

# International Tax Insights

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# Transfer Pricing Year-End Considerations for Multinational Companies

By Leo Parmegiani, CPA, Partner and Ralf Ruedenburg, Principal

A paradigm shift in the “timing” of conducting a transfer pricing analysis should be implemented by chief financial officers, tax directors, controllers, and treasurers to optimize a company’s profitability, moderate global tax exposures, evaluate operational performance and, consequently, increase a company’s earnings per share.

The conventional wisdom is to conduct a transfer pricing analysis annually to comply with Internal Revenue Code (IRC) §6662 documentation requirements, to evaluate whether intercompany pricing policies over the past year rendered an arm’s-length result under IRC §482, contemporaneously with the filing of a company’s tax return. Under the Transfer Pricing Guidelines of the Organization for Economic Cooperation and Development (OECD Guidelines) this has become even more paramount.

## Reasons for Conducting a Transfer Pricing Analysis

There are seven compelling reasons for initiating a transfer pricing assessment in the 4th quarter of a company’s fiscal year, or prior to closing its financial records for the year:

1. **Identify Transfer Pricing Opportunities and Exposures:** Annualizing pro-forma financial statements enables a company to use a transfer pricing analysis to assess economic opportunities (or exposures) within a consolidated group’s system profits, thereby capitalizing on cash-flow opportunities across tax jurisdictions and geographical operational boundaries.
2. **Quantify Arm’s-Length Transfer Pricing Adjustments:** Employing a Transfer Pricing Probability Scorecard (TPPS) allows a company to ascertain the magnitude of intercompany pricing adjustments that can be made in the United States or among foreign affiliates in order to avoid reassessments of income, potential double taxation, and the imposition of non-deductible penalties.
3. **Implement and Coordinate Transfer Pricing Adjustments:** Conducting a transfer pricing analysis provides a company with the flexibility to make transfer pricing adjustments in the United States and foreign tax jurisdictions – with the coordination of auditors and tax advisors in each local country – thus, avoiding potential transfer pricing disagreements proactively, given that many countries do not allow transfer pricing adjustments to be made after closing the annual financial records.
4. **Comply with ASC 740 (Formerly FIN 48) Requirements:** Requiring companies to comply with ASC 740 pertaining to uncertain tax positions necessitates an evaluation of their tax positions under a two-step process:
  - (i) determining whether the tax position taken meets the “more likely than not” standard to be sustained by a taxing authority or court, based on its technical merits, and
  - (ii) undertaking a measurement of the potential benefit the entity must recognize under the ASC 740 rules for financial and tax reporting purposes.
5. **Protect Against Transfer Pricing Ramifications:** Ensures that a company’s transfer pricing position is supportable throughout the year, minimizes potential tax return reporting adjustments upon filing the next-year tax returns, and can avoid potential disagreements with U.S. and foreign tax authorities.
6. **Evaluate Operational Proficiency and Managerial Compensation:** Conducting a transfer pricing assessment relative to comparable third-party companies, provides headquarter management with an objective operational benchmark against which to evaluate affiliated companies’ operational performance, ascertain capital requirements, and ascertain local-country management evaluations

7. **Capitalize on Extraneous Benefits:** Preparing budgets and forecasts, utilizing net operating losses, calculating value-added taxes, and ensuring that custom duties are appropriately accounted for reduces corporate financial risks and optimizes the benefits of a company's intercompany pricing regime.

## Eye on the Year-End

PKF O'Connor Davies, LLP can provide your company with solutions to these issues in order to meet year-end closing deadlines instead of being a year behind when conducting these analyses retrospectively – with potential lost opportunities and exposures that cannot be reconciled. Consequently, chief financial officers, tax directors, controllers, and treasurers can be proactive to optimize the benefits conferred by employing arm's-length transfer pricing principles.

Whether your company needs to update a previously conducted transfer pricing analysis, or is in need of conducting transfer pricing evaluations, our professionals are skilled in assessing your company's opportunities (or potential exposures) to render your company with a supportable transfer pricing position: currently, prospectively, and for historical periods. Our objective is to provide you with value-added transfer pricing solutions that can increase your company's earnings per share.

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## Internal Revenue Service Compliance Campaigns

By Leo Parmegiani, CPA, Partner

In July 2019, the Internal Revenue Service Large Business and International Division (IRS LB&I) announced the approval of additional Tax Compliance Campaigns, three of which affect individuals with international tax complexities. The initiation of a Compliance Campaign means the IRS has identified an area where they believe significant non-compliance exists.

The following campaigns are very important for internationally mobile U.S. persons or former U.S. persons:

### 1. Post-Offshore Voluntary Disclosure Program (OVDP)

This IRS initiative will focus on taxpayers who have failed to comply with the reporting of worldwide income and disclosure of foreign assets including non-U.S. securities and financial accounts. U.S. citizens and permanent residents are subject to worldwide taxation on their global income and must disclose certain foreign holdings. Severe penalties can be imposed for failure to meet these obligations. Over the last 10 years, the IRS has instituted OVDP designed to bring delinquent taxpayers into compliance with the promise of lesser penalties and avoidance of potential criminal charges. The IRS ceased such program in 2018 and will now address noncompliance through soft letters and examinations.

The new announced program is the IRS' latest weapon in combatting U.S. taxpayers living abroad who are not yet in compliance. These individuals should seek assistance from professional tax advisors and consider their options. Putting one's head in the sand is not an option. Relief could still be available in the form of "streamlined procedures" designed to bring non-willful non-compliant U.S. taxpayers into full compliance.

### 2. Expatriation

Another new IRS Compliance Campaign focuses on U.S. citizens and "long-term" residents (those lawful permanent residents with such status for any portion of 8 out of the last 15 years) who expatriated on or after June 17, 2008 who may have not met their filing requirements or tax liability obligations. The IRS will address such noncompliance in a variety of manners, including outreach, soft letters and examinations.

*Expatriation Tax Rules:* A U.S. person will be considered expatriating for tax purposes if he or she formally relinquishes U.S. citizenship requiring a host of conditions to be met or ceases to be

a permanent resident through an official revocation act or has been administratively judicially determined to have abandoned residency. When expatriation occurs, U.S. tax law imposes a mark to market regime, which means all property is treated as sold at fair market value as of the day before the expatriation date under certain circumstances.

Accordingly, a significant tax could be due in the year of expatriation. The IRS is aware that many individuals have expatriated without fulfilling their tax obligations. The new campaign has been instituted to seek out such individuals.

### **3. High Income Non-Filers**

A third international IRS compliance campaign is aimed at high income U.S. citizens and residents who no longer file U.S. income tax returns. Many of these individuals believe incorrectly there are no U.S. tax filings required and that they do not owe U.S. tax. This is clearly not always the case notwithstanding the availability of tax mitigation benefits such as the foreign earned income exclusion (FEI) and foreign tax credits (FTC), which can reduce the tax liability in some cases to zero. Tax returns must be filed to demonstrate that no tax is due.

*Foreign Earned Income Exclusion:* If certain conditions are met, U.S. citizens or resident aliens may qualify to exclude up to \$105,900 in 2019 for FEI plus a foreign housing exclusion.

U.S. citizens and resident aliens may take advantage of foreign tax credits on income which has already been or will be subject to a foreign tax. The foreign tax must be an income tax to qualify. A mechanical formula is available to determine the portion of the foreign tax eligible for a current credit.

Taken together, the FEI and FTC may completely offset one's U.S. tax liability; however, tax returns are required for U.S. and resident aliens in all cases.

### **4. Revocation of U.S. Passports for Taxpayers with Seriously Delinquent Tax Debt**

If an individual is certified as having seriously delinquent tax debt, the IRS transmits a certification to the U.S. State Department for an action such as denial, revocation or limitation of the individual's U.S. passport. Accordingly, applicants whose names are included on a certification are ineligible for a passport.

A seriously delinquent debt means an unpaid legally enforceable federal tax liability that

- (i) has been assessed
- (ii) exceeds \$52,000 (in 2019) and
- (iii) a notice of lien has been filed and the administrative rights have lapsed or been exhausted or a levy exists

If a taxpayer has referred his or her case to an IRS Taxpayer Advocate, there is a possibility the IRS will not proceed with the certification process. Thus, if a case is being handled as a Taxpayer Advocate Service (TAS), it is possible for a taxpayer to maintain his or her passport.

The current acting IRS National Taxpayer Advocate (NTA) has advocated the IRS halt the certification process for taxpayers who are actively working with TAS to resolve their tax liabilities. The NTA also expressed concerns about two aspects of the IRS passport certification program:

- (i) IRS is recommending the revocation of existing passports in certain cases even though IRS standards are vague
- (ii) Technology limitations prevent the IRS from sending certification, decertification and revocation notices to taxpayer representatives.

The NTA hopes to work with the IRS to improve current procedures

## **New Procedures to Enable Certain Expatriated Individuals to Become Compliant with U.S. Tax Filing Obligations**

By Peter D. Baum, CPA, Partner

In September 2019, the U.S. Internal Revenue Service announced new procedures that will enable certain individuals who relinquished their U.S. citizenship to come into compliance with their U.S. tax and filing obligations and receive relief for back taxes.

The Relief Procedures for Certain Former Citizens apply only to individuals who have not filed U.S. tax returns as U.S. citizens or residents, owe a limited amount of back taxes to the United States and have net assets of less than \$2 million. Only taxpayers whose past compliance failures were non-willful can take advantage of these new procedures. Many in this group may have lived outside the United States most of their lives and may have not been aware that they had U.S. tax obligations.

Eligible individuals wishing to use these relief procedures are required to file outstanding U.S. tax returns, including all required schedules and information returns, for the five years preceding and their year of expatriation. Provided that the taxpayer's tax liability does not exceed a total of \$25,000 for the six years in question, the taxpayer is relieved from paying U.S. taxes. The purpose of these procedures is to provide relief for certain former citizens. Individuals who qualify for these procedures will not be assessed penalties and interest.

The IRS is offering these procedures without a specific termination date. The IRS will announce a closing date prior to ending the procedures. Individuals who relinquished their U.S. citizenship any time after March 18, 2010 are eligible as long as they satisfy the other criteria of the procedures.

These procedures are only available to individuals. Estates, trusts, corporations, partnerships and other entities may not use these procedures.

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## **Current Status of U.S. Tax Treaties and International Tax Agreements**

By Ralf Ruedenburg, Principal

In July 2019, the U.S. Senate approved updates to the following tax treaties:

- Japan – 2013 Protocol to amend 2003 Treaty (Japanese Protocol)
- Luxembourg – 2009 Protocol to amend 1996 Treaty (Luxembourg Protocol)
- Spain – 2013 Protocol to amend 1990 Treaty (Spanish Protocol)
- Switzerland – 2009 Protocol to amend 1996 Treaty (Swiss Protocol)

Besides other changes, all protocols introduce updates to exchange of information provisions. It has to be noted that competent authorities are now required to collect and exchange information that may be foreseeably relevant for carrying out the provisions of the treaties and respective domestic laws for all taxes imposed by each country. It is irrelevant if the requested country may not need such information for its own tax purposes or that bank secrecy rules limit disclosure of such information. However, confidentiality provisions and provisions protecting a country from violating its own laws are included in the protocols.

The protocol with Japan entered into force on August 30, 2019 and the protocol with Spain will enter into force on November 27, 2019. Entry-into-force dates for Luxembourg and Switzerland have not been announced yet.

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# Classification of Cloud Transactions and Transactions Involving Digital Content

By Ralf Ruedenburg, Principal

The Internal Revenue Service published proposed regulations regarding the classification of cloud transactions for purposes of the international provisions of the Internal Revenue Code and changes to the sourcing for sales of digital content through an electronic medium (copyrighted article transaction). The proposed regulations would create a flexible and coherent framework to resolve complex tax issues raised by cloud computing transactions and the digital economy.

Cloud transactions are defined as transactions through which a person obtains non-de minimis on-demand network access to computer hardware, digital content, or other similar resources. In general, cloud transactions would have to be classified as the rendition of services or a lease of property. If a cloud-based arrangement comprises “multiple transactions,” it would be required to separately analyze each component of the arrangement.

The new approach for sourcing income from sales of digital content through an electronic medium requires to look where users download digital content. This is a departure from the existing rules for sourcing of inventory products (generally where right, title and interest transfer from sellers to buyers occur).

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## Contact Us

We can discuss your particular facts and circumstances to ascertain how we may be able to assist you and/or your company with respect to any of them matters discussed in this publication. Please contact the partner in charge of your account or any of the following:

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## About PKF O'Connor Davies

PKF O'Connor Davies, LLP is a full-service certified public accounting and advisory firm with a long history of serving clients both domestically and internationally. With roots tracing to 1891, eleven offices in New York, New Jersey, Connecticut, Maryland and Rhode Island, and more than 700 professionals, the Firm provides a complete range of accounting, auditing, tax and management advisory services. PKF O'Connor Davies is ranked 29th on *Accounting Today's* 2019 “Top 100 Firms” list and is recognized as one of the “Top 10 Fastest-Growing Firms.” PKF O'Connor Davies is also recognized as a “Leader in Audit and Accounting” and is ranked among the “Top Firms in the Mid-Atlantic,” by *Accounting Today*. In 2019, PKF O'Connor Davies was named one of the 50 best accounting employers to work for in North America, by *Vault*.

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