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Intercompany Agreements: Well-Drafted Agreements Are Only Half the Battle

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Since joining Mayer Brown in 1989, Scott Stewart's practice has focused exclusively on tax disputes and transfer pricing matters. He represents taxpayers at all levels of federal tax controversy, including audits, administrative appeals before the Internal Revenue Service, mediation involving the Appeals division of the IRS, and litigation before the United States Tax Court. Recognized by *Chambers USA* each year from 2006 through 2015, Scott is described as "a talented litigator and corporate advisor" who wins the confidence of clients with his "extraordinary communication skills" and "broad and deep experience." He is "recommended for his spot-on judgment and analysis," "his responsiveness and strategic thinking" and his "ability to anticipate issues before they arise." *Chambers* notes that he is "particularly adept at handling transfer pricing cases at all levels." Similarly, *Euromoney* recognizes Scott in its "Guide to the World's Leading Tax Advisers" and Legal 500 recognizes his "wide range" of experience and cites his "very strong reputation" in tax controversy.

Scott has extensive experience with deductibility of interest expense in related-party transactions, including debt-versus-equity characterization and "sham transaction" and "economic substance" issues, dating back to his involvement in the landmark *Nestlé Holdings* case during the 1990s. Recently, Scott led the Mayer Brown team that filed 15 Tax Court petitions concerning debt-equity issues on behalf of Tyco International and related companies. The cases involve $3 billion in interest expense incurred from 1998 through 2000.
Scott is also experienced in all aspects of international transfer pricing, including cross-border movements of tangible and intangible property, advance pricing agreements, cost sharing arrangements, Section 6662 documentation, transfer pricing litigation, and issues related to Section 936 Puerto Rico possessions corporations. His transfer pricing litigation experience includes a number of the major cases of the last two decades, such as *National Semiconductor, Seagate Technology, Nestlé Holdings* and *United Parcel Service*.

Scott's experience also includes acquisition-related issues, such as valuation of tangible and intangible assets. He advises clients on tax treaty matters, competent authority issues, attorney-client and related privilege issues, civil and criminal tax penalties, and accounting for tax matters under FIN 48 of the Financial Accounting Standards Board. His industry experience includes manufacturing, pharmaceutical, medical device and food processing companies. Scott holds a JD from Harvard Law School and an MBA from the Johnson Graduate School of Management at Cornell University.

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Brian Kittle is co-leader of Mayer Brown's Tax Controversy & Transfer Pricing practice. Since joining the firm in 2006, Brian has represented clients in every facet of tax controversy and litigation—from IRS examinations and administrative appeals, through the litigation, trial and appellate review of highly complex tax controversies involving a broad range of international and domestic tax issues. His controversy experience also includes frequent use of IRS alternative dispute resolution tools.

In addition to his controversy practice, Brian provides tax advice on related party and highly-sophisticated transactions involving acquisitions and integrations. He also frequently speaks on and authors articles about substantive and procedural tax issues. Brian has been repeatedly recognized as a rising star by *International Tax Review Tax Controversy Leaders* guide and Super Lawyers.

Transfer Pricing and Tax Advice: Brian has deep experience in international transfer pricing, particularly matters involving intercompany financing arrangements, including matters related to guarantees and factoring. He provides tax advice with respect acquisitions and post-transaction integration.

Tax Litigation: Brian's experience includes the litigation, trial and appeal of major corporate cases involving transfer pricing disputes (*Eaton Corp.*); substance-over-form, economic substance and step-transaction theories; valuation disputes, capitalization questions and debt-equity characterization issues; international tax issues etc. Brian has represented taxpayers in various courts in connection with IRS summons enforcement proceedings.

IRS Administrative Proceedings: Brian maintains a robust practice of advising and representing clients in administrative matters, including pre-audit planning, pre-filing agreements, and representation of taxpayers in examination, including the preparation of company personnel for IRS interviews and presentations; IRS Appeals, including fast track and appeals mediation procedures; and competent authority and Advance Pricing Agreement negotiations. In addition, he has prepared and defended scores of witnesses in IRS interviews and depositions and managed many site visits.

Before joining Mayer Brown, Brian served as an attorney advisor to Judge Joseph R. Goeke of the United States Tax Court. This experience provides him with unique insight into the Tax Court's procedures and decision making process.

Overview

- **Intercompany agreements**
  - Section 482
  - OECD-BEPS
- **Medtronic: Post hoc issue**
- **Analysis of Different Agreements**
  - Intercompany Debt Agreements
  - Sales Support and Marketing Services Agreement
  - Shared Services Agreements
  - License Agreements
  - Cost Sharing Agreements

- **What is the purpose of an agreement in an intercompany transaction?**
  - Comply with any local legal requirements.
  - Provide guidance for corporate activities.
  - Allocate risks and responsibilities.
  - Establish ownership of intellectual property.
  - Provide guidelines for tax compliance audits.
- **What does it mean for an intercompany agreement to be well drafted?**
  - What level of detail must be provided in the agreement?
  - Does an intercompany agreement need to mirror an agreement entered into at arm's length?
  - Should the agreement address a potential change in law?
  - Does the agreement reflect what the parties are actually going to do?

- **Will a well drafted intercompany agreement survive IRS or other tax authority scrutiny?**
  - Did the taxpayer comply with the terms of the agreement?
  - Was a transaction missed such that the IRS can impose another contractual arrangement?
  - What impact could the IRS's imposition of different terms have on your intercompany arrangements and pricing?

Current Legal Framework

- Section 482
- OECD – BEPS

Section 482

Section 482
Basics

- **Section 482:** The arm's length standard governs how taxpayers determine their true taxable income as it relates to intercompany transactions. Treas. Reg. § 1.482-1(b).
- **Best method:** Taxpayers are required to select the "Best Method"—the one that provides the "most reliable measure of an arm's length result." Treas. Reg. § 1.482-1(c)(1).
  - In doing so, there are two primary factors: (1) the degree of comparability between the controlled transaction or taxpayer and uncontrolled comparables, and (2) the quality of the data and assumptions used in the analysis. Treas. Reg. § 1.482-1(c)(1).
  - Intercompany agreements play a key role in determining comparability between controlled and uncontrolled transactions.

Section 482
Comparability – Contractual Terms

- **Comparability:** This analysis involves a comparison of the controlled transaction and the uncontrolled comparables. The more differences that are identified, the less likely the two transactions are comparable.
  - Factors used to assess comparability include: functions, contractual terms, risks, economic conditions and property or services. Treas. Reg. § 1.482-1(d)(1).
- **Contractual Terms:** Contractual terms of controlled and uncontrolled transactions could affect the results of the two transactions.
  - Terms include:
    - form of consideration paid;
    - purchase or sales volumes;
    - scope of warranties;
    - rights to updates;
    - revisions or modifications;

Section 482
Comparability – Contractual Terms

- **Contractual Terms (Cont.):**
    - duration of the agreement;
    - termination rights;
    - re-negotiation rights;
    - collateral transactions and on-going business relationship between the buyer and seller; and
    - extensions of credit and payment terms. Treas. Reg. § 1.482-1(d)(3)(ii).
- **Identifying Contractual Terms:** *Ex ante* contracts are generally given effect so long as the terms are "consistent with the economic substance of the underlying transactions." Treas. Reg. § 1.482-1(d)(3)(ii)(B).
    - Economic substance: This is not the judicial doctrine version or the section 6662 penalty version of economic substance. It's more akin to the concept of substance over form. And it's based on the actual conduct of the parties and legal rights of the parties to the transaction.

Section 482
Comparability – Contractual Terms

- **Identifying Contractual Terms (Cont).**
  - Lack of economic substance: The IRS may disregard contractual terms and/or impute terms consistent with the transaction. The parties' "course of conduct" is often used as the starting point for imputing terms or agreements. *See e.g.*, Treas. Reg. § 1.482-1(d)(3)(ii)(C) exs. 3 , 4, & 6 (imputing services arrangements).
- **No Written Agreement:** Where no written agreement exists, the IRS or a foreign tax authority may impute a contractual arrangement consistent with the economic substance of a transaction.
  - Is it a good idea to let the tax authority impute terms? Generally no.
  - Not having a written agreement may be like giving the tax authority the right to access your bank account so it can withdraw what it considers to be fair. This is so even if you provide transfer pricing documentation.

Section 482
Comparability – Risks

- **Risks:** The allocation of risks in a transaction may be reflected in a contract. Such allocation, however, must be consistent with the economic substance of the transaction. Treas. Reg. § 1.482-1(d)(iii)(B).
  - What does "economic substance" mean in this context?
    - Did the parties act in accordance with their allocated risks?
    - Do the risk holders have the financial wherewithal to assume their allocated risks?
    - Did the allocation reflect the level of control the risk bearing party had over the risk?

OECD - BEPS

BEPS Purpose

- **Summary of Action Items 8-10:** The OECD's transfer pricing guidelines are intended to establish a framework of rules under which transfer pricing outcomes are in line with value creation.

  The guidance ensures that:

  - actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality
  - contractual allocations of risk are respected only when they are supported by actual decision-making
  - capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance
  - tax administrations may disregard transactions when the exceptional circumstances of commercial irrationality apply.

BEPS, Guidance for Applying Arm's Length Principle, p. 13

BEPS
Purpose

- **Emphasis of BEPS on transfer pricing:** To accurately delineate actual transactions between the associated enterprises.
  - **Delineation**. BEPS suggests tax authorities should supplement, as needed, the "terms of any contract with the evidence of the actual conduct of the parties. The transaction is not simply delineated by what is set out in a contract."
  - **Section 482 comparison**. Treasury may believe it does not need to make major, or any, revisions to section 482 to address this specific issue as it has woven the "economic substance" concept into the fabric of section 482.
    - "[T]he United States generally interprets the arm's length standard in a manner consistent with the OECD Transfer Pricing Guidelines." *See generally*, 2006 U.S. Model Technical Explanation at 23.
    - Under the Model Treaty the IRS says it will examine contracts "to see whether" they meet "the arm's-length standard." And where they don't, an adjustment may be made, including "modifying the terms of the agreement or re-characterizing the transaction to reflect its substance." *See generally*, 2006 U.S. Model Technical Explanation at 30.

BEPS
Role of Comparability Analysis

- **Comparability Analysis:** Comparability is the "heart" of the arm's length principle. Guidance for Applying the Arm 's Length Principle, at 15.
  - **BEPS analysis**:
    - First, identify commercial or financial relations and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated; and
    - Second, compare the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent enterprises.
- **Commercial and Financial Relations:** Under BEPS, this is the center of the functional analysis. This starts by developing an understanding of how the MNE group operates. And then this process focuses on what each related entity does such that the commercial and financial relationships among them are identified.

BEPS
Role of Comparability Analysis

- **Commercial and Financial Relations (Cont.):** The OECD identified five factors for purposes of identifying these relationships. We are focused on the underlined factors.
  - <u>Contractual terms</u>
  - <u>Functions performed</u> with an eye on what assets were used and <u>what risks were assumed</u>
  - The characteristics of property transferred or services provided
  - The economic circumstances of the parties and of the market in which the parties operate
  - The business strategies pursued by the parties

BEPS
Comparability Analysis – Written Contracts

- **Contractual Terms:** Formalized agreements "provide the starting point for delineating the transaction between the parties." Contracts "were intended" to divide risks, responsibilities, and outcomes among the parties. BEPS, Guidance for Applying the Arm 's Length Principle at 18.
  - **Functional analysis.** Where there are material differences between contractual terms and the conduct of the associated enterprises in their relations with one another, the functions they actually perform, the assets they actually use, and the risks they actually assume, considered in the context of the contractual terms, should ultimately determine the factual substance and accurately delineate the actual transaction. *Id*. at 19.
  - **Section 482 Comparison.** The functional analysis in the BEPS guidance incorporates section 482 economic substance concepts by focusing on what the parties actually did.

BEPS
Comparability Analysis – Written Contracts

- **No Contract / Missing Terms:** Terms of a transaction may be "found in communications between the parties." BEPS, Guidance for Applying the Arm 's Length Principle at 18.
  - **Section 482 Comparison.** Both BEPS and section 482 contemplate imposing additional transactions and terms that were not included in any contract.

BEPS
Comparability Analysis – Risks

- **Risks:** The actual allocation of risk among the parties is part of a functional analysis. Without such consideration, the functional analysis would be incomplete as the "actual assumption of risks" would influence the prices between related parties. BEPS, Guidance for Applying the Arm 's Length Principle at 21-23.
  - **Steps for analyzing risks:**
    - Identify economically significant risks,
    - Identify how "economically significant risks" are contractually assumed / allocated,
    - Identify how the parties operate in relation to each economically significant risk,
    - Determine whether contract terms and the parties' actions are consistent, including whether the risk assuming party exercises control over the risk and has the financial ability to assume it, and
    - Incorporate findings related to risks into pricing.

BEPS
Comparability Analysis – Risks

- **Contractual Assumption of Risk:** There are benefits to allocating risks in *ex ante* contracts. *Ex ante* contracts may present the best evidence of the actual allocations of risk as *post hoc* events can only confirm which risks occurred. BEPS, Guidance for Applying the Arm ’s Length Principle at 28.

Best Practices
Section 482 and BEPS

- **Do:**
  - Memorialize different transactions that are economically significant in an *ex ante* written agreement
  - Confirm the parties that are allocated certain functions can and do perform them
  - Identify and memorialize which party will assume economically meaningful risk
  - Analyze whether the party that assumed a risk is financially able to do so
  - Assess which party controls the risk
- **Don't**
  - Leave it to the IRS to impose terms that will be fair

Medtronic Issue – Post Hoc Issue

Medtronic
Post Hoc Documentation

- Under intercompany agreements between Medtronic's Puerto Rican manufacturing subsidiary and its domestic parent, the Puerto Rican entity had been allocated all product liability risk.
- **IRS Argument:** The IRS is arguing that the allocation of product liability risk in the agreement was effectuated in a *post factum* manner, at a time when risks were "known" or "reasonably knowable".
  - **Economic substance**. The IRS believes that the terms of the agreement are not "consistent with the economic substance of the transaction" and should not govern for Federal tax purposes. *See* Treas. Reg. §1.482-1(d)(3)(iii)(B).
- **Take Away:** Identify transactions early and memorialize in an *ex ante* basis. Both BEPS and Section 482, as well other tax authorities, recognize the difficulty in altering contractual terms.

Key Provisions to Consider in Drafting Intercompany Agreements

- Intercompany Debt Agreements
- Sales Support and Marketing Services Agreements
- Shared Services Agreements
- License Agreements
- Cost Sharing Agreements

General Considerations

General Considerations

- "Signature Date" and "Effective Date": Documents that memorialize pre-existing agreements or understandings between the parties.
  - If the document is memorializing a prior agreement between the parties and, thus, has an effective date prior to its signature date:
    - Try to gather evidence supporting the pre-existing agreement or understanding
    - Make sure the parties' conduct prior to the execution of the document was consistent with the terms of the contract to be executed (e.g., accounting)
- Consider discussing and approving material intercompany agreement at the board meetings of the respective parties, as reflected in the relevant minutes.
- The agreement must be legally binding and enforceable (consult with local counsel as needed).
  - For example, the IRS is arguing in Medtronic that the purported allocation of product liability risk should be disregarded because the indemnity provisions lack the specificity required under applicable state law.

General Considerations (cont.)

- Consider the use of *Danielson* statements expressing the intent of the parties and their agreement to report the transaction in a consistent manner for U.S. and non-U.S. tax purposes.
- The parties should live by the terms of the agreement (*e.g.,* terms of invoicing and payment; written authorization to sub-license; written notice prior to termination).
- If the contracting parties have different functional currencies, consideration must be given to the tax implications of the selection of currency for the agreement.
- It is important to work with the external auditors to ensure that they are comfortable with the terms of the agreement and the tax implications resulting therefrom.
- The final version of the agreement and all subsequent amendments must be executed by authorized representatives and readily accessible upon a tax audit.

Intercompany Debt Arrangements

Intercompany Debt
Legal Frame Work

- **Debt:** "An unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." *See, e.g., Gilbert v. Comm'r*, 248 F.2d 399 (2d Cir. 1957).

- **Debt-Equity Factors:** Courts and the IRS have identified certain factors to determine whether a transaction is debt or equity. Some of these requirements directly impact the documentation of a loan.

Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972)
1. Labels
2. Maturity dates
3. Source of principal repayment
4. Enforceability
5. Management participation
6. Subordination
7. Intent
8. Capitalization
9. Identity of interest
10. Source of interest payments
11. Ability to obtain third-party loans
12. Purpose
13. Repayment

Litton Bus. Sys., Inc. v. Comm'r, 61 T.C. 367 (1973)
1. Intent. Was there a "genuine" intent to create a debt?
2. Reasonableness. Was there a reasonable expectation of repayment?
3. Economic Realities. Did the intent to create a debt match the economic realities of a debtor/creditor relationship?

Intercompany Debt
Typical Provisions

- **Debt-Equity Factors Reflected in Loan Documentation:**
  - **Labels.** If the document is intended to be debt in the U.S., it is better for it to be named a Note or Loan.
    - Hybrid instruments sometimes are not clearly named. This factor shouldn't control the analysis as it is merely a matter of form, but it's something examiners can easily identify.
      - In *Pepsico*, the agreements were named "Advance Agreements." The taxpayer intended not to characterize the instrument.
  - **Maturity Dates.** Loan agreements contain an express maturity date. That is a hallmark distinction between equity and debt.

Intercompany Debt
Typical Provisions

- **Debt-Equity Factors Reflected in Loan Documentation (cont'd):**
  - **Enforceability.** Creditor rights are central to debt instruments. Events of default and remedies are often clearly identified.
  - **Intent / Purpose.** Did the parties intend to create a financing arrangement? Although business purpose is not a requirement for an instrument to be characterized as debt, a statement of the parties' intent and purpose for the arrangement is helpful.
    - Designation as "permanently invested loan" for accounting purposes suggests equity characterization.

Intercompany Debt
Typical Provisions

- **Other Typical Loan Provisions:**
  - The amount of principal.
  - The rate of interest and when and how it will be paid.
  - Prepayment of interest and principal.
  - Priority / Subordination.
  - Covenants. There are often affirmative, negative and financial covenants (financial covenants can be structured as “maintenance” or “incurrence” covenants).
  - Governing law.

Intercompany Debt
Typical Provisions

- **Principal:**
  - **Loan.** "The Lender hereby agrees to grant a loan to the Borrower in U.S. Dollars and in an aggregate principal amount not exceeding One Thousand Four Hundred Million U.S. Dollars (US$ 1,400,000,000). Amounts borrowed under this Agreement and repaid or prepaid may not be reborrowed."
  - **Notes.** "Subject to the terms and conditions of this agreement, the Issuer will issue and sell to the Holder and the Holder will purchase from the Issuer, $1,000,000,000 aggregate principal amount of 2019 Notes."
- **Interest Payments:** "Cash interest on any Note which is payable, and is punctually paid or duly provided for, on any Interest Payment Date [often defined as quarterly and paid in arrears] shall be paid to the Holders."
- **Arm's Length Interest Rate:** Taxpayer should establish an arm's length interest rate. IRS may assert that rate is either too high or too low.

Intercompany Debt
Typical Provisions

- **Interest on Unpaid Principal and Interest:** "In the event that any amount of principal or interest on the Loan, or any other amount payable in respect thereof, is not paid in full when due (whether at stated maturity, by acceleration or otherwise), the Borrower shall pay interest on such unpaid principal, interest or other amount (in the case of interest, to the extent permitted by applicable law), from the date such amount becomes due until the date such amount is paid in full, payable on demand at a rate per annum equal at all times to the interest rate otherwise applicable to the Loan from time to time pursuant to this Agreement plus 1.00 % per annum. "

- **Events of Default: '**"Event of Default" means any one of the following events (regardless of the reason therefore)-
  - Failure to pay;
  - failure to comply with covenants;
  - bankruptcy; or
  - cessation of credit support.

Intercompany Debt
Typical Provisions

- **Covenants:**
  - Paying principal, interest, and any premiums owed on the notes.
  - Maintain specified financial ratios.
  - Maintain organizational existence.
  - Maintain insurance.
  - Maintain properties.
  - Limitations on the issuance of additional indebtedness.
  - Transaction limitations. Limits on intercompany transactions and asset sales.
- **Subordination:** "The Issuer agrees, and the Holders agree, that the payment of all Obligations owing in respect of the Notes is subordinated in right of payment, to the extent and in the manner provided herein, to the prior payment in full of all existing and future Senior Indebtedness of the Issuer and that the subordination is for the benefit of and enforceable by the holders of such Senior Indebtedness. The Notes shall in all respects rank *pari passu* in right of payment with all existing and future Senior Subordinated Indebtedness of the Issuer." Labels matter: Senior Subordinated Debt should be labeled accordingly.

Intercompany Debt
Typical Provisions

- **Governing Law: "**This Note shall be governed by and construed in accordance with the laws of the State of New York."
- **Approvals:** Corporate formalities help in defending against recharacterization and also support the risk-based return incorporated into the interest rate charged.
  - "All things necessary have been done to make the Notes, when executed by and issued by the Issuer, the valid, legally binding and enforceable obligations of the Issuer and to make this Note Purchase Agreement a valid, legally binding, and enforceable agreement of the Issuer, in accordance with their and its terms."

Intercompany Debt
Debt Capacity – Economic Substance

- **Debt Capacity:** Before putting intercompany debt in place it is important to consider whether the issuer has the capacity to service the debt.
  - Cash flow projections. A critical element to ensure intercompany debt is respected is to project the cash flows the issuer will have over the life of the instrument. This is often limited to 10 years.
  - Credit rating: A credit rating is an indication of a company's ability to service debt. Credit ratings are forward-looking so they typically take into account anticipated events, including the issuance of debt.
    - Credit rating software can be used for this purpose, but it can produce interesting results since it is formula driven.
    - Internal credit rating procedures can be used. But it is important to understand the limitations of any such analysis.
  - Bank letters: Company's typically have relationships with a number of banks and based on a cash flow projection the bank may be willing to provide a letter opinion as to the appropriate interest rate and / or estimated credit rating.

Intercompany Debt
Debt Modification

- Under U.S. tax law, certain "significant modifications" of a debt instrument will result in a deemed exchange of the unmodified debt instrument (the old instrument) for the modified debt instrument (the new debt). *See* Treas. Reg. § 1.1001-3.
- As such, a modification to the terms of a debt instrument may have various U.S. tax consequences to the extent it results in a deemed exchange (*e.g.,* cancellation of debt income to the issuer, gain or loss to the holder).
- Importantly, Treas. Reg. § 1.1001-3(f)(7) provides that, upon a modification of a debt instrument, it is necessary to determine whether the new instrument will be characterized as debt or equity for U.S. tax purposes (the "retesting requirement").
  - Note, however, that the deterioration in the financial condition of the obligor between the issue date of the debt instrument and the date of modification is **not** taken into account in this debt/equity analysis (exception: if there is a substitution of a new obligor, or the addition or deletion of a co-obligor)

Shared Services— Sales Support and Marketing Services Agreement

Sales Support and Marketing Services Agreement

- Country X Sub agrees to provide "sales support and marketing services" to its Parent (a Country Y corporation) with respect to Parent's sales within Country X.
- **Compensation**:
  - Generally, cost-plus (e.g., 5% mark-up)
    - Need to adequately determine the cost-pool (e.g., non-operating expenses such as interest and taxes may be excluded).
    - Parties often provide that charges are intended to comply with Section 482 and the OECD arm's length standard and will be reviewed accordingly from time to time.
  - Budget pre-approval by Parent.
  - Clarify terms of invoicing and payment and ensure the parties comply with these terms to avoid adverse tax consequences (*e.g.,* the carryover of unpaid balances by a U.S. parent to its CFC may create a Section 956 exposure)

Sales Support and Marketing Services Agreement (cont.)

- **Risk of Parent's permanent establishment in Country X:**
  - Traditionally, this PE risk was neutralized by providing in the agreement that Sub does not have authority to bind Parent.
  - **BEPS Action 7**: Even if Sub does not conclude contracts on Parent's behalf, Parent will still have a PE in Country X if Sub "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification" by Parent.
    - "convincing the third party to enter into a contract" with Parent: Creates a PE
    - "mere promotion or advertising" of Parent's products and/or services: No PE.
  - A concern has been raised that this type of arrangement may be caught under the BEPS-inspired UK Diverted Profits Tax.
- **VAT issues in non-U.S. jurisdictions:** Possible characterization as a zero-rate "export of service."

Shared Services Agreement

- A company provides certain services to its affiliates.
- **Types of services**: legal, accounting, auditing, HR, personnel training, financing advice, marketing, market research, IT support, etc.
- **Allocation of Compensation:** Allocation of direct and indirect costs typically based on an appropriate allocation key depending on the nature of the services (e.g., headcount for HR/payroll services; turnover for accounting services; number of users for IT services).
- **Profit Markup:**
  - **BEPS, Action 10**: "Simplified approach" for low value-adding intra-group services – 5% markup.
  - **The Services Cost Method ("SCM") in the Section 482 Regulations**:
    - Compensation equal to total services cost with *no markup*.
    - Applies to services identified in Rev. Proc. 2007-13 and other "low margin covered services" (i.e., services for which the median comparable markup on total services costs is 7% or less).

Shared Services Agreement (cont'd)

- **The Services Cost Method ("SCM") in the Section 482 Regulations (cont'd)**:
  - Excluded services**:**
    - manufacturing, production, construction, distribution or acting as sales or purchasing agent, research, development, engineering, financial transactions (including guarantees), insurance.
    - Services that represent a core function or key competitive advantage of the taxpayer (e.g., a financial institution may not be able to charge intercompany credit analysis services under the SCM).
      - Best practice: Director statement certifying that, in their business judgment, the services do not contribute significantly to key competitive advantages, core capabilities or fundamental risks of success or failure in one or more businesses of the group.
  - The use of the SCM is elective: statement in the taxpayer's books and records of its intent to apply the SCM.

- **The deductibility of the service fees in the jurisdiction of the service recipient:**
  - Issues presented by allocation methods.
  - Some jurisdictions require proof of benefit.

License Agreements

License Agreements

- US Co licenses its *existing* non-U.S. IP rights to Irish IPCo.
- Why is license treatment generally preferable from a U.S. tax perspective?
  - A license of non-U.S. IP rights generates foreign source income.
    - When may a sale of the IP be attractive instead of a license? US Co has NOLs that may expire or high tax basis in the transferred IP; a lump-sum sale would start the statute of limitations on the entire transfer.
- **Distinguishing license vs. sale:**
  - Substance prevails over form/labels/method of payment/transfer of legal title.
  - Factors to be considered when drafting the agreement:
    - Are all substantial rights in the IP licensed to IPCo?
    - What is the duration of the license?
    - Can US Co terminate the license?
    - Who retains the right to modify the IP?
    - Does IPCo have an absolute right to sub-license?
    - Did IPCo take legal title to the IP pursuant to the agreement?

License Agreements

- **Fixed or contingent royalties:**
  - A taxpayer may not affirmatively invoke Section 482 to make a hindsight adjustment to a fixed royalty arrangement if the possibility for such an adjustment was not specifically contemplated by the license agreement. *See* AM 2007-007.
- **Consider providing for the prepayment of royalties in the agreement (cash repatriation opportunity):**
  - Code section 956 concerns.
  - Did a controlled foreign corporation acquire the right to use a patent or copyright in the United States?
- **Legal versus economic ownership of patents and trademarks**
  - Which party has the right to enforce IP rights?
    - Patent owner <u>must</u> be a plaintiff
    - Exclusive licensee <u>can</u> be a co-plaintiff
    - Exclusive distributor <u>can</u> be a co-plaintiff

License Agreements

  - Non-exclusive licensee cannot be a co-plaintiff
- What damages can be sought for infringement?
  - Plaintiff must actually sell the patented product to recover lost profits or obtain injunctive relief
- Are the intercompany agreement sufficient to establish standing?

Cost Sharing Agreements - *Altera*

Cost Sharing Agreements—Altera

- In a cost-sharing arrangement ("CSA"), the parties agree to share IP development costs and each receives discrete rights (e.g., geographical) to exploit IP developed under the CSA.
  - Through a CSA, taxpayers ensure that Irish IPCo is the developer and beneficial owner of future non-U.S. IP rights without the need for a license or transfer of the IP, which are generally taxable to the US Co.
- The Treas. Reg. § 1.482-7 regulations contain several requirements for the establishment of a "qualified" CSA.
- The Tax Court's decision in *Altera* invalidated the regulation that *required* participants in a CSA to share stock-based compensation:
  - The importance of contemplating changes in law in an agreement – some taxpayers had included clauses in their CSAs that triggered adjustment payment in case the regulation was invalidated.
  - Challenges faced by taxpayers with CSAs that did not specifically provide for a change in law with respect to stock-based compensation.

The Rescission Doctrine

The Rescission Doctrine

- Provided certain conditions are satisfied, the “rescission doctrine” permits parties to unwind a transaction for tax purposes, returning the parties to the same positions they occupied prior to the transaction, as if it had never occurred.
- Rev. Rul. 80-58 set forth two requirements for the rescission doctrine:
  - The parties to the undesired transaction must be restored to the *status quo ante*
  - The restoration must occur within the same tax year as the rescinded transaction
- The rescission doctrine may apply even if the contract does not grant the parties a right to rescind.
- The IRS has issued private rulings allowing taxpayers to rescind various types of transactions (e.g., mergers, stock sales, conversion of an LLC to a corporation, debt-for-equity exchange).
  - But, nowadays, Rev. Proc. 2016-3 provides that the IRS will not issue rulings on “whether a completed transaction can be rescinded for federal income tax purposes.”

Questions