otherwise, the arm's length principle does not require analyzing CAHPL as an "orphan;" rather, it should be considered a member of the Chevron group.[158] Thus, the Chief Justice determined that an arm's length interest rate would be "the interest rate charged by the lender for the borrowing taking into account the guarantee, not given by the taxpayer, but given by the parent in the position of [CVX],"[159] and that such rate "would have been significantly below 9%."[160]

C. Discussion

The *Chevron* case, which was extremely complex and became one of the longest tax cases ever heard in Australia, should serve as a warning to even the most transfer pricing-savvy taxpayers.[161] While the court conducted its analysis under the Australian transfer pricing rules, several key elements of *Chevron* are relevant for MNEs based in any country that adheres to the arm's length standard. In this regard, *Chevron*—much like the Canadian *GE Capital Canada Inc.*[162]

156. *Id.*

157. *Id.* ¶ 63.

158. *Id.* ¶ 130.

159. *Id.* ¶ 64.

160. *Id.* ¶ 95.

161. *Deconstructing the Chevron Transfer Pricing Case*, *supra* note 5, at 1.

162. *See generally* The Queen v. General Electric Capital Canada Inc. [2010] F.C. 344 (Can.) (explaining that determining arm's length pricing of an intercompany guarantee fee "involves taking into account all the circumstances which bear on the price whether they arise from the relationship or otherwise," including implicit parental support).

case in the context of pricing intercompany guarantees—could become an important reference point for corporate taxpayers. Prominently, the *Chevron* court commented on several enduring ambiguities in the intra-group debt space, including: (i) the estimation of the borrower's credit rating, including the impact of implied parental support; (ii) the ability of the court to re-characterize or reconstruct transactions on the basis of conditions not present between the controlled parties; (iii) the application of the external CUP; and (iv) the reliability of transfer pricing economists as expert witnesses.

1. Estimation of the Borrower's Creditworthiness

A critical (and contentious) part of an external CUP loan analysis is the estimation of the borrower's creditworthiness. The borrower's stand-alone credit rating is frequently one of the most impactful determinants of the arm's length range of interest rates—as a rule, the more creditworthy, the lower the range because the probability of principal and interest repayment increases.[163] Two issues commonly emerge in this area. First, credit ratings, which are assigned by independent ratings agencies such as Moody's, Standard & Poor's, and Fitch, are frequently unavailable for both public and private companies, including certain affiliates of rated parent companies.[164] As such, transfer pricing economists commonly (i) utilize synthetic credit rating tools offered by independent ratings agencies;[165] and/or (ii) "notch down" from a parent's listed credit rating,

163. For example, a borrower that receives a "AAA" rating from Standard & Poor's has received the highest rating available, and "[t]he obligor's capacity to meet its financial commitments on the obligation is extremely strong." Conversely, a borrower that receives a "BB" rating "faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions that could lead to the obligor's inadequate capacity to meet its financial commitments on the obligation." *S&P Global Ratings Definitions*, *supra* note 91.

164. John C. Hollas & Gordon Hands, *Comparability Adjustments: Finding an Arm's-Length Interest Rate* 3, TAX MGMT. TRANSFER PRICING REP. (2009), http://www.cuftanalytics.com/Portals/52/Users/080/12/5712/CUFTanalytics_BNA_Comparability%20Adjustments_Finding%20an%20Arm's%20Length%20Interest%20Rate_Sept%2024-09.pdf, [https://perma.cc/Q2QG-DA24]; Aswath Damodaran, *Estimating a Synthetic Rating and Cost of Debt*, N.Y.U. STERN SCH. OF BUS., http://pages.stern.nyu.edu/~adamodar/New_Home_Page/valquestions/syntrating.htm (last visited Oct. 27, 2017), [https://perma.cc/V3EM-RXGJ]; Doron Nissim, *Synthetic Credit Ratings and the Inefficiency of Agency Ratings* (Columbia Bus. Sch., Research Paper No. 17-81, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3012723, [https://perma.cc/KPA8-2W9C].

165. For example, Moody's Analytics RiskCalc™ tool "offers a comprehensive approach to assessing the default and recovery of private firms and financial institutions." *RiskCalc™*, MOODY'S ANALYTICS, https://www.moodysanalytics.com/product-list/riskcalc

if available, to approximate an unrated subsidiary's respective rating.[166]

Second, in the absence of a legally binding guarantee agreement, it is unclear whether parental credit support should be implied to raise the creditworthiness of a subsidiary borrower based on "the expectation that a parent company will step in to support a subsidiary in the event of financial difficulty and meet its debt obligations."[167] The OECD Guidelines appear to welcome the concept of implied parental support on the basis of the "strength of the group's consolidated balance sheet,"[168] and some taxing authorities assert that the credit ratings of subsidiaries of "strategic importance to the group's ultimate parent company" should be notched upward.[169] Ratings agencies, for their part, regularly make such adjustments to account for implicit support on the basis of factors such as the strategic importance of subsidiaries (Standard & Poor's), the ability and willingness of a parent to support subsidiaries (Moody's), and the strength of parent-subsidiary ties (Fitch).[170]

In the 2015 *Chevron* decision, after an extensive discussion of the issue (since an implied guarantee of CAHPL by CVX could have resulted in upward notching and a lower interest rate), the court suggested that implied credit support has "little, if any, impact on pricing by a lender in the real world," but noted that this conclusion is fact-dependent and that group affiliation could be influential under other circumstances.[171] In addition, contrary to common practice in transfer pricing analyses, the court rejected a credit rating agency-based

(last visited Oct. 27, 2017), [https://perma.cc/7D62-BEC4].

166. Michel van der Breggen, *Netherlands*, *in* TRANSFER PRICING AND INTRA-GROUP FINANCING 417, 429 (Anuschka Bakker & Marc M. Levey eds., 2012); Hollas & Hands, *supra* note 164, at 3. The credit rating of a MNE group or parent is likely to be higher than that of its individual subsidiaries. Vann & Cooper, *supra* note 5, at 30.

167. Paul Wilmshurst, *Dealing with Implicit Support in Relation to Intra-group Debt* 1, CHARLES RIVER ASSOCIATES (2012), https://www.crai.com/sites/default/files/publications/Dealing-with-implicit-support-in-relation-to%20intra-group-debt.pdf, [https://perma.cc/5W6D-8HSU].

168. OECD GUIDELINES, *supra* note 1, ¶¶ 1.164–1.166.

169. Wilmshurst, *supra* note 167, at 1.

170. *Id*. at 3–6.

171. *Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n [No. 4]*, at ¶ 606; Mark Loveday & Kim Atwill, *Landmark Transfer Pricing Win for ATO in Tax Dispute with Chevron*, EY TAX WATCH (Nov. 2015), http://www.ey.com/nz/en/services/tax/ey-tax-watch-edition-10-november-2015-landmark-transfer-pricing-win-for-ato-in-tax-dispute-with-chevron, [https://perma.cc/3WF7-ACL5]; *Deconstructing the Chevron Transfer Pricing Case*, *supra* note 5, at 6; Chand, *supra* note 106, at 895.

approach to estimating borrower creditworthiness, advocating instead for analysis from the perspective of a commercial lender.[172] In the 2017 *Chevron* decision, the court was more willing to consider the impact of an implicit guarantee from CVX, holding that the arm's length principle does not require analyzing CAHPL as an "orphan."[173] Overall, the *Chevron* case does little to resolve the confusion that surrounds the passive association benefit (e.g., ratings methodologies used by banks are non-transparent).[174] If taxpayers cannot reliably predict whether taxing authorities will accept their internal notching practices, the central determinant of loan pricing analysis comes unhinged.

2. Reconstruction of the Transaction Under Nonexistent Conditions

A central debate in *Chevron* was whether the court should reprice the loan under the actual terms of the intercompany agreement or whether it should reconstruct the loan under terms it believed would more realistically occur between uncontrolled entities.[175] The *Chevron* court found that the transfer pricing rules permitted the ATO to adjust factors beyond the interest rate, including security and loan covenants, when analyzing the total consideration transferred under the loan agreement.[176] For example, Justice Robertson found that the ATO could look beyond the form of the transaction to suggest that if the Credit Facility Agreement had been negotiated between two hypothetical uncontrolled parties at arm's length, the borrower (here, a participant in the oil and gas exploration industry[177]) would have had to give both security and certain covenants; under such conditions, a lower interest rate would have been assigned.[178]

172. *Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n [No. 4]*, at ¶ 503; Chand, *supra* note 106, at 894. This can be contrasted with the guarantee fee analysis in the *GE Capital Canada* case, where the judge accepted credit rating agency practices as relevant to arm's length analysis. The Queen v. General Electric Capital Canada Inc. [2010]; *Deconstructing the Chevron Transfer Pricing Case*, *supra* note 5, at 6.

173. *Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n* [2017], at ¶¶ 63–65, 130.

174. Chand, *supra* note 106, at 894; Vann & Cooper, *supra* note 5, at 27.

175. Vann & Cooper, *supra* note 5, at 18.

176. *Deconstructing the Chevron Transfer Pricing Case*, *supra* note 5, at 4.

177. *Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n [No. 4]*, at ¶ 80.

178. *Deconstructing the Chevron Transfer Pricing Case*, *supra* note 5, at 4. *See also Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n* [2017], at ¶¶ 82–94 (discussing "conditions operating between CAHPL and CFC which differ from conditions that might be expected to operate between CAHPL and an independent lender" and concluding that "the transaction actually entered between associated enterprises" should be given "weight, but not

The ATO took issue with eleven substantive conditions[179] that it claimed differed from those that might be expected in an uncontrolled transaction, and the court accepted many of them. Moreover, the 2015 *Chevron* court remarkably suggested that the ATO need not "identify how each identified condition was said to have impacted on the pricing of the loan and to have resulted in the non-accrual of profits."[180] While the court indicated that this hypothetical "re-write" of a loan between unrelated parties should not "depart from reality more than is necessary for the hypothesis" and "should remain close to undertaking the actual loan,"[181] *Chevron* confers a tremendous power upon the government and a parallel uncertainty upon taxpayers.

It bears mentioning that had domestic Australian law been worded differently,[182] this loan might have been re-characterized as equity and not just reconstructed under different terms as described above. Specifically, given the lack of financial covenants and security, there was strong evidence that no lender would have agreed to this loan with CAHPL at arm's length.[183] For similar reasons, under the new BEPS guidance developed in Actions 8–10, taxing authorities could probably apply the "commercially rational" behavior test to the *Chevron* loan.[184] Under this test, an intra-group loan may be disregarded for transfer pricing purposes—triggering double taxation—if the loan differs from that which parties behaving in a "commercially

irredeemable inflexibility" when assessing the transfer price charged).

179. The eleven conditions included the following:

> [T]hat CAHPL owned CFC and they both had a common parent, CVX; CVX Treasury decided how much debt and at what interest rate CAHPL should borrow from CFC; there was no bargaining or negotiation between CAHPL and CFC; the terms and conditions of the Credit Facility Agreement, including the terms in respect of the interest rate charged, the duration and the currency of the loan and the absence of covenants; the sole reason for CFC's incorporation, and the purpose of its commercial paper program, was to raise funds solely to on-lend to its parent CAHPL; that the credit profiles of CFC and CAHPL could be controlled by decisions made by CVX; that CFC profited from lending to CAHPL at a high interest rate; and the higher the interest-bearing loan from CFC and the higher the interest rate, the more profit CAHPL stood to make.

Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n [No. 4], at ¶ 582.

180. *Id.* ¶ 585.

181. *Id.* ¶ 499. *See also Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n* [2017], at ¶ 90 (reiterating that the actual transaction "may, to a degree, be altered if it is necessary to do so to permit the transaction to be analysed through the lens of mutually independent parties").

182. The Australian tax law authorized only price adjustments, not re-characterization.

183. Chand, *supra* note 106, at 894.

184. *BEPS Action 8–10 Final Report*, *supra* note 108, at ¶ 1.122.

rational manner" would adopt.[185]

Taxpayers should be aware of the persuasive value of *Chevron* and the new BEPS guidance, which could encourage taxing authorities to reconstruct or, more dramatically, re-characterize intragroup loans.

3. External CUP Analysis

The *Chevron* court expected "arguably, unrealistically high"[186] standards of comparability under the external CUP method. The court rejected each of the uncontrolled loan agreements put forth by both the ATO and CAHPL, suggesting that their terms differed significantly from those of the tested loan and that (despite the fact that the taxpayer consulted two investment banks regarding the chosen interest rate) the CFC-CAHPL agreement would never exist between uncontrolled commercial lenders and borrowers.[187]

4. Expert Witnesses

Despite the laborious efforts that went into calling nineteen expert witnesses (including oil and gas industry experts, commercial lenders, banking industry experts, transfer pricing economists, bond rating experts, an accounting expert, a former U.S.-Australia tax treaty negotiator, and a former OECD official with expertise in the OECD Guidelines) and many additional lay witnesses, Justice Robertson spent 118 pages of his 2015 opinion summarizing—and largely discounting—their testimony.[188]

The court was especially critical of transfer pricing witnesses on both sides, slighting the robustness of their comparability analyses and criticizing them for not assessing the arm's length nature of all terms and conditions of the related party agreements.[189] Of course,

185. *Id.*; Chand, *supra* note 106, at 894.

186. *The Chevron Transfer Pricing Case—The Story So Far*, GREENWOODS & HEBERT SMITH FREEHILLS 6 (Nov. 5, 2015), http://www.greenwoods.com.au/media/1721/new-tb-re-chevron-dated-5-november-2015.pdf, [https://perma.cc/GQ7U-XAQZ]; Vann & Cooper, *supra* note 5, at 31.

187. *The Chevron Transfer Pricing Case—The Story So Far*, *supra* note 186, at 6–7. Reasons put forth included differing principal amounts, existence of security or financial covenants, differing tenors, and differing industries, among others. Chand, *supra* note 106, at 895; Vann & Cooper, *supra* note 5, at 31–32.

188. Vann & Cooper, *supra* note 5, at 7–8.

189. *Deconstructing the Chevron Transfer Pricing Case*, *supra* note 5, at 3. *See, e.g.*

transfer pricing is a largely subjective field in which results-oriented experts may arrive at different arm's length ranges on the basis of equally reasonable assumptions about the taxpayer's functions, risks, assets, and industry. Warning future taxpayers proposing transfer pricing evidence, Justice Robertson stated, "I give no weight to the opinions of transfer pricing economists where those opinions appear not to be founded in the statutory language which the Court must apply."[190] Given the perception that transfer pricing studies can be manipulated by pulling countless factual and economic levers, taxpayers should prepare for the court's scrutiny of their experts' economic analyses in the event of litigation.

5. Transfer Pricing Audit Appetite

The *Chevron* case presents a tremendous win for taxing authorities at a time when BEPS is pressuring governments to more stringently enforce their transfer pricing rules. Seeking to replicate this victory, taxing authorities within and outside Australia might be emboldened to take on more inbound financing audits. Moreover, despite the length and complexity of *Chevron*, taxing authorities might view funding transactions as low-hanging fruit when compared with harder transactions for which no reliable comparables exist (e.g., a highly bespoke, hard-to-value intangibles transaction involving a partially developed or novel technology with uncertain future cash flows or income projections).[191] As Vann and Cooper stated so pithily, "The decision in *Chevron* displays again the greatest indictment of the transfer pricing edifice: its inability to handle even the simplest questions in anything like a straightforward manner."[192]

IV. THE ADVANCE PRICING & MUTUAL AGREEMENT PROGRAM

As the majority of this Note has aimed to demonstrate, the arm's length range lies at the center of a costly legal and economic tug-of-war between taxpayers and taxing authorities. The rules of the

---

Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n [No. 4], at ¶ 381.

190. *Chevron Austl. Holdings Pty Ltd v Comm'r of Tax'n [No. 4]*, at ¶ 500; Vann & Cooper, *supra* note 5, at 8.

191. OECD GUIDELINES, *supra* note 1, ¶ 6.189. For a discussion of the complexity of intangible property cases, see Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 392–404 (2013).

192. Vann & Cooper, *supra* note 5, at 9.

game are vague and increasingly political, and the courts choose their winners based on a subjective analysis of the taxpayer's functional, risk, and asset profile in the context of a particular industry, geographic region, and trade flow. As the IRS candidly acknowledges, "[t]ransfer pricing cases are usually won and lost on the facts."[193]

Through the APMA Program, taxpayers can mitigate their transfer pricing exposure by negotiating with the IRS to prearrange joint victories before commencing high-risk transactions. Given the regulatory disorder overlaying even the most inoffensive transfer pricing arrangements, this Note advises that U.S. corporate taxpayers with high-volume and/or high-value intra-group debt transactions consider entering the APMA Program to gain more prospective—and even retrospective[194]—tax certainty.

A. Overview of the APMA Program

The APMA Program, an office of the U.S. competent authority within the IRS's Large Business and International Division, has a stated mission of "resolv[ing] actual or potential transfer pricing disputes in a timely, principled, and cooperative manner"[195] in such a way that "secures the appropriate tax bases of the United States and its treaty partners."[196]

APAs are binding[197] unilateral (between the taxpayer and one taxing authority), bilateral (between the taxpayer and two taxing authorities), or multilateral (between the taxpayer and more than two taxing authorities) agreements that stipulate negotiated transfer pricing methodologies ("TPMs") that the taxpayer must apply with respect to specified "Covered Transactions" over a fixed "APA Term" that generally spans at least five to seven taxable years.[198] Each year

193. INTERNAL REVENUE SERV., TRANSFER PRICING AUDIT ROADMAP 1 (Feb. 2014), https://www.irs.gov/pub/irs-utl/FinalTrfPrcRoadMap.pdf, [https://perma.cc/6QNQ-4HR4].

194. ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS, *supra* note 7, at 12; Rev. Proc. 2015-41 § 3.03.

195. INTERNAL REVENUE SERV., ADVANCE PRICING AND MUTUAL AGREEMENT PROGRAM (Oct. 7, 2016), https://www.irs.gov/businesses/corporations/apma, [https://perma.cc/E3KX-ADT6].

196. Rev. Proc. 2015-41 § 2.02(1).

197. Rev. Proc. 2015-41 § 6.01.

198. *APAs: The Basic Elements*, EY, http://www.ey.com/gl/en/services/tax/international-tax/guide-to-advance-pricing-agreements--apa----apas--the-basic-elements (last visited Jan. 13, 2017), [https://perma.cc/Z3WB-52P7]; ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS, *supra* note 7, at 11.

of the APA Term, taxpayers file an "APA Annual Report" that demonstrates the taxpayer's compliance with the TPM and calculates "Primary Adjustments" to taxable income as necessary to achieve compliance.[199] Provided the taxpayer accurately applies the TPM and does not violate "Critical Assumptions" enumerated in the APA, such as the standard assumption that the taxpayer's business activities, functions performed, risks assumed, assets employed, and tax and financial accounting practices "will remain materially the same as described or used" in the APA request,[200] the IRS is committed to accepting the financial results generated by the TPM.[201]

At its core, the APA process promotes a "spirit of openness and cooperation"[202] by allowing for the "discussion and resolution [of issues] in advance, before the consequences of such resolution are fully known to either taxpayers or the IRS."[203] APAs save time and costs for both taxpayers and the IRS, warding off many potential years of tax controversy and permitting more efficient allocation of audit resources.[204] In this spirit, APAs may be revised by agreement of the parties.[205]

Since 1991, taxpayers have filed 2,245 APA applications, with 1,597 agreements executed and 398 requests pending by year-end 2016.[206] In 2016, taxpayers filed ninety-eight APA applications (down from a record-setting 183 APA applications in 2015[207]), including fourteen unilateral requests, eighty-four bilateral requests, and no multilateral requests.[208] On average, it took 37.9 months to complete new and renewal APAs executed during 2016, with unilateral APAs averaging 24.1 months and bilateral APAs averaging 42.4

199. FUNDAMENTALS OF INTERNATIONAL BUSINESS TRANSACTIONS 1326 (Ronald Brand ed., 2000); ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS, *supra* note 7, at 1314; Rev. Proc. 2015-41 §§ 7.01, 7.02.

200. ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS, *supra* note 7, at 11, 23.

201. Rev. Proc. 2015-41 § 6.02.

202. To incentivize disclosure, the APA Request and any supplementary materials are considered confidential return information. Rev. Proc. 2015-41 § 9.01.

203. Rev. Proc. 2015-41 § 2.02(2).

204. Monique van Herksen et al., *supra* note 127, at 42.

205. Rev. Proc. 2015-41 § 7.05.

206. ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS, *supra* note 7, at 3–4.

207. *Id.* at 3.

208. *Id.*

months.[209]

Covered Transactions in APAs executed during 2016 included the sale of tangible property into or out of the United States (forty-four percent), the performance of services by a U.S. or non-U.S. entity (thirty-four percent), the use of intangible property by a U.S. or non-U.S. entity (twenty percent), and other types of transactions (two percent).[210] Because the U.S. transfer pricing regulations discuss intra-group debt transactions separately from "services" transactions, and because loans are not defined as belonging to the "services" category,[211] it is assumed that intra-group debt transactions fall into the rather trivial "all other types of covered transactions" category.[212]

Revenue Procedure ("Rev. Proc.") 2015-41[213] is the primary authority providing taxpayers with "guidance and instructions on filing APA requests as well as guidance and information on the administration of APAs."[214] Under IRS practice, the APA process has five phases: (i) application; (ii) due diligence; (iii) analysis; (iv) discussion and agreement; and (v) drafting, review, and execution.[215] The next section of this Note discusses the overlooked opportunity presented by intra-group debt APAs and walks through an application of Rev. Proc. 2015-41 to a hypothetical intra-group debt transaction with the external CUP as the TPM.

B. Intra-group Debt APAs

1. Agreement on Underlying Methodologies, Not Just Specific Prices

Generalizing from the limited publicly available IRS data introduced above, it appears that taxpayers have not greatly leveraged the APMA Program to support their intra-group debt transactions (although it is noted that the IRS lists Bloomberg and LoanConnector as commonly used sources of external comparable data).[216] Argua-

209. *Id*. at 12.

210. *Id*. at 8.

211. Courtnage, *supra* note 77, at 20.

212. ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS, *supra* note 7, at 8.

213. Rev. Proc. 2015-41 supersedes Rev. Proc. 2006-9 (as modified by Rev. Proc. 2008-31). Rev. Proc. 2015-41 § 1.01.

214. ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS, *supra* note 7, at 2.

215. *Id.* at 3–4.

216. *Id.* at 10.

bly, the APMA Program's domination by tangible and intangible goods transfers and services transactions—as opposed to intercompany financial transactions such as loans—has been driven in part by (i) the bespoke nature of loans, (ii) the extensive amount of time necessary to arrive at negotiated agreement with the IRS, (iii) the difficulty of predicting an entity's financing needs years in advance, and (iv) fewer IRS audits of intra-group debt matters.

The first three of these theorized reasons seem to begin with the faulty premise that the APA Program exists as a mechanism that facilitates agreement regarding standalone *prices* (in this context, the interest that is paid on an individual loan). On the contrary, this Note strongly posits that the APMA Program, which is centrally concerned with the negotiation of TPMs (where "M" stands for "methodology"), is fundamentally a process that allows parties to agree on underlying pricing *methodologies* (here, a repeatable process applicable across many different loans with varying characteristics). In this regard, MNEs such as global banks with active central treasuries and capital-intensive companies that rely on intra-group loans to fund their investments and operations (e.g., Chevron) might benefit from taking the time and expense to negotiate an APA.

2. Application of Rev. Proc. 2015-41 to an Intra-group Debt Transaction[217]

MMC's European competitor, Germany-based Deutsche Autos AG ("DA-Parent"), aims to enter the autonomous car business through its U.S. subsidiary ("DA-U.S."). To fund DA-U.S.'s new venture (R&D, new factories, etc.), Deutsche Autos arranges to have DA-U.S. borrow from DA-Parent pursuant to an intercompany loan agreement. Happily, this arrangement also produces a slight tax benefit for the Deutsche Autos global group because the borrowing entity is able to take interest deductions at a relatively higher corporate tax rate than that applied to the lending entity's resultant interest income.[218] Given the potential U.S. tax exposure that this arrangement

217. The reader should note that this represents only one possible method of negotiating an APA for certain intra-group debt transactions. Of course, there are many possible ways that such an analysis could be conducted, and this Note does not purport to put forth the only, or even the best, method. It merely hopes to show that intercompany funding APAs could be useful and should be explored to a greater extent given the current regulatory environment.

218. Of course, the tax consequences of this transaction are subject to change as U.S. or German tax rates are modified. For purposes of this hypothetical, it is assumed that the U.S. corporate tax rate is higher than the German corporate tax rate.

creates should the IRS assert that the interest rate paid by DA-U.S. is too high, Deutche Autos elects to apply for a bilateral APA between the United States and Germany covering intra-group lending transactions between DA-U.S. and DA-Parent. From a U.S. perspective, Rev. Proc. 2015-41 governs the application process and administration of this APA.

a. Pre-filing Requirements, APA Request & Competent Authority Negotiations

Before commencing the APA process, DA-U.S.'s lawyers and/or tax consultants might contact APMA for an informal, anonymous consultation regarding potential covered issues or the APA process in general.[219] To formally initiate the APA process, the taxpayer must: (i) meet certain pre-filing requirements; (ii) submit an APA Request; and (iii) pay a user fee.[220]

If the taxpayer wishes to file a unilateral APA covering an issue that could also be covered under a bilateral or multilateral APA, or if the Covered Transactions will involve intangibles, global trading arrangements, business restructuring, or certain entities (e.g., pass-through entities, hybrid entities, or disregarded entities), Rev. Proc. 2015-41 requires taxpayers to submit a pre-filing memorandum that requests a pre-filing conference with APMA and sets out procedural and/or substantive issues for discussion.[221] Alternatively, taxpayers may voluntarily—and anonymously—submit a pre-filing memorandum should their transaction present a novel or complex issue.[222] Given the apparent complexity of transfer pricing debt (as demonstrated in *Chevron*), it is recommended that DA-U.S. submit pre-filing information and request a pre-filing conference to get the conversation with APMA started early and in a less formal setting. Moreover, as Rev. Proc. 2015-41 requires that taxpayers expand the scope of their proposed APAs to include any "interrelated matters" naturally considered along with the Covered Transactions, the pre-filing conference is a good place to explore transactions that the IRS might lump together with DA-U.S.'s funding transactions.[223]

219. Rev. Proc. 2015-41 § 2.02(5).

220. Rev. Proc. 2015-41 § 2.03(1). User fees are generally USD 60,000 for new APAs and USD 35,000 for renewal APAs, and less for APA Requests eligible to pay "small case" user fees. Rev. Proc. 2015-41 app. § 3.03.

221. Rev. Proc. 2015-41 § 3.02(4).

222. Rev. Proc. 2015-41 § 3.02(5).

223. Rev. Proc. 2015-41 §§ 1.01(1), 2.02(4).

Preparation of the APA Request will be time-intensive and will probably require extensive work by expensive outside lawyers and/or tax consultants. Taxpayers should prepare for thorough functional interviews with key employees, as such interviews form the backbone of the taxpayer's negotiating position with taxing authorities. The APA Request, which consists of a Request Letter and Exhibits, must meet a long list of requirements set out in the Appendix to Rev. Proc. 2015-41.[224] The Request Letter must include an executive summary, administrative information, a detailed explanation of the proposed Covered Transactions, a detailed explanation of the selection and application of the proposed TPMs, and a list of proposed APA terms and conditions.[225] The Exhibits must include administrative items such as an authorization form, "penalties of perjury declaration," and consent to disclosure (in the case of bilateral and multilateral APAs), as well as substantive items such as diagrams of the Covered Transactions and the controlled group's legal and tax structures, a table including a step-by-step summary of the selection process for comparable data (here, external CUPs), a proposed draft APA agreement, financial statements, and written intercompany agreements pertinent to the Covered Transactions.[226]

After APMA determines that an APA Request is complete, the parties will generally hold an opening conference to help the IRS team better understand the facts and circumstances underlying the taxpayer's request.[227] APMA's thorough evaluation process drills deeply into the precise allocation of functions and risks among the controlled entities party to the Covered Transactions.[228] As the IRS and foreign taxing authorities attempt to reach competent authority resolution, taxpayers should be prepared for written information requests by, and phone calls or in-person meetings with, the taxing authorities to discuss their questions and concerns. In the context of an intra-group debt APA, given the number of comparability factors considered in the pricing of a loan and the lack of concretely identified loan pricing methods in the U.S. transfer pricing regulations, success in these negotiations will be critical to the acceptance of the APA.

The APA is effective on the day it is executed by both the

224. Rev. Proc. 2015-41 app. § 1.01.

225. Rev. Proc. 2015-41 app. § 1.02.

226. Rev. Proc. 2015-41 app. § 1.03.

227. Rev. Proc. 2015-41 § 4.03(2).

228. ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS, *supra* note 7, at 9.

IRS and each taxpayer.[229]

b. TPM

As explained above, an application of the best method rule will—in all likelihood—result in a method analogous to the external CUP that is based on direct market comparables. In its APA Request, DA-U.S. must detail the process by which it will apply this method.[230] First, it must establish how it will determine the credit rating of the borrower, DA-U.S., if it does not have a public credit rating. Second, it must establish how it will calculate the agreed arm's length range of interest rates.

If DA-U.S. does not have a public credit rating, the company has a couple options, as introduced above.[231] First, it could attempt to utilize a synthetic credit rating tool published by an independent rating agency.[232] Second, it could argue for a "notching" approach that sets its credit rating a few notches below that of DA-Parent.[233] As *Chevron* warns us, the U.S. and German taxing authorities will likely engage in detailed negotiations on this point after the APA Request is submitted; nevertheless, it seems possible to arrive at an agreement that will establish either: (i) a single credit rating applicable throughout the APA Term, subject to the APA's Critical Assumptions (e.g., DA-U.S. is presumed to have a BB rating); or (ii) a flexible methodology to determine DA-U.S.'s credit rating throughout the APA Term (e.g., notch one or two ratings downward from DA-Parent's rating).

To establish the arm's length range of interest rates, DA-U.S. will search for publicly available uncontrolled transaction data (e.g., bond yield market[234] and corporate loan data[235]) that can be analyzed using comparability factors such as currency, timing of the transac-

229. Rev. Proc. 2015-41 § 4.06.

230. Rev. Proc. 2015-41 app. § 1.02.

231. See *supra* notes 164–166 and accompanying text.

232. *Id*.

233. *Id*.

234. Notably, some have criticized the use of corporate bond yield data as not sufficiently comparable to intercompany loan transactions because corporate bonds are traded in the secondary bond markets. *See* Hollas & Hands, *supra* note 164, at 1.

235. For example, LoanConnector/DealScan contains data on third-party loan transactions. *See LoanConnector/DealScan*, THOMSON REUTERS LPC, https://www.loanpricing.com/products/loanconnectordealscan/ (last visited Oct. 27, 2017), [https://perma.cc/E6UZ-Q9BG].

tion, principal amount, duration of the loan, and embedded loan rights.[236] For example, DA-U.S. might be able to find comparable uncontrolled financial transactions through the publicly available credit agreements that borrowing corporations file with the SEC.[237] Alternatively, DA-U.S. might be able to access Bloomberg's bond yield data, which can be pulled and adjusted for comparability factors such as maturity, currency, sector, and credit rating.[238] Under this approach, DA-U.S. might begin by pulling the yield curves for credit ratings above and below DA-U.S.'s stipulated credit rating (with all other terms held constant) to establish the upper and lower boundaries of the arm's length range. Next, DA-U.S. might have to apply several adjustments to make the bond yield data more comparable to the tested interest rate.[239] For example, DA-U.S.'s loan might be a floating rate loan (whereas the bond yield data presents fixed yields) or denominated in EUR (whereas available bond yield data might be in USD). The APA Request should set out the data sources that DA-U.S. intends to consult for each anticipated comparability adjustment, as well as the process through which it will reliably realize each adjustment. Ultimately, this negotiated step-by-step process should allow for the consistent calculation of arm's length ranges of fixed (e.g., from one percent to three percent) or floating (e.g., 1M USD LIBOR + 50 basis points ("bps") to 1M USD LIBOR + 70 bps) interest rates, as appropriate, against which DA-U.S.'s actual fixed or floating interest rates can be reliably benchmarked over the APA Term.

c. APA Administration

Suppose that during year one of the APA Term, DA-U.S. en-

236. Courtnage, *supra* note 77, at 23 (suggesting that "bond yield market and corporate loan data are common sources which can be aggregated in order to make a best effort at mirroring the financial standing of a particular entity"); Tim Reichert et al., *How To Accurately Price and Design Intercompany Debt* 3 (Economics Partners, LLC, White Paper #2012-02, 2012), http://www.econpartners.com/wp-content/uploads/2015/07/Economics-Partners-White-Paper-2012-02-Accurately-Pricing-Intercompany....pdf, [https://perma.cc/B8ZK-9D43].

237. *See* Hollas & Hands, *supra* note 164, at 1 (noting that "while not all credit agreements provide enough loan pricing detail to enable comparability adjustments . . . even during the credit crunch of 2008, sufficient credit agreements exist to apply the . . . method").

238. *See generally Index Methodology*, BLOOMBERG (2016), https://data.bloomberglp.com/indices/sites/2/2016/01/633470877_INDX_GFI_WP_151022.pdf, [https://perma.cc/ZY3A-7WWW].

239. *See generally* Hollas & Hands, *supra* note 164.

ters an agreement to borrow USD 2 billion in principal from DA-Parent, with a tenor of five years and a (purely hypothetical) interest rate of 3M USD LIBOR + 300 bps, payable quarterly.

At year-end, having established the external CUP as the TPM and set ground-rules for its application, DA-U.S. must submit an APA Annual Report to the IRS, demonstrating its compliance with the TPM.[240] To "test" the actual interest rate charged during the APA year, DA-U.S. will apply the TPM to the tested interest rate. Assuming that the bond-yield methodology sketched above is the TPM, DA-U.S. will first pull data from Bloomberg establishing the five-year bond yield on the loan's effective date for credit ratings above and below DA-U.S.'s stipulated credit rating. Next, DA-U.S. will make adjustments to the bond yield data in accordance with the TPM. If the resulting arm's length range stems from 3M USD LIBOR + 250 bps to 3M USD LIBOR + 500 bps, DA-U.S.'s tested interest rate of 3M USD LIBOR + 300 bps lies within the adjusted comparable range and is compliant with the TPM.

However, had DA-U.S. instead paid an interest rate of 3M USD LIBOR + 550 bps, it would need to make a primary adjustment to back into an interest rate within the calculated arm's length range. Based on guidance from APAs executed in 2016, primary adjustments will probably bring the results to the center or the "closer edge" of the range.[241] While such primary adjustments might limit the tax benefit of the Covered Transactions, the taxpayer will benefit from the avoidance of excessive or unexpected adjustments (as it will have negotiated the methodology ahead of time), penalties, litigation expenses, and associated negative publicity.

C. Exploring a Compulsory Participation Model

As it stands, the APMA Program is a "voluntary process" that taxpayers may engage with in order to hedge risk.[242] However, this Note posits that the IRS could adopt an alternative—and more targeted—solution to confronting BEPS by making the APMA Program (in a unilateral sense) compulsory in certain instances. Specifically, perhaps the IRS should make any taxpayer that has previously demonstrated a lack of compliance with arm's length debt pricing (regardless of intent to avoid taxes) clear its future transfer pricing policies

240. Rev. Proc. 2015-41 § 7.02.

241. ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS, *supra* note 7, at 11.

242. Rev. Proc. 2015-41 § 2.02(2).

through participation in the APMA Program for a prescribed number of years. This piecemeal solution would greatly reduce the risk of "recidivist" profit-shifting through intra-group lending and might serve as a deterrent to the many taxpayers who prefer to keep the IRS at arm's length.

CONCLUSION

Much like the townspeople dressed a woman as a "witch" in *Monty Python and the Holy Grail*, forcing her to don a false nose and pointy hat before proclaiming, "We have found a witch, may we burn her?", the G20/OECD have whipped up a frenzied popular view of MNEs as manipulators that deserve punitive constraints on their competitive processes, including the terms of their debt financing.[243] While the APMA Program presents a promising solution for some taxpayers that seek to mitigate heightened transfer pricing risk in this rekindled regulatory environment, such as financial MNEs with active central treasuries and capital-intensive MNEs that require large intra-group loans to fund their operations, it simply cannot be cost-effective for all taxpayers. In addition to cost concerns, some taxpayers might be hesitant to consent to the exchange of their APAs, APA Annual Reports, and related factual information among taxing authorities pursuant to treaties or other agreements.[244]

Given the necessity of intra-group financing to many MNEs' value chains and the expenses inherent in negotiating and maintaining APAs, perhaps courts should be wary of the negative attention that the BEPS Project casts on related party debt transactions. More broadly, given the relative simplicity of debt arrangements when compared to those involving high-value intangibles with limited or unreliable comparables, perhaps the international community should reconsider the boundaries of its corporate witch-hunt before *Chevron* spreads the fire to more palpably complex intercompany transactions.

*Kailey B. Flanagan**

243. Tobin, *supra* note 58.

244. Rev. Proc. 2015-41 § 9.04.

*J.D. Candidate, Columbia Law School, 2018; B.S.F.S., Georgetown University, 2012. Having worked for three years as a transfer pricing consultant prior to law school, I aim to provide commentary in this Note that is based on independent research yet informed by my own experience in the industry. I am grateful to Professor Michael J. Graetz for his invaluable guidance and feedback throughout the writing of this Note. Opinions expressed are my own and do not reflect the views or opinions of my current or former employers, colleagues, or professors.