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This month's issue of Global Tax Briefing is written entirely by members of the Tax Controversy and Transfer Pricing Practice at Mayer, Brown, Rowe & Maw LLP, a full-service, global law firm providing legal solutions to clients for over a century. See the back cover for more information about Mayer, Brown, Rowe & Maw LLP or visit www.mayerbrownrowe.com

The Time Is Right to Take Transfer Pricing In-House

By Larry R. Langdon and Steven C. Wrappe

Recently, the numbers of multinational enterprises (MNEs) that prepare a large portion of their transfer pricing documentation in-house has increased dramatically. The big changes to the transfer pricing regulations—best method analysis, profit-based methods, penalties and contemporaneous documentation—occurred over a decade ago. So why would MNEs choose now to add transfer pricing compliance to the responsibilities of their in-house staffs, and why didn't they do it before now?

Surprisingly, the same factors that a decade ago encouraged MNEs to outsource transfer pricing documentation are now encouraging the same MNEs to take more of the transfer pricing compliance activity in-house. Three key factors, then and now, are: the overall cost of transfer pricing compliance, transfer pricing experience and the availability of transfer pricing professionals, and the degree of management focus on the issue. The impact of these factors has changed considerably since the introduction of sweeping new transfer pricing regulations in 1994.

1994—Modern Era of Transfer Pricing

In October 1994, approximately 280 pages of new transfer pricing regulations became effective, ushering in the modern era of transfer pricing. Many new and controversial concepts, debated and refined over six years of public and private comment, were adopted: the best method rule, an arm's-length range of results, and the comparable profits method. In 1996, penalty regulations became effective that imposed 20% and 40% penalties, but contemporaneous documentation could limit penalty exposure. The combination of these two events spawned a cottage industry in outsourced transfer pricing documentation.

The new Code Sec. 482 regulations and Code Sec. 6662 penalty regulations were difficult and complex, and they only applied in the United States. In most industries, the in-house study of the extensive new rules and development of new transfer pricing report processes and formats was thought to be too expensive to be borne by a single MNE for a single country's compliance. Further, no software was available to support taxpayers

attempting to prepare their own documentation. Besides, the transfer pricing regulations and the documentation "requirement" to avoid penalties were new, and only a handful of MNE tax staffs had any experience with transfer pricing and few transfer pricing experts were available to be hired. Finally, corporate management generally had no knowledge of and no interest in transfer pricing.

Thus, most MNEs outsourced nearly all of the transfer pricing compliance function to professional firms. The transfer pricing professionals quickly developed the processes and reports to comply with the new rules. Over the next decade, a standardized approach emerged. First, standardized questionnaires were sent to MNE personnel, followed by interviews of company personnel to produce a function-and-risk analysis that characterized the tested party. The function and risk analysis supported the development of a comparable set and adjustments to derive the interquartile range of arm's-length results. In-house staff was typically involved throughout the interviews to develop the function and risk analysis, but was not involved in the economic analysis to develop the arm's-length range. In-house staff was given the opportunity to comment on a draft report before it became final.

This documentation process was not inexpensive or easy, but the outsourced specialization in transfer pricing arguably allowed MNEs to benefit from the spreading of the cost of process and report development over the professional firm's client base. The MNE employees involved in the in-house support of the transfer pricing documentation gained experience in transfer pricing issues. MNE upper management was largely uninterested in transfer pricing compliance issues except from a cost perspective. However, some MNEs' upper management were interested in the potential for transfer pricing planning to reduce global effective tax rates.

Ten Years After—So What's New?

A decade later, transfer pricing compliance has changed significantly. With the exception of intercompany services and some intangibles issues, the transfer pricing regulations have generally remained the same as when released in 1994. The documentation process and the format for presentation of the transfer pricing study have become quite standardized. Software packages are now available to support an MNE's in-house prepared documentation. Possibly the biggest change is the number of other countries that require or encourage documentation—now at least 35—and the number of countries that actively examine transfer pricing issues. Thus, despite standardization of the documentation process and similarity of the economic analysis in most countries, the cost of global transfer pricing compliance continues to rise substantially. Much of this expense is due to the employment of transfer pricing advisors in multiple locations, and an inability or reluctance to standardize the documentation efforts across borders to reduce compliance costs.

Another change that has taken place over the last decade concerns the number of transfer

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pricing professionals. From nearly zero experienced personnel in 1994, transfer pricing professionals now number in the thousands in the U.S. alone. Further, the in-house staff members who have been involved in the transfer pricing documentation process now possess valuable transfer pricing experience.

Finally, the interest of upper management in transfer pricing decisions is considerably higher than it was in 1994. The readiness requirements of the Sabanes-Oxley Act of 2002 place individual responsibility on certain financial personnel for the internal controls surrounding transfer pricing (and other issues), regardless of whether that documentation is outsourced. More recently, FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), creates yet another non-tax reason for upper management to become interested in transfer pricing issues: to avoid financial reporting problems. Finally, the $3.4 billion settlement by GlaxoSmithKline of a transfer pricing issue with the IRS caught the attention of many executives who doubted the ability of the IRS to effectively pursue transfer pricing issues.

The above-described changes help to explain why more MNEs are looking for an alternative to outsourced transfer pricing analysis. The cost of global documentation continues to soar, despite a growing level of standardization of process and reports. Recently legislated and adopted financial reporting requirements strongly encourage management to gain considerably more control over its transfer pricing determinations.

The growing familiarity of in-house staff with transfer pricing issues presents the best opportunity for achieving management's seemingly inconsistent goals of reduced costs and increased control over transfer pricing compliance. The hourly rate on any work taken in-house should be substantially reduced. Further, internal control over transfer pricing decisions can be enhanced by assignment to in-house personnel. Finally, management of transfer pricing decisions and documentation in-house is likely to increase the global consistency of transfer pricing policies and documentation.

How and What Transfer Pricing Issues to Take In-House

Despite the opportunity for up-front cost savings, few MNEs are dismissing their outside transfer pricing advisors altogether. Instead, what often seems to occur is that the taxpayer will restructure the transfer pricing compliance function to place global transfer pricing responsibility with one person within the tax department. That person will decide whether to outplace specific transfer pricing documentation projects or to perform the analysis in-house. Routine documentation updates may be performed in-house, with complex or higher-risk transfer pricing analysis more likely to be outsourced. Even on outsourced projects, in-house personnel are likely to be responsible for interviews and drafting of the function and risk analysis. Finally, outside advisors are nearly always involved in any substantial transfer pricing planning or controversies.

Conclusion

Due to the newness of the transfer pricing rules in 1994, and the U.S.-only aspect of those rules, outsourcing the transfer pricing documentation made good business sense. For a number of good reasons, it may be time for MNEs to take more of the transfer pricing compliance function in-house. In addition to reduced professional fees, the move in-house could enhance global internal control over transfer pricing determinations. However, even with the increased role for in-house personnel, outside advisers should be retained for complex issues and controversies. ◆

The Intersection Between FIN 48 and Transfer Pricing

By Paul A. DiSangro and John T. Hildy

As companies march ahead to implement FIN 48—FASB's new rules for uncertain tax positions—they are encountering many challenges in evaluating their transfer pricing positions. FIN 48 replaces the discretion once left to companies with a highly structured framework designed to standardize tax uncertainty reporting. Applying this standard to transfer pricing issues, which are subject to varying interpretations and ranges of outcomes, requires careful consideration of the facets of FIN 48. It also commands the application of sound tax judgement when evaluating an inherently uncertain transfer pricing position under the relatively rigid FIN 48 standard.

The FIN 48 Standard

The base innovation behind FIN 48 is that it adopts an asset or benefit recognition approach, rejecting the alternative impairment or liability model. The difference can be understood by analogy to burden-of-proof concepts. Under FIN 48's benefit recognition approach, the default rule is that there is no tax benefit recorded in the financial statements unless and until the taxpayer makes an affirmative showing that it is entitled to such benefit. In other words, the taxpayer is "guilty until proven innocent." Many taxpayers had previously followed an "innocent until proven guilty" approach under which tax benefits were automatically booked as filed on the tax return, and only reduced or impaired when a negative showing could be made that they were not entitled to the full benefit. The difference here is more than mere semantics; in a world in which there may be little or no authority on tax issues (especially in smaller jurisdictions with less prolific tax authorities), making an affirmative showing can be considerably more difficult than waiting for a negative one. FIN 48's base model thus represents a sea change for many companies.

FIN 48 prescribes a new two-step process for first determining whether a tax benefit should be recognized at all, and second, measuring those positions that are worthy of recognition.

Step #1: Recognition

First, in order for a position to be recognized at all, a position must have a more likely than not (MLTN) chance of being sustained on audit based on the technical merits if the taxpayer were to litigate the issue all the way to the court of last resort. For purposes of applying this test, the term "technical merits" includes the usual sources of tax authority, such as statutes, regulations, legislative history, administrative and judicial rulings and opinions, and the application of those authorities to the facts. FASB recognized, however, that in rare circumstances technical merits might also include certain past administrative practices and precedents in the tax authority's interaction with the taxpayer or its peers, provided that such practices are widely understood.

This is a binary inquiry; a position either satisfies this first step or it does not. If a tax position fails to pass this binary test, the entire tax benefit must be reserved in full, generally by recording it as a liability on the financial statements.

Step #2: Measurement

Once a position has been deemed worthy of recognition, it moves on to the second step, which is determining how much of the position to recognize on the financial statements. FIN 48 applies a "bounded best estimate" approach to measurement here. The number that is recognized is not necessarily the single best estimate of the likely outcome; rather, it is the single best estimate of likely outcomes that happens to exceed a 50% cumulative probability of being realized upon ultimate settlement.

In reality, even a taxpayer that believes it will "win" on the merits in Step #1 is likely to ne-

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gotiate a settlement compromise of less than the full amount claimed due to hazards of litigation. The realities of these types of settlements are reflected in Step #2 as the company is allowed to use its best judgment to measure the amount that the taxpayer would ultimately accept in a settlement.

How to Implement FIN 48

FIN 48 has given rise to a flurry of activity as companies muster resources to implement its guidance. FIN 48, with its heavy emphasis on achieving levels of certainty based on technical legal merits, requires considerably more substantive analysis than the recent SOX 404 implementation efforts, which were principally process driven. However, important lessons in implementation may be exported from the SOX 404 experience into the FIN 48 implementation effort. Half the battle in achieving FIN 48 compliance will be in proper implementation planning, process documentation, and developing a structure for periodic review and update involving company personnel involved in transfer pricing, tax audit, and outside advisors.

Transfer Pricing Units of Account

A significant skirmish in this battle lies in articulating and documenting the number of transfer pricing positions that must be evaluated under FIN 48's analytical framework. FIN 48 applies its tests on the basis of the appropriate "unit of account" for each tax position. Does "unit of account" imply that FIN 48 must be applied on an SKU-by-SKU or widget-by-widget basis? Of course not. The unit of account depends upon the facts and circumstances, but is informed by the manner in which the company prepares and supports its income tax return and the manner in which the company expects the tax authorities to audit the issue. If a taxpayer documents its transfer pricing on the basis of transaction types, product lines, or some other aggregation, and the government audits such transfer pricing issues along the same lines, FIN 48 should not require any finer a cut in its analytical approach.

That is not to say identifying the unit of account is an easy chore. Indeed, some multinational taxpayers have identified hundreds, even thousands, of distinct transfer pricing units of account. For some companies, FIN 48 compliance will involve a formidable exercise in mapping the webs of transaction flows as goods, services, and intangibles touch upon multiple taxing jurisdictions, and periodically monitoring and updating those webs over time, especially in integrating newly acquired businesses and assimilating their new transaction flows and transfer pricing models.

Recognizing a Position

Many have suggested that FIN 48's recognition step may be fairly easy to satisfy in the context of transfer pricing. This view may result from an example found in FASB's Exposure Draft that was intended to show how transfer pricing problems might be evaluated under the new two-step benefit recognition approach. The Exposure Draft stated the Step #1 inquiry in simple terms: Does the taxpayer have the requisite level of confidence that under the laws of the taxing jurisdictions on both ends of the transaction an arm's-length calculation is an appropriate methodology? (In the U.S., adherence to the arm's-length principle is, of course, set by statute.) If so, then assuming the taxpayer has performed an arm's-length calculation under reasonable, supportable, and auditable assumptions, then it may proceed to Step #2. Notably, the final version of FIN 48 does not include this example or any other guidance specific to transfer pricing situations. Still, the Exposure Draft provides some of the only insights into FASB's (albeit preliminary) view of the intersection between transfer pricing and the benefit recognition model.

Measuring a Position

The measurement step is more difficult in the transfer pricing context. Identifying a single measurement point that is cumulatively MLTN to be sustained is a somewhat alien concept in transfer pricing. Recognizing that transfer pricing is more art than science, the U.S. rules (and those of many

foreign regimes) embrace the interquartile range concept and eschew pinpoint conclusions.

Another aspect of the measurement step relates to the nature of, and opinions expressed in, transfer pricing studies. The language commonly used in transfer pricing studies varies. A few studies may express an opinion that it is MLTN that the pricing is correct. Other studies opine that the analysis represents a proper application of Code Sec. 6662 and its regulations, which require only a "reasonable" application of the Code Sec. 482 regulations to avoid penalties. Nomenclature aside, however, for most transfer pricing positions, management's judgment as to the underlying merits and the quality of the economic analysis will most heavily inform the FIN 48 result, not the specific verbiage of the study.

Competent Authority Relief

A common question arising under FIN 48 is the extent to which companies might simply avoid any evaluation of a U.S. transfer pricing uncertainty on the theory that the company will receive offsetting competent authority relief in a foreign jurisdiction. FIN 48, however, states that each tax position must be taken into account without the possibility of offset or aggregation with another position. A "tax position" is defined by reference to a position taken on a single "tax return." Competent authority relief situations necessarily involve two "return" positions with two different tax authorities. Thus, they represent two distinct tax positions, each subject to their own uncertainties and independent evaluation under FIN 48. This may become especially apparent in the context of adjustments involving foreign treaty partners with emerging or increasingly aggressive transfer pricing regimes that will not blindly accept without independent analysis the adjustment proposed by their U.S. counterpart. Divergent uncertainties among competent authority positions will be particularly acute where the U.S. position has developed unfavorably (see, for example, recent U.S. positions with respect to cost-sharing buy-ins and stock-based compensation).

Conclusion

The threat of failing to recognize all or part of a transfer pricing position under FIN 48 has placed a new emphasis on increasing certainty with respect to those positions. For some taxpayers, increasing certainty may mean developing transfer pricing documentation for previously undocumented transactions, or shoring up documentation already in place. For other taxpayers in search of certainty, Advance Pricing Agreements may become an attractive way to enhance predictability of transfer pricing results. At the margins, some taxpayers may even opt to settle transfer pricing audits in order to achieve certain results. Regardless of the level of certainty attained, it is essential for all taxpayers to go through the exercise of thoughtfully evaluating their transfer pricing positions within the FIN 48 framework. ◆

Patrolling the Safe Harbor: Transfer Pricing for Services

By Gregory L. Barton and Brian P. Trauman

The drafters of the 1968 transfer pricing regulations recognized that rules addressing services would affect a large volume of intragroup back-office services common across many industries; they were therefore determined to minimize related compliance burdens, especially for services that did not significantly contribute to a business's success or failure. Thus, the 1968 regulations contained a cost-only safe harbor, which permitted services to be charged at the direct and indirect costs incurred in rendering those services; no profit element was required.

Since those rules became final, cross-border services transactions have become increasingly significant as part of U.S. and global economies, and among

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members of controlled groups. Thus, the safe harbor has become more important, and more contentious, than ever. In 2006, temporary regulations replaced the 1968 safe harbor with the Services Cost Method (SCM), which permits only certain low-margin services to be priced at cost. This replacement was intended to further reduce compliance burdens, and to solve some of the problems in applying the old safe harbor. The SCM made some progress in this regard, but taxpayers should be careful in deciding how best to apply it.

1968 Regulations

The original safe harbor permitted taxpayers to charge all services out at cost, unless they were "integral" services under one of four tests. The 1968 regulations gave four tests for "integral," but conceptually, the term meant a service that was an important or significant part of the taxpayer's business. Particularly problematic was the test providing that a service was integral if the renderer was "peculiarly capable" due to some special skill, customer relationship, or intangible.

The IRS and Treasury were motivated to revise this safe harbor because they believed that the 1968 regulations had been applied too liberally, allowing high-margin services to be priced at cost. Further, they found that the four tests were difficult to apply.

Thus, the IRS and Treasury intended to reduce administrative and compliance burdens by providing certainty concerning the pricing for low-margin services, thereby allowing compliance efforts to focus on high-value services. Although the SCM appears to eliminate the controversy of the "peculiarly capable" standard, and provides the certainty of a "black list" of excluded services and a "white list" of per se covered services, it is not as routine in application as one might expect.

2006 Temporary Regulations

The SCM permits electing taxpayers to charge at cost only "covered services" which, among other things, (i) are not on the list of excluded services, (ii) either are included on the list of approved specified covered services or qualify as low-margin covered services, and (iii) meet the business judgment rule.

Excluded Transactions

The 1968 regulations focused special scrutiny on four types of transactions—manufacturing, production, extraction, and construction—because they were generally, and rebuttably, presumed to be integral to an enterprise. The SCM excludes those activities and six others, notably including research and development and distribution. The drafters concluded that cost is an inappropriate reference point for determining profits of these transactions.

Specified Services

Revenue Procedure 2007-13, I.R.B. 2007-3, 295, contains the current list of 101 (yes, 101) specified covered services that the IRS determined constitute support services of a type common across industry sectors and that generally do not involve a significant arm's-length markup on total services costs. These specific services are per se eligible for treatment under the SCM.

Indeed, there are low-margin services that are not included on this list but, perhaps more problematically, the utility of this white list is quite limited from a practical perspective. To properly use this list, a taxpayer would need to allocate costs to each specified covered service, and determine the extent to which each of its affiliates benefited from the service. Very rare is the taxpayer that keeps track of its costs by specific service, such as "compiling and posting employee time and other information needed to calculate periodic compensation to employees." To track expenses in this manner would create an enormous compliance burden, and defeat a major purpose of the list. Rather, the vast majority of taxpayers track their costs by department, or by affiliate, which in many cases are organized by the service they provide. That is, many taxpayers track their costs for broader functions such as accounting, human resources, information and technology

services, and purchasing. Thus, the white list is anticipated to cause additional practical compliance burdens for taxpayers who use it, and more taxpayers are likely to seek qualification of their services as low-margin covered services.

Low-Margin Covered Services

Low-margin covered services are those services that, based on arm's-length comparables, command arm's-length markups on total services costs of 7 percent or less.

Taxpayers are more likely to rely on this low-margin services rule than the list of specified covered services, although qualifying under this standard has its own compliance burdens and lack of certainty. Any service can qualify under this test, unless it is specifically excluded or fails the business judgment test, so this method allows for broader inclusion than does the list of specified covered services. Best of all, low-margin services can reasonably be aggregated for purposes of this test, so taxpayers that account for costs by department or other function will reduce their compliance burden, and increase the volume of the services that can be charged at cost, by treating their services as low-margin covered services rather than as specified covered services.

Certainly, qualification as low-margin cost services requires a transfer pricing study showing a median markup of seven percent or less, but these studies are practically accomplished with modest effort. This effort is even less daunting when weighed against the burdens of attempting to apply the white list.

Business Judgment Rule

Lastly, to qualify for the SCM, a taxpayer must reasonably conclude (using its business judgment) that the service does not contribute significantly to the key competitive advantages, core capabilities, or fundamental risks of success or failure of the business of the enterprise. The drafters introduced this rule to provide taxpayers flexibility in determining whether or not a service qualified under the SCM, when not addressed by the black list or the white list, because the same service may contribute differently to businesses in different contexts.

However, this flexibility was roundly criticized under the 1968 regulations for creating controversy, when embodied as the contentious "peculiarly capable" test. Taxpayers and practitioners can expect to encounter the same difficulty in determining whether a service met the "peculiar capable" test as in determining whether a service contributes significantly to its "key competitive advantages."

Although the standards are similarly complex and may lead to similar controversy, the drafters have attempted to reduce this controversy through a greater deference to the taxpayer's decisions. That is, the taxpayer's exercise of the business judgment rule, unlike its determination under the peculiarly capable rule, generally will not be disturbed by the IRS, according to the regulations. Although these statements do not reduce the complexity in exercising one's business judgment, they do provide taxpayers with some amount of certainty that their judgment will be respected.

Conclusion

Taxpayers now tread in generally calmer waters with regard to determining their transfer prices for intragroup service transactions. Divisive issues such as the peculiarly capable test have been eliminated, and certainty has been added with respect to specifically excluded and included services. Nevertheless, taxpayers should take notice that the white list of specified covered services may not be as helpful to navigate as the rules regarding low-margin covered services, and that the application of the business judgment rule remains in uncharted waters. ◆

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The New Temporary Intangibles Ownership Regulations

By Charles S. Triplett and Jason M. Osborn

On August 4, 2006, the Treasury Department and the Internal Revenue Service published new temporary regulations under Code Sec. 482 regarding the ownership of intangible property and contributions by one controlled taxpayer to the value of an intangible owned by another controlled taxpayer. These temporary regulations, which were issued in a package including the new temporary regulations under Code Sec. 482 regarding controlled services transactions, are effective for all tax years beginning after December 31, 2006.

In general, the temporary regulations are very similar to 2003 proposed regulations regarding intangibles ownership, but make several important changes and clarifications from the intangibles ownership rules included in the 1994 regulations that these temporary regulations replace. Of significance, the temporary regulations:

- Retain, but clarify, the "legal ownership" rule for determining the ownership of legally protected intangibles;
- Provide that each intangible has only one "owner" recognized under Treas. Reg. §1.482-4;
- Adopt a "practical control" standard for determining ownership of intangibles without an identifiable legal owner; and
- Replace the "developer-assister" rule of the 1994 regulations with a general requirement that a controlled taxpayer contributing to the value of an intangible owned by another controlled taxpayer receive arm's-length compensation.

Legal Ownership Rule

Temp. Treas. Reg. § 1.482-4T(f)(3)(i)(A) generally treats the "legal owner" of an intangible pursuant to the intellectual property law of the relevant jurisdiction, or the holder of rights constituting an intangible per contractual terms (e.g., through a license), as the "sole owner" (i.e., no subdivided ownership approach) of the intangible, unless the taxpayer's legal ownership of the intangible is inconsistent with economic substance. While this rule makes reference to "intellectual property law," the Preamble clarifies that the rule does not require "an in-depth application of intellectual property law." Rather, the Preamble explains that the Treasury Department and the IRS intend that the "legal ownership" rule treat the taxpayer possessing "title" to the intangible as the owner. Identifying the title holder of an intangible, in turn, requires a consideration of facts and circumstances, such as government filings and intercompany contractual terms.

The temporary regulations retain the "economic substance" override to the general legal ownership rule. As explained by the Preamble, this override is intended by Treasury and the IRS to provide "a safeguard against purely formal assignments of ownership, that, if given effect for purposes of Code Sec. 482, could produce results that are inconsistent with the arm's-length standard." The economic substance override might apply, for example, if a multinational enterprise centrally registers title to all worldwide patents, copyrights, and other registered intangible property in the name of a single controlled taxpayer which did not bear the costs of intangible development.

One-Owner Approach for All Intangibles

As noted above, the temporary regulations treat the legal owner of an intangible as the "sole" owner of the intangible. An Example in the temporary regulations clarifies, however, that two separate intangibles arise from an intangible subject to a license—the underlying intangible itself (e.g., a trademark) and the license, which is a separate "intangible" within the meaning of Treas. Reg. § 1.482-4(b).[1] Thus, in this example, the licensor of the trademark is treated as the owner of the trademark, while the licensee is treated as the owner of the license rights. In

contrast, the 1994 regulations provided that a single intangible could have multiple owners, and treated licensors and licensees as co-owners of the licensed intangible "with respect to their respective exploitation rights."[2] While the "one owner" approach of the temporary regulations may resolve confusion that may have resulted from the former "multiple owner" rule, it should nevertheless reach substantially the same practical results.

Practical Control Standard for Intangibles Without a Legal Owner

Temp. Treas. Reg. § 1.482-4T(f)(3)(i)(A) applies a test of "control," based on all facts and circumstances, for determining ownership of intangibles that do not have an identifiable legal owner under the rules described above. As an example, the temporary regulations state that a controlled taxpayer having knowledge of, and practical control over, the use and dissemination of a customer list[3] would be treated as the owner of the customer list. This "practical control" standard represents a change in framework from the so-called developer-assister rules of the 1994 regulations. The 1994 regulations treated the "developer" of a "non-legally protected intangible," generally defined as the controlled taxpayer that bore the largest portion of the intangibles development costs, as the owner of such intangible.[4]

Although the "owner" of an intangible under the "practical control" standard of the temporary regulations will usually be the same taxpayer as the "owner" of the intangible under the developer-assister rules of the 1994 regulations, the rules may reach different results in some cases. For example, suppose that a U.S. subsidiary distributes its foreign parent's products in the U.S., and has practical control over the use and dissemination of its list of U.S. customers and other U.S. marketing intangibles. The foreign parent, however, compensates its U.S. subsidiary on a cost-plus basis, such that the foreign parent bears all of the costs of marketing in the U.S. and developing the U.S. market. Under these facts, the temporary regulations would attribute ownership of the customer list to the U.S. subsidiary, which has practical control, while the 1994 regulations would have attributed ownership to the foreign parent which bore the costs of developing the U.S. market.[5] Fact situations such as these, particularly involving the U.S. and another treaty country, invite the strong consideration of an Advance Pricing Agreement.

Arm's-Length Compensation for Contributions to the Value of Intangibles Owned by Another Controlled Taxpayer

The temporary regulations provide that a controlled taxpayer[6] must receive arm's-length compensation for contributions that develop or enhance (or that are reasonably anticipated to develop or enhance) the value of an intangible owned by another controlled taxpayer. Here, the temporary regulations, as illustrated by the relevant Examples and the Preamble, adopt a generally flexible framework for taxpayers to structure and document transactions in intercompany contracts on an upfront basis. The temporary regulations expressly permit compensation for such contributions to be either separately stated and analyzed (e.g., a separate agreement for R&D or marketing services), or to be embedded within the contractual terms of another controlled transaction (e.g., a reduction in a royalty paid for use of the intangible or a reduction in the transfer price for tangible property), provided that appropriate comparables for an embedded approach can be located.[7]

The temporary regulations replace the "developer-assister" rules and the so-called Cheese Examples of the 1994 regulations, which had been interpreted as limiting compensation for so-called assisters (i.e., non-developer/owners) to a routine services return, while allocating income from the intangible to the owner or owners. This interpretation stemmed in part from Example 3 of the Cheese regulations, which treated a "bare" distributor

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of trademarked goods as a routine services provider even though it bore significant unreimbursed marketing expenses, and Example 4, which in contrast treated an exclusive distributor of trademarked goods (under otherwise similar facts) as a non-services provider/entrepreneur, consistent with the exclusive distributor's status as an owner of rights in the trademark in the U.S. market.[8] The Preamble explains that the temporary regulations are intended to reduce the potential for such "inappropriate, all-or-nothing results" by ensuring that all "contributors" to the value of an intangible receive appropriate arm's-length compensation. ◆

End Notes

1 Temp. Treas. Reg. § 1.482-4T(f)(3)(ii), *Example* .
2 Treas. Reg. § 1.482-4(f)(3)(i).
3 Temp. Treas. Reg. § 1.482-4T(f)(3)(ii), *Example*.
4 Treas. Reg. § 1.482-4(f)(3)(ii)(B).
5 Nevertheless, the temporary regulations may ultimately (and depending on other factors, such as the taxpayers' contractual terms, if any) reach similar results as the 1994 regulations, in terms of allocating income to both the foreign parent and U.S. subsidiary for their respective contributions to the U.S. market. See, e.g., Temp. Treas. Reg. § 1.482-4T(f)(4)(i) (arm's-length compensation required for contributions enhancing the value of intangibles owned by another taxpayer).
6 Temp. Treas. Reg. § 1.482-4T(f)(4)(i).
7 Temp. Treas. Reg. § 1.482-4T(f)(4)(i).
8 Compare Treas. Reg. § 1.482-4(f)(3)(iv), Examples 3, 4.

The New Code Sec. 482 Cost-Sharing Regulations

By Thomas Kittle-Kamp

Tax law, perhaps more so than any other field, continually produces cases illustrating the law of unintended consequences. A prime example is cost sharing. This regulatory mechanism, originally intended to reduce disputes arising from the exploitation of intangible assets by related parties, has instead become a key area of contention between the IRS and taxpayers, with the IRS contending that taxpayers have abused the existing regulatory regime to migrate intangible profit outside the United States, and taxpayers contending that the IRS has confused legitimate tax planning with abusive tax schemes. The result has been continued regulatory evolution and controversy. The IRS has estimated that there is some $26 billion at stake in cost-sharing disputes. To understand the issues and disputes requires a tour of the regulatory history.

The 1995 Regulations

Qualified Cost-Sharing Agreements

The basic rules for governing qualified cost-sharing agreements (QCSAs) appear in Treas. Reg. §1.482-7, issued in 1995. Under the 1995 regulations, a QCSA allows participants to (i) share the costs of developing intangibles, and (ii) then exploit their proportionate shares of the intangibles that they develop, without having to pay any royalties to their co-participants. In this regard, the 1995 regulations set forth the rules that apply for sharing the costs of intangible development under a QCSA, and for compensating a QCSA participant for making intangible property (IP) "available" to the QCSA in a so-called buy-in transaction.

The Cost Pool

The QCSA participants must share all the costs of developing the intangibles, in proportion to each participant's "reasonably anticipated benefits." If the participants fail to share "all" costs, or if the participants fail to determine benefits on a reasonable basis, then the IRS may adjust those costs or shares.

Although these rules seem fairly straightforward, some controversies have arisen in recent years, most significantly over which costs should be included in the pool of costs that the participants must share (as for example in the case of Xilinx v. Commissioner, concerning whether the participants in a QCSA must share the "costs," if any, of stock-based compensation).

Buy-Ins

If a participant in a QCSA "makes available" any "pre-existing" intangible property to the other participants, then the other participants must make "buy-in" payments. This provision was designed to ensure that the participants pay arm's-length amounts for intangible property that might serve as (or be useful to developing) a platform or basis for the intangibles being developed under the QCSA (called the "covered intangibles"). The 1995 regulations do not, however, tell taxpayers how to value buy-in payments.

In practice, the buy-in provisions have led to numerous high-dollar controversies between taxpayers and the IRS. Many controversies have focused on valuing the intangible property made available to the QCSA; correspondingly, this has led to controversies over whether certain valuation techniques (e.g., profits splits, and the so-called market cap method) apply to buy-in transactions. Other controversies have involved, for example, which intangibles (if any) were "made available" to the QCSA, or whether certain items—goodwill, going concern value, and workforce in place—have been "made available" and if so, whether they technically were subject to the buy-in provisions. Further, the very term itself—"buy-in"—carried a connotation of a purchase (buy) transaction, when in fact, no intangible-property sale had or would have taken place.

These controversies—combined with a concern over the lack of specific guidance on valuation techniques in a QCSA context—led the IRS to rethink the 1995 regulations in their entirety. That process has resulted in the IRS issuing proposed regulations that, although not yet law, signify the current IRS position regarding many of the areas of controversy noted above.

2005 Proposed Regulations

The IRS issued proposed regulations in August 2005. The proposed regulations apply only to specifically prescribed cost-sharing arrangements (CSAs). A CSA must satisfy several requirements, including that the CSA 's participants comply with specified contractual, documentation, accounting, and reporting rules. The arrangement also must (i) address up front (ex ante) the CSA's reasonably anticipated benefits and burdens, (ii) provide for sharing all ongoing developmental costs, and (iii) address the arm's-length pricing for certain "preliminary or contemporaneous transactions" (PCTs, explained below).

The proposals, if finalized, would not simply amend the 1995 regulations; instead, they would replace the provisions entirely with a regime that focuses in large part on achieving arm's-length compensation for the "external contributions" that each participant makes to the CSA. Some key features of the proposed regulations are highlighted below.

Ex ante allocations on a territorial basis

The CSA participants must, at the outset of the arrangement, divide among themselves all interests in the cost-shared intangibles on a territorial basis. In other words, the participants must allocate the risks of the project before it is undertaken, and then live with the ex post consequences, even if that means, for example, that costs end up being allocated to a low-tax jurisdiction without the successful development of an intangible to place income there as well.

Valuing PCTs

The proposed regulations attempt to address, through valuation, the perception that U.S. taxpayers have combined cost sharing with aggressive valuation techniques to migrate valuable technology to low-tax jurisdictions, in return for little or no arm's-length consideration. Among the perceived buy-in abuses are: using limited-rights transfers to produce low valuations; using licenses that rapidly step-down the royalty rates; valuing intangibles by assuming that the intangible's useful life expires before the next generation of products begins; using "residual profit-split" valuations that use extremely short useful-life assumptions; and claims that "make or sell rights" satisfy the buy-in

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requirements. The proposed regulations thus contain comprehensive rules and examples to address arm's-length compensation for the IP transactions that can (or must) take place preliminarily to, or contemporaneously with, a CSA.

The PCT rules provide that when an IP owner makes an "external contribution" to a cost-sharing arrangement, the other participants must compensate that owner. An "external contribution" includes "any resource or capability that is reasonably anticipated to contribute to developing cost shared intangibles," and that was "developed, maintained, or acquired externally to (whether prior to or during the course of) the CSA." The "external contributions" thus encompass not only intangibles, but also services; the regulations provide that an experienced R&D team can be an "external contribution" for which compensation is due over and above the ongoing payments for R&D costs. Further, "external contributions" must be "exclusive and perpetual," thus addressing certain taxpayer arguments that their buy-in payment was low because they simply contributed short-term IP rights to the QCSA. Moreover, make-or-sell rights (i.e., rights to exploit existing intangibles without further development) are not external contributions, since the goal of a CSA is to develop new intangibles, not to make or sell products from existing IP.

In contrast to the 1995 regulations, the proposed regulations provide detailed valuation guidance, including the income method, the acquisition price method, the market capitalization method, and the residual profit split method (plus unspecified methods as well). These methods largely borrow from common appraisal methods for valuing IP, and therefore are not particularly controversial (except for market cap, which some IRS agents have used to calculate buy-ins that equal the entire residual value of a publicly traded corporation).

CWI

The commensurate with income (CWI) standard requires intangibles-derived income to be analyzed retrospectively, rather than simply on the facts that existed at the outset of an intangibles transaction. Some taxpayers have claimed the right to make downward income adjustments, in accordance with the CWI standard, when the original projections for the results of the QCSA did not pan out. The proposed regulations take the position, however, that the CWI standard is a "one-way street" by which the IRS, and not taxpayers, have the right to adjust income under that standard.

"Realistic alternatives"

The proposed regulations specify that the arm's-length charge for a PCT should reflect the general principle that uncontrolled taxpayers dealing at arm's length would have evaluated the terms of a transaction, and only entered into a particular transaction, if no alternative were preferable. Thus, if a company realistically could develop and license an intangible itself and realize operating income with a net present value (NPV) of $X million, then the company should also realize an NPV of $X million by contributing the IP to a CSA.

"Investor model"

Further, the proposed regulations set forth an "investor model" concept by which each CSA participant must receive an arm's-length return on its net cost-sharing investment (total PCT payments made or received, and total intangible development costs incurred or reimbursed). For example, if the projected financial return on the net cost-sharing investment for a PCT contributor was 10%, but the appropriate discount rate was 12%, the PCT contributor either is undercompensated for its external contribution or incurred excessive unreimbursed IDCs.

Summary and Prognosis

The proposed regulations represent a comprehensive attempt by the IRS to address, through published guidance, the large variety of issues that have developed over the years in applying the provisions of the 1995 regulations. Thus far, the proposals have met with substantial commentary, including significant objections to, and some very pointed criticisms of, the

proposals. The IRS currently is reviewing the commentary, and anticipates acting upon it (either through final regulations, or revised proposals or temporary regulations) in the near future.

On the controversy front, as part of its new industry issue focus approach to compliance, the IRS has identified cost sharing as a so-called Tier 1 issue, meaning that the IRS views cost sharing as among the most significant compliance risk issues. The goal of this new industry issue focus approach is for the IRS to develop and resolve issues with taxpayers in a consistent fashion. On April 5, 2007, the IRS issued an industry director directive to provide Exam with direction on the development of cost-sharing issues. A coordinated issues paper has also been promised for mid-summer. Cost sharing will undoubtedly continue to absorb the attention of the IRS and taxpayers for many years to come. ◆

Trends in Code Sec. 482 Litigation

By Gary S. Colton, Jr., Daniel A. Dumezich, William A. Schmalzl, and Joel V. Williamson

Transfer pricing disputes with the IRS have evolved over the last thirty plus years. Once the focal point of large case litigation in the 1980s and early 1990s, transfer pricing litigation slowed to a trickle during the late 1990s due to changes in the governing regulations and a decreased emphasis by the IRS. Now, with further changes in the regulations and increased IRS focus on cross border transactions, transfer pricing litigation may be making a resurgence.

The 1970s

In the 1970s, transfer pricing disputes with the Internal Revenue Service followed a somewhat consistent pattern. IRS examination of transfer pricing issues often resulted in significant adjustments. If it looked like the dispute would not be settled, taxpayers held their cards close to the vest, not wanting the IRS to see all their data and supporting arguments. Taxpayer and IRS pricing methodologies often differed greatly. Taxpayers were not required to have documentation in place supporting their pricing structure before their tax return was filed, so methodologies supporting their transfer prices were commonly developed after the fact. Tax litigation was predominately in the United States Tax Court, as the only forum that does not require the prepayment of proposed tax, penalties, and interest. This consideration increased in importance proportionately with the size of the proposed deficiency. Taxpayer and IRS experts would often battle it out in court, offering opinions that were difficult, if not impossible, to reconcile. The IRS often used in-house experts who did not understand the underlying facts; these experts were generally not well received by the Tax Court. At trial, the IRS was frequently represented by one or two trial lawyers, while the taxpayers were represented by litigation teams.

The 1980s

The 1980s marked a sea change in the manner in which the IRS tried large transfer pricing cases. The IRS concluded that a significant portion of collectible tax deficiencies resided in the very largest cases, many of which involved complex transfer pricing issues. The IRS also recognized that if it were to compete successfully in litigation involving these complex issues, more resources would have to be devoted to every stage of the process, beginning with the audit stage and extending through administrative appeals and trial. By applying resources earlier in the process, the IRS became better prepared to handle transfer pricing litigation. Thus, the Coordinated Examination Program (now called the Coordinated Industry Case (CIC) program) and the Industry Specialization Program were born, whereby the IRS began to identify and

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designate important issues for litigation (see below) and systematically litigate complex, fact-intensive corporate cases involving large deficiencies with experienced Special Trial Attorneys supported by multidisciplinary legal, accounting, economic, and engineering teams. Thus, the playing field was evened, or at least moving towards parity. *See, e.g., Eli Lilly and G.D. Searle.*

The 1990s

Building upon some favorable results in the mid-1980s, the IRS targeted an increasing number of transfer pricing cases for litigation in the late 1980s and early 1990s. There were plenty of cases already in the transfer pricing litigation pipeline, with many notable court cases being decided between 1992 and 2000 (e.g., *Westreco (Nestlé)*, *National Semiconductor*, *DHL*, *Compaq*, *Apple*, *Seagate*, and *UPS*). In several of these cases the IRS fared poorly, despite deployment of increased resources to, and emphasis on, transfer pricing cases. With regard to the closely watched *Westreco (Nestlé)* case, *The Wall Street Journal* said the following about the quality of the respective taxpayer and IRS trial attorneys: "[S]everal lawyers who watched the proceedings say the IRS was very badly outgunned."[1]

In 1994, the IRS released final Code Sec. 482 regulations. These regulations conformed to the Tax Reform Act of 1986 (TRA '86), which amended Code Sec. 482, requiring that consideration for intangible property be "commensurate with the income attributable to the intangible." The genesis of the amendment was a concern that income from high-profit potential intangibles developed in the U.S. was escaping taxation due to transfers of the intangibles to low-tax, offshore jurisdictions. The regulations also forced taxpayers to have contemporaneous transfer pricing documentation to avoid penalties under Code Sec. 6662(e). In practice, the new regulations caused a fundamental shift of focus in Code Sec. 482 controversies from whether the IRS audit determinations regarding transfer pricing adjustments were arbitrary and capricious to whether a taxpayer's documentation and methodology was adequate to support the taxpayer's reported taxable income.

The Early 2000s

By the year 2000, the IRS was advocating a host of nonjudicial remedies to resolve transfer pricing disputes, such as Advance Pricing Agreements, Pre-Filing Agreements, Arbitration, and Mediation. Major Code Sec. 482 cases were in sharp decline. Some thought the IRS was devoting fewer resources to transfer pricing and that it was waiting to see how the new transfer pricing regulations would play out in taxpayer examinations. One area, however, was starting to receive increased attention: cost-sharing agreements. The issue of cost sharing of employee stock options was a specific concern, as highlighted by the filing of the Xilinx case in Tax Court in 2001.

Although the 2000s marked a sharp decline in transfer pricing litigation, some large cases continued to be filed. Xilinx was one of only six transfer pricing cases filed in 2001, the lowest number in anyone's memory. Further, the collective amount in dispute in these cases also was small ($615 million), with most of that amount attributable to *Xilinx*. The number of transfer pricing cases filed in 2002 increased to 11, but the collective amount in dispute was relatively small ($163 million). Three major cases were resolved in 2002: *DHL*, *MedChem*, and *UnionBanCal*. By 2003, both the number of transfer pricing cases filed and the total amount in dispute hit all-time lows (only two cases were filed in 2003, with $88 million in dispute). The largest case resolved in 2003 was *UPS*, a case dealing with *UPS*'s Bermuda subsidiary's excess value insurance business. *UPS* was settled as a transfer pricing case after the Tax Court was reversed on its assignment of income/sham transaction theories by the Eleventh Circuit Court of Appeals. By the end of 2003, most of the large transfer pricing cases had worked their way through the courts.

Few transfer pricing cases were filed in 2004, but those that were filed tended to be larger cases. GlaxoSmithKline filed the largest suit in Tax Court history, disputing $7.8 billion in Code Sec. 482 allocations for the years 1989–1996. *Clorox* filed suit, protesting $552 million in Code Sec. 482 allocations. In 2005,

GlaxoSmithKline filed another suit in Tax Court, disputing an additional $5.4 billion in Code Sec. 482 adjustments for the years 1997–2000. This was one of only seven transfer pricing cases filed in 2005. The Clorox case was resolved in 2005, with the IRS conceding all of the $552 million in proposed Code Sec. 482 adjustments. That same year, the Tax Court also issued its opinion in the Xilinx case, holding that Xilinx did not have to include the costs from stock options awarded for research and development activities in its cost-sharing agreement with its subsidiary. The government promptly appealed the decision to the Ninth Circuit Court of Appeals.

Practitioners began to note a change in IRS attitudes towards taxpayers' transfer pricing documentation. Then IRS Commissioner Mark Everson announced a "currency initiative" that forced IRS examination teams to push forward undeveloped cases, often not accepting taxpayers' transfer pricing documentation and imposing penalties. More penalties were approved by the IRS's transfer pricing penalty review committee in 2006 than in any other year. On August 1, 2006, Everson reported to a Senate subcommittee that IRS international examination activity was growing and that the IRS would be devoting additional resources to the area.

In 2006, the trend towards mega-cases continued. Veritas filed suit, disputing $2.5 billion in transfer pricing allocations, almost all of which related to a lump-sum cost-sharing buy-in payment made by its Irish affiliate. GlaxoSmithKline settled its cases in 2006, agreeing to pay $3.4 billion (an amount which included interest) and to abandon its refund claim. IRS Chief Counsel Donald Korb used the settlement announcement to trumpet the competency of IRS counsel:

> I am often asked the question…whether the Chief Counsel's lawyers are being constantly outgunned by the large law firms they face in the big dollar cases in the Tax Court. During my tenure as Chief Counsel it has become quite evident to me that our lawyers can go up against the best firms the private tax bar has to offer in the Tax Court and achieve quite successful results.[2]

The Future

With the success of its programs to shut down the marketing of tax-advantaged transactions and to force taxpayers who utilized such transactions into one-size-fits-all settlements, the IRS is now focusing on cross-border transactions as an area of perceived aggressive tax planning. Cost-sharing buy-ins and the transfer of intangibles offshore continue to be considered some of the most significant compliance problems for the IRS. Taxpayer responses to the phaseout of Code Sec. 936 exit strategies have been singled out by the IRS as potentially involving "very aggressive" tax strategies that must be closely examined. The IRS has issued audit guidelines for possessions corporations (corporations that utilized the provisions of Code Sec. 936 to obtain U.S. tax benefits for conducting business in Puerto Rico) that have converted to controlled foreign corporation status. On August 1, 2006, the IRS released proposed and temporary regulations that updated the 1968 regulations regarding related-party services. The changes to long-standing regulations, together with emphasis on transactions involving intangibles, will create uncertainty and litigation while the nuances of the post-1968 regulations are being flushed out. An emboldened IRS, with a focus on transfer pricing issues, will likely generate a new wave of transfer pricing litigation in the near future. ◆

End Notes

1 Jill Abramson, *Ex-Tax Collectors Help Foreign Firms Fight U.S. Efforts to Get More Funds*, Wall St. J., Oct. 18, 1991, at A16.

2 IRS News Release: "IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute," IR-2006-142 (Sept. 11, 2006).

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Current Reasons to Consider an Advance Pricing Agreement

By Charles S. Triplett and Steven C. Wrappe

The Internal Revenue Service formally established the Advance Pricing Agreement (APA) Program in March 1991 as a common-sense alternative to litigation and as a means of resolving transfer pricing disputes. An APA is a prospective agreement between a taxpayer and the IRS (and possibly other governments) with regard to certain transactions, in which the parties agree on the facts, the best transfer pricing method (TPM) for those transactions, and an arm's-length range of results. The agreement specifies the term of the APA (usually five years), operational and compliance provisions, critical assumptions regarding future events, and the requisite recordkeeping and compliance responsibilities.

APA cases may be "unilateral" or "bilateral." A unilateral case involves a "unilateral APA" between the U.S. taxpayer and the IRS. That, however, offers no protection against non-U.S. tax adjustments. Typically, a taxpayer will ask the IRS to reach agreement with the relevant treaty partner regarding the covered transactions, thus achieving a bilateral APA.

Over the 16 years and 692 cases since the establishment of the APA Program, taxpayers have pursued APAs to address particular objectives. APA applications in 2006 totaled 109, a 33 percent increase over 2005.

Primary Reasons to Seek an APA

Certainty of Tax Treatment

The most important benefit of an APA is certainty of tax treatment. This certainty extends to freedom from exposure to penalties, freedom from a transfer pricing adjustment by the IRS, and freedom from double taxation created by different reporting in the U.S. and the other involved country. The costs of transfer pricing uncertainty have risen dramatically in recent years. As transfer pricing examination activity in the U.S. has increased, the likelihood of a sustained adjustment and penalty have increased. The same is now true in other countries.

In the APA process, the taxpayer and the IRS agree upon facts, the TPM, and an arm's-length range of results. If the taxpayer complies with the terms and conditions of the APA, the IRS will regard the results of the taxpayer's TPM as satisfying the arm's-length standard. Further, any examination of transactions covered by the APA is limited to establishing the taxpayer's compliance with the APA. Therefore, compliance with an APA protects taxpayers from both IRS transfer pricing adjustments and penalties. A bilateral APA also addresses the taxpayer's exposure to inconsistent treatment in other countries and the attendant risk of double taxation.

Time and Cost Savings Over a Transfer Pricing Examination Defense

Transfer pricing examinations are time consuming and expensive. The IRS will use a variety of tools to obtain information from and about the taxpayer, requiring the taxpayer to expend significant time and money providing the IRS with great quantities of information, oftentimes only a fraction of which will ultimately be relevant to the taxpayer's transfer pricing issues.

Transfer pricing disputes involve complex factual and economic issues that require the application of subjective judgment. Combining the confrontational approach inherent in an examination with poor communication can result in a bitter impasse between the IRS and the taxpayer.

The APA process is designed to avoid the confrontation inherent in an examination and foster more effective communication. The APA process begins with the taxpayer describing its relevant operations and a proposed TPM. The parties discuss areas that require factual development and agree on necessary information. By focusing the taxpayer and the IRS on the relevant facts and an appropriate TPM, the APA process minimizes the information that must be produced and analyzed. This cooperative approach can produce significant cost savings to both taxpayers and the IRS.

The APA process generally takes less time and money to complete than a transfer pricing examination and administrative review. An examination can easily last three to four years. If the dispute leads to litigation, resolution may take over 10 years. In contrast, the IRS has set a goal of concluding unilateral APAs within 12 months, and agreeing on the U.S. competent authority negotiating position for bilateral APAs within 12 months.

In many cases, the prospect of rolling back an APA-developed TPM to resolve prior tax years also provides time and cost savings. Rolling back an APA to tax years under examination provides a cost-effective way to resolve an ongoing transfer pricing dispute. Taxpayers can resolve all open tax years as well as five prospective tax years in a single negotiation. For example, if ABC Corporation's transfer pricing is being examined for tax years 2003–2005 and tax year 2006 is filed but not yet examined, ABC could potentially negotiate an APA to cover tax years 2007–2011 and roll back the approach to resolve all the other open years—both those under examination and those not yet under examination.

An additional benefit of an APA is the elimination of the annual update of relevant comparability data used in the taxpayer's transfer pricing documentation. Taxpayers are generally required to maintain contemporaneous documentation to avoid Code Sec. 6662 penalty exposure. An APA eliminates the need for comparable updates. The APA generally sets a range of results for the entire term of the APA, usually five years. The taxpayer need only compare its results to the range of results required by the APA. The cost of gathering and comparing the taxpayer's internal data to the range required by the APA is a fraction of the cost of annually updating transfer pricing documentation reports.

Implement a Change in Transfer Pricing Policy

Many taxpayers have pursued an APA to manage the examination exposure created when the decision is made to change the taxpayer's transfer pricing policy. Changes related to a business change are often perceived by governments as tax-motivated restructurings, and so are subjected to rigorous examination. Changes not related to a business change are often triggered by a taxpayer re-evaluation of outdated or poorly conceived documentation, exposing the taxpayer's prior years to governmental re-evaluation.

Taxpayers with both types of change have employed the APA process to manage the expectation of the IRS and other governments regarding the changed transfer pricing policy. The generally cooperative setting of the APA Program allows taxpayers to explain the reasoning behind the change and ensure that the IRS's first impression of the issue is factually correct. Also, the highly experienced staff of the APA Program has generally understood the practical, operational reasons behind the change.

Retroactively Avoid a Penalty

Pursuant to Code Sec. 6662(e), a penalty of 20 percent is imposed on any underpayment of tax attributable to a substantial valuation misstatement—either the transfer price is 200 percent or more, or 50 percent or less, than the correct price (net transaction penalty), or the net transfer price adjustment exceeds the lesser of $5,000,000 or 10 percent of the taxpayer's gross (net adjustment penalty). Pursuant to

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Code Sec. 6662(h), the penalty is increased to 40 percent in the case of a gross valuation misstatement with respect to either penalty. Penalties will not be imposed on any portion of an underpayment for which the taxpayer reasonably relied upon contemporaneous documentation.

Taxpayers that have no documentation with respect to transactions that could reach the monetary thresholds of a substantial valuation misstatement have employed the APA process to avoid penalties. If the taxpayer files an APA request before receiving notice of the IRS intention to examine, the APA request constitutes a qualified amended return, thus allowing the taxpayer to retroactively eliminate the adjustment that would otherwise trigger the penalty.

Important New Nontax Reasons to Seek an APA

Two recent nontax developments have made APAs a more important transfer pricing compliance alternative. U.S.-based multinationals have been motivated to pursue APAs to achieve certainty for financial reporting purposes.

Sarbanes-Oxley

In 2002, the U.S. Congress enacted the Sarbanes-Oxley Act of 2002 (SOX). Section 404 of SOX requires that a company establish that it had controls in place to ensure accurate financial reporting. Transfer pricing often involves subjective standards and high-dollar amounts. Failure to demonstrate adequate internal controls over transfer pricing determinations could lead to identification of a material weakness in the taxpayer's financial statements.

Some taxpayers have pursued an APA to prevent exposure to a material weakness based on poor internal controls surrounding transfer pricing determinations. If certainty regarding the facts, method, and arm's-length range have been established in negotiations with the IRS, the taxpayer's requisite internal controls surrounding transfer pricing are greatly reduced.

FIN 48

For years ending after December 15, 2006, Interpretation No. 48 of the Financial Accounting Standards Board, "Accounting for Uncertainty in Income Taxes" (FIN 48) (interpreting FASB Statement No. 109), requires a detailed evaluation of tax positions. Transfer pricing is considered a tax position for purposes of FIN 48, triggering a two-step process to evaluate tax positions for financial reporting. The recognition step requires a "more likely than not" expectation of sustention at examination, and the measurement step allows recognition of the highest amount that is more than 50 percent likely to be sustained.

Similar to SOX, FIN 48 is encouraging some taxpayers to pursue APAs to eliminate the uncertainty of the two-step test. With an APA, the recognition test is met and the transfer pricing-related tax position is recognized, without reduction.

Conclusion

With the increasing need for certainty, time and cost savings, ability to manage transfer pricing policy changes, and penalty avoidance, IRS APA applications continue to rise. Recent changes in financial reporting further encourage taxpayers to consider the nontax benefits of certainty. ◆

Developments in the OECD Approach to Attribution of Profits to Permanent Establishments

By Nathaniel Carden, Noel S. de Santos, and Scott M. Stewart

Introduction

The practices of Organisation for Economic Co-operation and Development (OECD) and non-OECD member countries regarding the attribution of profits to permanent establishments (PEs) and these countries' interpretation of Article 7 (Business Profits) of the OECD Model Tax Treaty are far from uniform. Varying interpretations of Article 7 may result in double taxation. In response to this ambiguity, the OECD Committee on Fiscal Affairs (CFA) sought to achieve greater consensus in this area by beginning a process that would culminate in a new version of Article 7 with accompanying revised commentary.

On December 21, 2006, the OECD released its Report on the *Attribution of Profits to Permanent Establishments* (the Attribution Report[1]). This new version replaced all the previous versions of the frequently modified *Discussion Draft on the Attribution of Profits to Permanent Establishments*. Borrowing heavily from the Attribution Report, on April 10, 2007, the OECD further published a draft Revised Commentary on Article 7 of the *OECD Model Tax Convention* (Draft Revised Commentary). After the OECD has had time to review public comments regarding the Draft Revised Commentary, a new version of Article 7 with accompanying new commentary is scheduled to be released by the end of 2007. The new version of Article 7 and its accompanying commentary will then proceed through the normal OECD process of finalization of changes that are included in the regular updates of the OECD Model Tax Treaty, with the possibility that member countries may introduce reservations or observations at that stage. This article discusses the OECD's current approach outside of the context of global dealing in financial instruments. The Attribution Report takes a somewhat different approach to attribution of profit in that context, which is outside the scope of this discussion.

The Attribution Report's Approach

The "Authorized OECD Approach" for determining the profits attributable to a PE under Article 7 of the OECD Model Tax Treaty is the "functionally separate entity approach." The Attribution Report explains that under this approach, "the profits to be attributed to a PE are the profits that the PE would have earned at arm's length as if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle." Importantly, this approach applies whether the PE is a branch or an agent of the nonresident enterprise. This requires a two-step analysis. First, functions, risks and assets are attributed to the hypothesized distinct enterprise. Then, based on the functions, risks and assets attributed, the PE's dealings with unrelated enterprises, as well as its transactions with related enterprises, can then be examined under OECD transfer pricing principles to determine the proper attribution of profit to the PE.

The threshold question for attribution of profit is which of a PE's transactions, or "dealings," will be recognized. Under the Authorized OECD Approach, a dealing will be recognized if it "relates to a real and identifiable event," such as the physical transfer of stock in trade, the provision of services, use of an intangible asset, a change in which part of the enterprise is using a capital asset or the transfer of a financial asset. In applying the test for recognition of dealings, any relevant internal documentation is the natural starting point. However, the functional and factual analysis should determine whether the event has occurred or if "the terms of the dealing have not been followed or are a sham."

Further, the dealings must be attributed to the PE. The properly attributable rights and obligations of

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a PE are those that the PE should be hypothesized to have entered into. This determination is based upon the allocation of risks and assets under the functional and factual analysis discussed below. The OECD notes that countries may wish to require taxpayers to demonstrate clearly that it would be appropriate to recognize dealings through accounting records and internal documents of the PE showing the existence of the dealing. The terms of the dealing may be found in accounting records and any other documents or communications that discuss the transfer of risks, responsibilities and benefits between various parts of the entity. The OECD also encourages taxpayers to maintain accounting records and other contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits in order to "reduce substantially the potential for controversies regarding application" of the Authorized OECD Approach.

Attribution of Functions, Risks and Assets to the "Distinct and Separate Enterprise"

In order to determine the profit attributable to the PE's recognized dealings, the Authorized OECD Approach analyzes the risks, economic ownership of assets and capital that should be attributed to the hypothetically distinct and separate PE. In most instances, this analysis starts with determination of the "significant people functions relevant to the assumption of risk and the significant people functions relevant to the economic ownership of assets."[2] For example, the PE may act as a distributor for the multinational enterprise and carry on all the associated activities, including market research in its jurisdiction. In such a case, the PE would typically be deemed to perform the significant people functions related to inventory and marketing risk.

As discussed above, the first step in the Authorized OECD Approach is a functional and factual analysis of "significant people functions." The concept of significant people functions was only introduced in the Attribution Report whereas all previous versions referred to "key entrepreneurial risk taking functions" (KERT). Currently only Part III of the Attribution Report (for the global dealing of financial instruments) refers to KERT as opposed to significant people functions. The OECD has indicated that the change in terminology is meant to reflect that, aside from the financial enterprise sector, the extent to which risk taking is or is not the proper focus of the functional and factual analysis varies from business sector to business sector and from enterprise to enterprise within sectors.

Attribution of Risks

Risk must also be assigned to the PE. The PE is considered to bear all risks for which its personnel perform, in the PE's location, the significant people functions relevant to the assumption of risk. For example, a PE would be treated as assuming the risks arising from the negligence of its employees. The allocation of risk is highly fact-specific, taking into account factors such as compensation arrangements of the enterprise, and business practices of comparable independent enterprises, as well as internal documentation. Importantly, the OECD's emphasis on "significant people functions" suggests an underlying reluctance to recognize that parties may, at arm's length, use contractual provisions to allocate risk in a way that reflects the ownership of assets and the provision of capital, without regard to where an enterprise's employees are located. It should also be noted that even if a PE's personnel create and manage a risk, if the risk is not ultimately borne by the PE or the enterprise as a whole, the risk may not be allocated to the PE under the Authorized OECD Approach. Allocation of risk is important because the amount and nature of the risks assumed affects the amount of capital that needs to be attributed to the PE and the return that such capital should earn when applying Article 7's arm's-length standard. The OECD's emphasis on who bears the ultimate risk should allay fears that some commentators expressed regarding the whether a research and development facility may give rise to a PE. In this and other contexts, the Attribution Report makes clear that it does not address the question of "whether a PE exists in respect of any particular business activity."

Attribution of Assets

The functional and factual analysis must determine both the assets used by the PE and the conditions under which the assets are used. For example, if the PE were the licensee of an intangible, then the intangible asset would be solely owned. However, if the PE is a party to a cost-sharing agreement, then the intangible would be jointly owned. Further, in addition to legal ownership, the functional and factual analysis looks to determine "economic ownership," which is based upon the significant people functions which create or use the asset.

Tangible Property

In the case of tangible assets, the economic owner of the asset is often based on the physical location of the asset, but again the allocation of risks is a relevant component of the analysis. Moreover, whether the PE is treated as the economic owner or as a lessee of the tangible asset is often insignificant from a practical standpoint, as both treatments lead to either depreciation or rent deductions. However, where the differing treatments lead to differing profit allocations, the general consensus among OECD member countries leads to application of the economic ownership view in the majority of cases.

Intangible Property

In the case of intangible assets, the functional and factual analysis becomes more complicated. This complication is due in part to the increasingly complex nature of intangibles, the increased importance of intangibles to an enterprise, the pace of technological development and the varied nature of intangibles. The Authorized OECD Approach applies differing treatments based upon the type of intangible in question.

Internally developed trade intangibles. The Authorized OECD Approach first deals with internally developed trade intangibles, such as computer software or patents. Development of an intangible does not automatically lead to a PE being the economic owner of the intangible. The economic owner of the intangible is the enterprise that acts as the entrepreneur, bearing the risk associated with the development of the intangible property. The significant people functions relevant in this context are those functions that require "active decision-making" for the taking on and management of individual risk associated with development of the intangible. This often turns on the highly specific factual analysis of the enterprise's overall business model. If the enterprise is highly centralized in its decision-making process, so that a central office reviews all data produced by tests and bears the ultimate responsibility for deciding whether further resources should be allocated to the development of the intangible, the PE may not be treated as the economic owner of the intangible. Finally, it should be noted that the intended user of the intangible within the enterprise is not the per se economic owner, as it may be a mere licensee. However, intended use may be considered in determining whether a PE is the economic owner of the intangible. Moreover, as contemplated by these factors, and as the OECD makes clear, the contract development model for intangible property is still a valid business model which should be respected by the Authorized OECD Approach if supported by the functional and factual analysis.

Acquired trade intangibles and marketing intangibles. While trade intangibles and marketing intangibles are often internally developed, they may also be acquired from another enterprise through sale or license. Allocation of acquired trade intangibles again depends upon the significant people functions relevant to determining economic ownership. The relevant queries in such a case include: (i) who made the decision to acquire the intangible; (ii) who decides what, if any, further development is necessary; and (iii) who evaluates and manages the risk of deploying the intangible asset. Similarly, allocation of marketing intangibles, acquired or internally developed, also depends upon the significant people functions. The relevant queries for marketing intangibles include: (i) who controls the functions related to the creation of and control

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over branding strategies; (ii) who determines trademark and trade name protection and enforcement; and (iii) who decides questions related to the maintenance of established marketing intangibles.

Attribution of Capital

The Authorized OECD Approach is also concerned with the proper allocation of so-called free capital, which actually refers to capital that does not give rise to a tax deduction (i.e., equity, as opposed to debt). In general, the capital allocated to PEs must be sufficient to support their functions, risks and assets and should be consistent with the arm's-length principle. This step is animated in part by the OECD's concern that PEs may be too heavily capitalized with debt, and use interest deductions to shift income out of the PE host country.

The OECD recognizes that there is no international consensus among member countries for a single approach for allocating free capital to a PE. As such, the Authorized OECD Approach allows for several methods to be used in the allocation of free capital. The "capital allocation approach" is the purest method of allocating capital based on the attribution of assets owned and risks assumed. For example, if a PE has 10% of the enterprise's assets and/or risks, it will have attributed to it 10% of the enterprise's free capital. Almost exclusively used in the banking context, the "economic capital approach" makes reference not to regulatory measures of capital but to economic capital. This approach has been suggested because regulators are only concerned with certain types of risk. Under the "quasi thin capitalization/regulatory minimum capital approach," a PE would be allocated only the amount of free capital as would be required to be carried by an independent enterprise carrying on the same or similar activities under the same or similar conditions in the PE's host country. Under the thin capitalization approach, each PE is attributed an amount of capital equal to the amount of free capital that a comparable independent enterprise carrying on the same or similar activities under similar conditions would have. After the allocation of free capital, "capital other than free capital" is allocated using any of the methods, regardless of the method used to allocate free capital.

After the allocation of capital, the attribution of funding costs of the PE must be attributed. The Authorized OECD Approach recognizes that the PE requires a certain amount of funding. First, the amount of funding necessary for the PE to operate is calculated by reference to the PE's rights and obligations. The amount of free capital allocated to the PE is then subtracted from the total amount of funding costs and the remaining balance is the amount by which interest deductions may be calculated.

Conclusion

The attribution of business profits to a PE under Article 7 requires an analysis of the contracts, risks, functions, assets and capital that will be attributed to the PE. Under the framework proposed in the Attribution Report, attribution generally turns on the "significant people functions" performed by the PE and related enterprises. How these functions will be defined, and how economic significance will be ascribed to them, will continue to be reviewed by the OECD during 2007 and beyond. What is clear, however, is that the analysis will likely be highly dependent on a particular PE's facts and circumstances, as well as the practices of unrelated parties engaged in similar businesses. ◆

End Notes

1 For additional information on the OECD's project, see Attribution of Profits to Permanent Establishments: Update on Status and Release on New Versions of Parts 1, II, and III, ¶ ¶ 1-2 (Dec. 21, 2006) (Status Report).

2 Part III of the Attribution Report relates to attribution of profit in the global dealing of financial instruments. This portion of the OECD's approach refers to "Key Entrepreneurial Risk Taking," or "KERT" functions, rather than "significant people" functions. How (or even whether) KERT functions differ from significant people functions is an open question.

Tax Controversy and Transfer Pricing Practice at Mayer, Brown, Rowe & Maw LLP

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