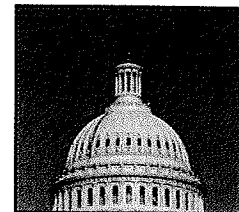


A Washington National Tax Services (WNTS) Publication

WNTS Insight*



Transfer pricing tops IRS Commissioner Shulman's list of international tax compliance priorities

December 18, 2009

Transfer pricing, withholding taxes, and taxpayer use of hybrid instruments, entities, and structures are among the IRS's top priorities in the international tax compliance area, IRS Commissioner Douglas Shulman announced in a recent, high-profile speech.

Addressing a George Washington University-Internal Revenue Service institute, Commissioner Shulman stated that the IRS and the Obama Administration are focused on implementing a comprehensive international tax compliance strategy intended to ensure that corporate taxpayers do not "use the international capital markets and tax code complexities to push tax planning beyond acceptable bounds" and that individual U.S. taxpayers with overseas assets "pay what they owe."

Transfer Pricing

Commissioner Shulman announced that the IRS is establishing a new "Transfer Pricing Practice" within the Large and Mid-Size Business Division to administer transfer pricing issues strategically and systematically. The IRS Transfer Pricing Practice will consist of a group of experts in the transfer pricing area who will coordinate the IRS approach to the most important transfer pricing issues, identify emerging issues and trends, help examination personnel throughout the organization by providing technical expertise, assist in the development of new risk assessment techniques to identify the taxpayers and issues with the greatest risk, and develop examination best practices to ensure optimal resource allocation. **Observation:** The creation of this new group is the latest signal of the importance placed on transfer pricing enforcement at the highest levels of the IRS.

Commissioner Shulman stated that the new Transfer Pricing Practice grew out of a realization that the IRS needed to change the way it does business in the transfer pricing area. From the taxpayer's perspective, the IRS was taking too long to resolve transfer pricing cases and resolutions were not always consistent. From the IRS perspective, the agency needed more staff with industry specific and transfer pricing expertise to match up with corporate taxpayers, to develop issues fully, and to discuss the issues with taxpayers and their representatives.

Thus, the IRS is creating the new Transfer Pricing Practice to address these issues and to "ensure organizational consistency and focus." The goal is to improve significantly how the IRS addresses transfer pricing issues in the future.

Observation: With a focused national team of experts charged with driving transfer pricing enforcement, taxpayers can expect the IRS to intensify its scrutiny of transfer pricing issues. Because transfer pricing clearly has the attention of high-level tax officials as a key focus of the IRS long-term international tax enforcement strategy, this area likely will be identified as a priority when budget resources are allocated.

Hybrid Instruments, Entities, and Structures

Commissioner Shulman noted that the IRS will continue to scrutinize arrangements that utilize hybrid entities (entities treated as fiscally transparent for U.S. tax purposes but as corporations for foreign tax purposes) and hybrid instruments (instruments treated as debt for U.S. tax purposes but as equity for foreign tax purposes, and vice versa) to engage in "tax arbitrage -- exploiting different countries' tax rules...to achieve a lower overall tax burden."

Observations

The continued focus on corporate organizational structures using hybrid entities and instruments is reflected not only by the IRS's regulatory and enforcement activity, but also by the Administration's international tax legislative proposals. Specifically, the Administration has proposed a significant change to the entity classification regulations, which currently allow certain "eligible" business entities to elect their entity classification for U.S. federal income tax purposes. An eligible business entity with a single owner may elect to be treated as either a corporation or an entity disregarded as separate from its owner (a "disregarded entity").

Under the Administration's proposal, a foreign eligible entity may elect to be treated as a disregarded entity only if its owner is organized under the laws of the same foreign country under the laws of which the foreign eligible entity is organized. Except in cases of U.S. tax avoidance, this rule would not apply to a first-tier entity wholly owned by a U.S. person.

If enacted, this proposal may impact the ability of foreign-based multinationals to manage their U.S. tax risk through the use of foreign disregarded entities. In addition, it may limit the ability of foreign-based multinationals that currently have such foreign disregarded entities within their structures to undertake certain internal restructuring transactions.

Also in his speech, the Commissioner said that international tax arbitrage is a global concern and stressed interactions with foreign tax authorities.

Withholding Taxes

Commissioner Shulman devoted the majority of his speech to issues surrounding withholding taxes. He first discussed certain measures that the IRS currently is taking to curtail taxpayers' improper avoidance of withholding taxes, noting that a comprehensive review of the compliance practices of commercial banks, hedge funds, and other similar taxpayers is underway. Further, the IRS is developing tools to help field examiners review so-called "yield enhancement" techniques involving securities lending and swap transactions that certain taxpayers have used to avoid the withholding tax imposed on dividends.

Observations

The Administration's proposals reflect a similar focus on preventing the avoidance of dividend withholding taxes through the use of equity swaps. Under current law, U.S.-source fixed or determinable annual or periodical (FDAP) income, which includes dividends, paid to a non-U.S. person ordinarily is subject to a 30-percent tax (withheld at source). The source of a dividend is determined by reference to the residence of the payor. In contrast, the source of income derived from notional principal contracts generally is determined by reference to the residence of the investor. Accordingly, substitute dividend payments made to a non-U.S. investor with respect to an equity swap referencing U.S. equities are treated as foreign-source income and, thus, not subject to U.S. withholding tax.

To prevent foreign investors from using equity swaps (in lieu of actual equity investments) to benefit from appreciation in value and dividends paid with respect to stock while avoiding U.S. withholding taxes, the Administration has proposed to revoke prior IRS guidance (which modified the application of the regulations on taxation of certain payments made with respect to cross-border securities lending transactions) and issue guidance that eliminates the benefits of such transactions. In addition, the Administration's proposal, which has been incorporated into the proposed Foreign Account Tax Compliance Act of 2009 (FATCA), discussed below, would treat income earned by foreign persons with respect to equity swaps that reference U.S. equities as U.S.-source to the extent the income is attributable to, or calculated by reference to, dividends paid by a domestic corporation.

Qualified intermediaries

Stressing his concerns regarding both U.S. and foreign taxpayers' use of offshore accounts and entities to evade U.S. tax, Commissioner Shulman made clear that both the IRS and the Administration remain focused on fortification of the information reporting and withholding systems that facilitate U.S. taxation of income earned through such accounts and entities. In this regard, the qualified intermediary (QI) program was identified as a critical element of the U.S. withholding regime that must be strengthened.

Observations: The QI program generally allows foreign financial institutions to contract with the IRS to operate according to a set of withholding and information reporting rules. Specifically, QIs agree to collect identifying documentation from their customers, file withholding tax returns and information returns, and submit to periodic audits supervised by IRS examiners. A withholding agent (that is, any person that is responsible for payment of an item of income of a foreign person subject to U.S. withholding) is not required to withhold tax on payments ordinarily subject to withholding if such payments are made to a QI.

FATCA

Commissioner Shulman noted that several of the Administration's international tax proposals were directed at combating offshore tax evasion through the bolstering and expanding of the QI program and other information disclosure procedures. The primary thrust of several of these proposals was subsequently incorporated into FATCA, which was introduced in Congress in late October. In his discussion of withholding taxes, the Commissioner expressed his support for FATCA, a modified version of which passed the House December 9.

Observations

FATCA would significantly alter several aspects of the current U.S. withholding tax regime. For example, under current law, a non-U.S. financial intermediary receiving income from U.S. sources on behalf of its accountholders can claim an exemption from U.S. withholding tax by entering into a QI agreement with the IRS, as noted above, or by providing certain certifications on behalf of each accountholder individually. The FATCA regime would eliminate this flexibility and require withholding agents to withhold 30 percent of the gross amount of all payments of U.S.-source FDAP income and gross proceeds from the sale of securities that can produce U.S.-source dividends or interest ("withholdable payments") made to any "foreign financial institution" unless such institution has entered an agreement with the IRS similar to, but more complex and expansive than, the current QI agreement. Under these agreements, the foreign financial institution would agree to: (1) obtain information from accountholders necessary to identify "U.S. accounts" (including accounts of foreign entities with substantial U.S. owners) (2) annually report specific information to the IRS regarding such accounts; and, (3) comply with certain IRS requests for additional information regarding such accounts.

In addition, FATCA would impose new information reporting and withholding requirements on foreign entities that are not financial institutions. Specifically, a withholding agent would be required to withhold 30 percent of the gross amount of any withholdable payment made to such entities unless the beneficial owner of the payment either certifies to the withholding agent that it does not have any direct or indirect substantial U.S. owners or provides the name, address, and tax

identification number of each substantial U.S. owner. A "substantial U.S. owner" is any U.S. person that owns, directly or indirectly, greater than a 10 percent interest (by vote or value) in the foreign entity, is treated as an owner of a grantor trust, or owns any interest in a foreign investment entity.

Information Sharing

Another trend discussed by the Commissioner, with important implications for enforcement in numerous areas, is the growing international cooperation among tax administrations. Commissioner Shulman discussed various steps that the IRS is taking to enhance cooperation with other nations' tax administrations, noting that the United States continues to work with countries around the world to establish a "new paradigm of transparency and information exchange" and currently has in motion new tax treaties or information exchange agreements with 10 countries. Importantly, he stated that the United States also is working on a protocol to conduct joint audits with some U.S. tax treaty partners.

Other Issues

Among the other issues Commissioner Shulman discussed was one on which he has focused recently -- the role of a corporation's board of directors in corporate governance. He again stressed "the importance of appropriate oversight of tax compliance." Commissioner Shulman said his "goal is to promote good governance on tax issues and engage the corporate community in a dialogue about the appropriate role of the board of directors in tax risk oversight." For more on this issue, see WNTS Insight, "IRS Commissioner Shulman urges corporate directors to take active role in overseeing tax risk," October 20, 2009.

One noteworthy issue the Commissioner did not discuss was the status of the IRS's "policy of restraint" regarding tax accrual workpapers. In August, the IRS won a significant victory in *U.S. v. Textron*, in which the First Circuit Court of Appeals held that the work product doctrine does not protect a corporation's tax accrual workpapers from an administrative summons. Textron has until December 24 to ask the Supreme Court to review the First Circuit's decision. (For prior discussion, see WNTS

Insight, "[Textron: First Circuit holds tax accrual workpapers not protected by work product doctrine](#)," August 18, 2009.)

Final Observations

Commissioner Shulman's remarks indicate that multinationals should anticipate enhanced scrutiny of their transfer pricing practices and use of hybrid instruments and entities. In addition, they may want to begin reviewing their current compliance standards and practices to develop strategies that will allow them to react quickly to the potentially sweeping changes that currently proposed legislation may make to the withholding and information reporting regimes.

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December 14, 2009

A Transfer Pricing
Publication

Pricing Knowledge Network*

Focusing on the impact of major intercompany pricing issues

Significant IRS loss in cost-sharing buy-in Tax Court decision

On December 10, 2009, the Tax Court issued an opinion in *Veritas Software Corp. (Symantec Corp.) v. Commissioner*, addressing important issues regarding the valuation of cost-sharing buy-ins. The decision is a significant defeat for the IRS in its attempt to value buy-ins under pre-2009 regulations using a transfer pricing methodology which exists in current regulations that is based on the net present value of perpetual income streams (i.e., the "Income Method"). The Court flatly rejected the underlying premise offered by the IRS for applying an Income Method. Instead, the Court applied a Comparable Uncontrolled Transaction ("CUT") method similar to that used by the taxpayer in determining a buy-in valuation based on the value of a declining royalty stream over a useful life of four years.


In reaching its decision, the Court rejected IRS arguments that the buy-in valuation should encompass the synergy value of multiple intangible assets as a group, that the value of the assembled research team was an intangible that should be included in the buy-in value, and that the buy-in value should reflect intangibles developed under the cost sharing agreement ("CSA") after the buy-in transaction. The case was decided under the regulations in place in 1999, and to some extent the Court's conclusions are based on specific language in those regulations that is not contained in the temporary regulations issued in December 2008 (Temp. Treas. Reg. § 1.482-7T). Nevertheless, the Court's reasoning could call into question some of the principles underlying the current temporary regulations.

Specific details of the facts and the court's reasoning are outlined below.

Summary Facts and Issue

On November 3, 1999, Veritas Software Corp. ("Veritas US" or "taxpayer") entered into a CSA with its subsidiary in Ireland ("Veritas Ireland"). Pursuant to the terms of the CSA, Veritas US transferred preexisting intangible

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property to Veritas Ireland in exchange for a buy-in payment of \$124.3 million (after a true-up adjustment). Veritas Ireland developed and owned intangible property as a result of the CSA and was responsible for the development of the international market for Veritas products. Veritas Ireland's efforts yielded a five-fold increase in international revenue during the 1999-2004 period.

The taxpayer evaluated the buy-in payment using the CUT method, one of the specified methods provided for in the applicable Treasury Regulations issued under IRC § 482 ("Section 482 Regulations"), and applied a ramp-down factor to the royalty rate to account for the decay in the value of the preexisting technology over its useful life. This declining-royalty CUT method was applied using a four-year life. The lump-sum value of the buy-in was then determined by converting the royalty stream produced by this analysis into a net present value. (As discussed below, the Court followed the same procedure, starting with a higher royalty rate determined from a different set of CUT observations.)

Upon audit, the IRS issued a notice of deficiency for the buy-in payment that increased the value of the preexisting technologies contributed by Veritas US by \$2.5 billion based on the report of Dr. Brian Becker (its first expert) that utilized the foregone profits (income) method, the acquisition price method, and a market capitalization analysis. During pre-trial, the IRS abandoned Dr. Becker and his report and presented to the Court a revised Income Method calculation (set out by its second expert, Dr. John Hatch) which utilized actual Veritas' actual operating results rather than projected income. The revised Income Method yielded an increase to the Taxpayer's value of the preexisting intangibles of \$1.7 billion, approximately \$800 million less than the IRS's original assessment.

PwC Observes:

In his opinion, Judge Foley noted the IRS's lack of a consistent approach to address the valuation of preexisting intangibles which may have caused him to doubt the reliability of the analysis presented by the IRS's experts. Judge Foley also presided over the trial in the *Xilinx* Tax Court case. In that case, his opinion also appeared to express an element of frustration with the government's contradictory positions regarding the use of grant date or exercise date as the most reliable approach to stock option valuation and its lack of adherence to the arm's-length standard. In this *Veritas* decision, Judge Foley seemed frustrated by the IRS's inconsistent valuation methodologies and the significant differential in results from one IRS expert's report to another. Judge Foley's opinion quoted the same portions of the Section 482 Regulations cited in *Xilinx* regarding the government's lack of conformity with the arm's-length standard.

Applicable Regulations

During trial, the IRS's second expert, Dr. Hatch, attempted to explain why the IRS's "akin to a sale" viewpoint and, hence, the Income Method was the best method to value the preexisting intangibles, despite the fact that the Income Method was not a specified method in the Section 482 Regulations that were in force during the years in question. Judge Foley, in his opinion, repeatedly

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pointed to the fact that by using the Income Method and the use of terms such as a platform contribution transaction, the government was inappropriately trying to apply the logic and methods of Temp. Treas. Reg. § 1.482-7T, issued almost a decade after the 1999-2001 period at issue in this case. In addition he found Dr. Hatch's testimony to lack creditability on a number of bases: "Put bluntly, his testimony was unsupported, unreliable, and thoroughly unconvincing."

PwC Observes:

In his opinion, Judge Foley made clear that his decision was based on the Section 482 Regulations in effect during the years at issue which explicitly limited the buy-in payment to cover only the preexisting intangibles. Taxpayers should take care not to draw inferences regarding the applicability of Judge Foley's decision with respect to transactions that are governed by Temp. Treas. Reg. § 1.482-7T, issued in December 2008. Nevertheless, his comments regarding the "akin to a sale" theory, preexisting intangibles, and workforce in place may cast some doubt on the government's support for the introduction of new methodologies in the current Temporary Regulations.

Application of the Income Method

Dr. Hatch determined an increase in value for the buy-in of \$1.7 billion using an Income Method that assumed a discount rate of 13.7 percent and a 17.9 percent compound annual growth rate declining to 13 percent with an assumed seven percent growth in perpetuity. His discount rate was developed from a Weighted Average Cost of Capital ("WACC") calculation that relied on the Capital Asset Pricing Model ("CAPM"). Dr. Hatch's CAPM analysis applied an industry beta rather than the beta specific to Veritas Corp. Accepting the testimony of Professor Burton Malkiel, Judge Foley noted that Microsoft, as one of largest companies in the software industry, skewed downward the results for the industry beta, and therefore, the appropriate beta for Veritas Corp. was significantly understated in Dr. Hatch's calculation of a discount rate.

Further, again accepting Prof. Malkiel's testimony, Judge Foley noted that the market risk premium used by Dr. Hatch to determine the discount rate was also too low. Dr. Hatch applied current market observations rather than the historical data reported by Ibbotson Associates, which, as Judge Foley notes, "is the recognized industry standard for historical capital markets data" and further Dr. Hatch used the wrong Government Bond rate. Hence, Dr. Hatch's equity risk premium of five percent was also determined to be substantially understated which resulted in a discount rate that was too low. When using more appropriate betas and market-risk premium data, Judge Foley factually determined that a discount rate (WACC) of 20.47 percent was appropriate for Veritas. The Court applied that discount rate to determine the present value of the buy-in under the declining-royalty CUT method.

PwC Observes:

The Income Method is particularly sensitive to the discount rate and growth rate assumptions. Dr. Hatch's discount rate was far too low (as he eventually admitted during cross examination) and his growth rate was unreasonably

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high. Judge Foley viewed the IRS's expert as potentially manipulating discount and growth rates to achieve a larger buy-in payment. In considering its future options, the government may need to evaluate the impact on its favored Income Method of using the discount rate (20.47 percent) determined by the Tax Court, together with more realistic growth rate assumptions.

"Akin" to a Sale Theory

The IRS contended that the transfer of preexisting intangible property from Veritas US to Veritas Ireland was "akin" to a sale because "the assets collectively possess synergies that imbue the whole with greater value than each asset standing alone." Therefore, the IRS argued that the valuation under the Income Method appropriately aggregated the controlled transactions.

The IRS position captures in its Income Method valuation of the intangibles contributed to the cost sharing arrangement *all* intangible assets associated with an enterprise, including workforce in place, goodwill, and going concern value. Judge Foley noted that the Administration's Fiscal Year 2010 Revenue Proposals proposed to expand the definition of intangibles governed by Section 482 of the Internal Revenue Code to include workforce in place, goodwill, and going concern value. However, Judge Foley repeatedly ruled that for the years at issue in this case, Treas. Reg. § 1.482-7 does not prescribe the government's "akin to a sale" theory or its inclusion of workforce in place, goodwill, and going concern value as intangible property for which payment ought to be made. As he stated in *Xilinx*, Judge Foley repeated, "Taxpayers are merely required to be compliant, not prescient."

PwC Observes:

The approach set forth under the "akin" to a sale theory was the same as that set out by the IRS in TAM 200907024. In that TAM, the IRS analyzed a transfer of intangibles under IRC § 367(d) and § 936(h)(3)(B) by aggregating the intangible property rather than valuing intangibles separately. Judge Foley noted that the IRS expert's defense of the "'akin' to a sale theory" was "akin to a surrender." In footnote 29 of the Opinion, Judge Foley points out that the district director may only evaluate the results of a transaction as actually structured by the taxpayer unless lacking economic substance. Judge Foley concluded that this transaction "certainly had economic substance" and therefore the transaction at issue must be evaluated as a license of preexisting intangibles, not a sale of a business.

Footnote 31 in the Opinion also is of significant importance to those companies faced with IRS adjustments regarding the transfer of a workforce, for it rebuts the position taken by the IRS in Tier One Section 936 conversions audits. In the footnote, Judge Foley noted that the value, if any, associated with Veritas US' R&D and marketing teams is primarily based on the services of individuals (i.e., the work, knowledge, and skills of team members). Thus Judge Foley concluded that the workforce should be excluded from the buy-in valuation because it is not an item of "intangible property" as defined in section 936 (h)(3)(B), which excludes items that do

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not have "substantial value independent of the services of any individual." This logic also supports the Judge's characterization of the Administration's current tax reform proposal as a "change" in law rather than a "clarification" of the definition of intangible property.

Useful Life of Assets:

Under the declining royalty CUT methodology employed by the taxpayer, a key issue is determining the economic life of the contributed intangible property. Under its Income Method, the IRS contends that the preexisting intangibles have a perpetual life due to the ability to further develop these preexisting intangibles. The taxpayer, on the other hand, determined and demonstrated based on third-party agreements that the appropriate useful life of its preexisting software products and research was four years. Judge Foley agreed with Veritas, giving great weight to the third-party agreements that included ramped down royalties.

At the end of the day, Judge Foley viewed the IRS's position to be arbitrary, capricious and lacking credibility. Although Judge Foley viewed the taxpayer's position, based on Veritas' agreements with third parties, as more reliable, he performed a CUT analysis based on a different set of Veritas' third-party agreements with OEMs that covered the OEMs' "unbundled" sale of the taxpayer's software products separately from other hardware or operating systems.

PwC observes:

The decay in the useful life of the intangible assets observed in Veritas' declining-royalty CUT method is also observed in the Residual Profit Split Method ("RPSM") used by many taxpayers during this same period. The RPSM and the declining-royalty CUT method, in contrast to the Income Method, generally values the preexisting intangible assets directly contributed to the CSA and not the benefits of future intangibles (i.e., the very intangibles to be developed under the CSA).

Conclusions

This ruling is a significant victory for Veritas and a major defeat for the IRS's attempt to enforce the prior buy-in regulations using current rules. However, taxpayers need to be cautious in the application of this decision because it is based on regulations that have since been replaced and many of the very favorable facts supporting the factual aspects of the decision are specific to Veritas. Given that Judge Foley dismissed one of the IRS's key intangible valuation theories (premised on the existence of intangible asset synergies and the value of future developments) on the basis that such items are not included in the definition of intangibles in the Section 482 Regulations, and given the Administration's current tax reform proposals that attempt to "clarify" that existing law already includes such items as workforce, goodwill and going concern value, it would seem that the IRS will take a hard look at appealing this decision. As with the *Xilinx* case, which was recently overturned at the appellate level (and a request for a rehearing *en banc* is currently pending), this Tax Court decision also would be appealed to the Ninth Circuit Court of Appeals.

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October 20, 2009

A Transfer Pricing
Publication

Pricing Knowledge Network*

Focusing on the impact of major intercompany pricing issues

In this issue:

Joint Committee on
Taxation comments on
proposals designed to
limit shifting of income
through intangible
property transfers


Joint Committee explanation suggests possible fundamental changes to the transfer pricing regime for intangibles

On September 14, 2009, the staff of the Joint Committee on Taxation ("JCT") released *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment*(JCS-4-09), which describes and analyzes the international tax provisions included in the Obama Administration's federal budget proposals for fiscal year 2010. One of the Administration's proposals, which directly targets transfer pricing, is the proposal to "Limit Shifting of Income through Intangible Property Transfers," primarily by "clarifying" the definition of intangible property for purposes of sections 482 and 367(d) of the Internal Revenue Code. For a link to PwC's prior PKN Alert, "President Obama's proposal to limit shifting of income through intangible property transfers" (May 22, 2009), which analyzes the Administration proposal and was cited in the JCT document, please click here:

<http://www.publications.pwc.com/DisplayFile.aspx?Attachmentid=2102&Mailinstanceid=11212>

The JCT document goes beyond merely explaining the Administration proposal on this subject, however, and offers suggestions for additional legislative modifications intended to limit opportunities for multinational taxpayers to shift intangible property income outside of the United States. Some of the suggested changes could fundamentally alter the transfer pricing rules as they apply to intangible property transactions.

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PwC Observes:

Pointing to the empirical evidence, the JCT document suggests that inappropriate income shifting with respect to intangibles continues to erode the U.S. tax base, despite the current statutory and regulatory rules under sections 482 and 367(d), and "despite the substantial resources devoted by the IRS to their enforcement." By signaling that enforcement of the current rules will not adequately protect the U.S. tax base, this conclusion sets the stage for proposed fundamental modifications to tighten the current transfer pricing regime for intangibles.

The JCT document describes various ways in which a U.S. taxpayer can make intangible property available to a foreign affiliate, including intercompany sales or licenses of intangible property, cost sharing arrangements, and contributions of intangible property subject to section 367(d). A particular focus of the JCT discussion is the CWI standard, which cuts across all these types of transfers. The CWI standard, enacted in 1986, provides that income with respect to a transfer or license of an intangible must be commensurate with the income attributable to the intangible. The JCT document notes that, in an apparent attempt to reconcile the CWI standard with the arm's length principle, the Treasury Department's 1988 White Paper and the CWI provisions of the current section 482 regulations tempered the stronger language contained in the legislative history of the CWI enactment. The JCT revisits this point later in its document, suggesting several fundamental modifications to the transfer pricing rules that the JCT staff believes to be more faithful to the original intent of the CWI standard.

Goodwill, Going Concern Value, and Workforce in Place

As described in the May 22, 2009, PKN Alert, a contentious issue that has arisen in many high stakes controversies between taxpayers and the IRS is the appropriate treatment of goodwill and going concern value under the section 482 transfer pricing rules and under the rules governing outbound transfers subject to section 367(d). These controversies have arisen in part because of the wave of outbound restructurings of U.S. manufacturing operations fostered by the expiration of the section 936 possessions credit rules. Similar issues have also arisen in cases involving cost-sharing buy-in payments.

IRS audits of the restructuring and buy-in cases frequently involve disputes regarding whether goodwill, going concern value, and workforce in place are intangible property for which compensation must be recognized. Both sections 367(d) and 482 reference the definition of intangible property provided in section 936(h)(3)(B), but that section fails expressly to mention goodwill, going concern value, and workforce in place as part of the definition. Because these three items are not explicitly included in the definition, taxpayers have argued that transfers of these items are not compensable. The IRS disagrees.

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where the value of the intangibles as a group is greater than the sum of the values of the intangible assets individually. The proposal would require that the additional value arising from the interrelation of intangible assets be properly attributed to the underlying intangible assets in the aggregate and properly compensated.

In its discussion of aggregation for valuation purposes, the JCT document provides an example of the aggregate value of the assets being greater than the sum of each asset individually. The example involves the transfer of 10 patents by a pharmaceutical company for a new wonder drug it developed. Individually the patents may be only marginally valuable, but as a group they constitute the formula for the new drug and that value could be substantially higher than the sum of the values of the individual patents.

The IRS addressed the issue of asset-by-asset valuation in Technical Advice Memorandum 200907024. The JCT document states that the IRS's position on the aggregate valuation of intangible assets is consistent with court decisions outside of the section 482 context (which were cited in the Technical Advice Memorandum), and with the recently issued cost sharing regulations. As section 367(d) valuation issues are resolved by reference to section 482, the proposal would have implications for 367(d) transactions as well as for sales, licenses, and transfers made in conjunction with cost sharing agreements.

Highest and Best Use Principle

Another change contained in the Obama Administration proposal would require application of the "highest and best use" principle when valuing intangible property. The proposal would require that intangible property be valued (a) at its highest and best use, (b) as it would change hands between a willing buyer and willing seller, (c) neither being under any compulsion to buy or to sell, and (d) both having reasonable knowledge of the relevant facts.

The highest and best use standard is not defined in the Treasury Regulations, but has been developed through case law dealing principally with land valuations (for example, for purposes of eminent domain or charitable contribution determinations). The JCT document cautions that the fact that the highest and best use case law developed in contexts so different from a related-party transfer of intangible property could complicate, rather than simplify, tax administration efforts. The JCT document points out, for example, that some cases have held that value unique to the owner of the relevant property is not appropriately taken into account under the highest and best use standard. The JCT document recommends that any legislation prevent taxpayers from arguing that such unique value is not compensable, and ensure that the IRS has the ability to take into account the unique capabilities the controlled parties contribute to the transaction.

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October 20, 2009

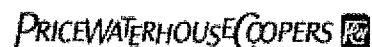
permitted deviation from projected profit. Treasury and IRS officials have stated that profit falling outside this range will not automatically trigger an adjustment, only an investigation into the circumstances giving rise to the variance. The JCT document argues that the legislative history of the CWI standard suggests a more determinative role for actual profit experience when there is a significant variance between projected and actual profits.

The third possible reform discussed is a revision of the cost sharing framework. The JCT staff's concern is that the current framework may be unintentionally encouraging U.S.-based multinationals to shift intangible property development and economic ownership offshore. The JCT document suggests that a new, more limited framework may be appropriate. Under the suggested limited framework, cost sharing arrangements among related parties would not be recognized in the absence of comparable arrangements among uncontrolled parties.

PwC Observes:

The possible reforms suggested by the JCT staff could fundamentally alter the U.S. transfer pricing regime for intangibles. Depending on how the specifics are developed, the suggested reforms could (except in very limited circumstances) effectively prohibit use of the CUT method, mandate automatic periodic adjustments made with hindsight, and repeal cost sharing. Such modifications could raise concerns about how these newly adopted standards could be reconciled with the generally recognized arm's length standard and methods as applied in other countries, and with U.S. tax treaty policy and treaty obligations mandating the arm's length standard.

For example, the OECD Transfer Pricing Guidelines endorse the use of comparable uncontrolled transactions as a method to evaluate related-party license transactions, and some taxing authorities prefer to evaluate such transactions based on observable arm's length benchmarks rather than internal profit data. Similarly, the OECD Guidelines explicitly recognize cost contribution arrangements among related parties ("cost contribution arrangements" are the OECD analogue to cost sharing arrangements). In addition, many may question whether mandatory periodic adjustments made with hindsight are consistent with the arm's length standard. Combined with an express legislative endorsement of income-based methods for unique intangible property, mandatory periodic adjustments could raise concerns among U.S. trading partners about excessive and automatic allocations of intangible property income to U.S. licensors. As a consequence, multinational taxpayers could be caught in the middle as they seek to comply with inconsistent transfer pricing rules in both the United States and other countries, and the number of difficult competent authority disputes could grow.



Pricing Knowledge Network*

June 10, 2009

PKN Alert United States - Xilinx: Ninth Circuit overturns Tax Court rejecting arm's length standard to require cost sharing of stock option compensation

On May 27, 2009, the Ninth Circuit, in a 2-1 decision in favor of the Commissioner, reversed the Tax Court in Xilinx and held that stock option compensation must be included in cost sharing arrangements despite finding that such inclusion conflicts with the arm's length standard.

EXECUTIVE SUMMARY

The court held that the cost sharing regulations in effect for Xilinx's 1997-1999 tax years require that related companies developing intangibles in a cost sharing agreement ("CSA") must share all costs associated with the intangible development activity, regardless of what an analysis pursuant to the arm's length standard demonstrates. Specifically the court found that the "cost" of stock option compensation must be shared, even though it was established that these costs are not shared in arm's length arrangements. In reaching its decision, the court relied upon the following rationales:

1. **Structural Analysis and Regulatory Construction:** The court gave two primary reasons for its interpretation of the regulatory requirements. First, it found that the structure of the Regulations supported its conclusion that the Treas. Reg. § 1.482-7 ("Cost Sharing Regulations") are "a self-contained provision creating an exception to the general [arm's-length] methodology...a bright line rule [that] governs what costs must be shared [uninformed by] similar agreements between unrelated parties." Second, the court reasoned that the more specific provisions of Treas. Reg. § 1.482-7(d)(1) (providing for the inclusion of all costs related to a CSA) trumps the more general arm's length standard under Treas. Reg. § 1.482-1(b)(1).
2. **Definition of Costs:** The court determined that employee stock options ("ESOs") are intangible development costs for the purpose of applying Treas. Reg. § 1.482-7(d)(1).
3. **Tax Treaty Aspects:** The court held that under the US-Ireland Income Tax Treaty savings clause, Treas. Reg. § 1.482-7(d)(1) can be applied to Xilinx without violating the Treaty, even when the result is inconsistent with the arm's length standard.

The Court remanded back to the Tax Court to consider whether Xilinx should be subject to a transfer pricing penalty, noting that for the tax years at issue there was a lack of regulatory guidance regarding the inclusion of ESOs as a cost.

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Xilinx may request a rehearing by the three-judge panel or an *en banc* rehearing by the entire Ninth Circuit, and/or seek review by the U.S. Supreme Court.

DETAILED SUMMARY OF COURT'S HOLDING [WITH PRICEWATERHOUSECOOPERS' OBSERVATIONS]

Background

In 1995, Xilinx, Inc., a U.S. corporation, and Xilinx Ireland entered into a CSA to jointly develop and own technology that was developed under this agreement. Under the terms of the CSA, each party was required to pay a percentage of R&D costs in proportion to its anticipated benefits. The parties did not include ESOs in their definition of R&D. The IRS issued notices of deficiency for tax years 1997 through 1999 contending that the value of the ESOs issued to employees that supported Xilinx's R&D activities should have been included in the definition of R&D costs and therefore shared by the parties.

Xilinx petitioned the Tax Court. The Tax Court held that the IRS's allocation is contrary to the arm's length standard because evidence presented at trial demonstrated that uncontrolled parties would not agree to share the costs of ESOs. The Tax Court reasoned that the IRS's allocation was arbitrary and capricious because it included the value of the ESOs in the pool of costs to be shared, while evidence Xilinx presented at trial demonstrated that unrelated companies dealing with each other at arm's length would not share those costs. The government appealed the Tax Court's ruling to the Ninth Circuit Court of Appeals, arguing that the evidence demonstrating that unrelated parties would not share the cost of options is irrelevant and the arm's length standard is met in a CSA only when the parties actually share all costs including ESOs.

Structural Analysis and Regulatory Construction

The court held that related companies in a CSA must share all costs incurred in the development of intangibles, despite the evidence demonstrating that unrelated parties would not treat ESOs as a cost to be shared in their dealings. The court was not persuaded by the IRS's or the taxpayer's attempts to harmonize the arm's length standard and the "all cost" requirement in the Cost Sharing Regulations. The court found these provisions were "irreconcilable" and that the all cost requirement of the Cost Sharing Regulations controls in light of the "elementary tenet of statutory construction that . . . a specific statute will not be controlled or nullified by a general one." The court found support for this conclusion in the structure of the Regulations, which it found indicated that the Cost Sharing Regulations are a self-contained regime whose rules do not necessarily have to comport with the arm's length standard. The court observed that Treas. Reg. § 1.482-1 does not explicitly refer to Treas. Reg. § 1.482-7 as one of the subsections providing tests for arm's length results (in contrast to subsections -2 through -6). The court also believed that the regulatory history suggested CSAs were viewed as "a unique type of controlled transaction meriting a distinct method of analysis."

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PwC Observes:

The court's conclusion effectively treats cost sharing as a regulatory safe harbor. This treatment is inconsistent with the statements made by Treasury and the IRS in the preamble to the Proposed Cost Sharing Regulations: "Transactions in connection with a CSA must produce results consistent with the arm's length standard. The proposed regulations, therefore, dispel the misconception that cost sharing is a safe harbor." It is also contrary to the IRS's oft repeated contention that the Cost Sharing Regulations are not a safe harbor.

Further, the decision by the court appears contrary to the plain meaning of the Regulations that provide for the application of the arm's length standard in every case: "In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." Treas. Reg. § 1.482-1(b)(1).

In footnote 9 of the opinion, the court dismissed any concern that recent modifications to the Regulations (explicitly requiring that cost sharing agreements produce arm's length results as well as mandating the sharing of ESOs) might undercut its structural argument. The court declared that the Treasury could give a technical definition to "arm's length" that is contrary to (indeed "irreconcilable" with) its plain meaning.

Definition of Costs

The Ninth Circuit determined that ESOs are "costs," even though this issue had not been addressed by the Tax Court. For financial statement and cost sharing purposes, Xilinx had used APB 25, which did not treat ESOs as a cost for financial statement purposes. The court, however, determined that FAS 123 (which treated ESOs as costs) was the preferred business accounting method in effect during the relevant tax years. The court also found persuasive that Xilinx treated ESOs as "expenses" by claiming them as a U.S. tax deduction under IRC §§ 83 and 162. Further, the court also determined that the relevant ESO costs were related to the development of intangibles, dismissing Xilinx's argument that ESOs were different from other types of compensation or benefits received by employees.

Tax Treaty Aspects

The court held that the United States - Ireland Tax Treaty (the "Treaty") did not preempt the all-costs requirement. While the court recognized that the Treaty provides for the application of the arm's length standard, the court pointed out that the Treaty's savings clause allows a contracting state to apply its domestic laws to its own residents and citizens, even if those laws conflict with the Treaty. Thus, the court concluded that Treas. Reg. § 1.482-7(d)(1) can be applied to Xilinx without violating the Treaty, even when the result is inconsistent with the arm's length standard.

PwC Observes:

The court's reasoning affirms that the IRS may prescribe non-arm's length standards without violating U.S. income tax treaty commitments. This course of action could prompt both the IRS and foreign tax authorities to adopt

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domestic regulations that conflict with the arm's length standard and potentially result in difficult matters for the Competent Authorities to resolve. Currently, the U.S. Competent Authority is faced with the task of resolving double tax matters as a result of foreign governments' refusal to recognize ESOs as a cost in evaluating the arm's length nature of controlled transactions. Thus, companies may be faced with the prospect of increased risks of double taxation.

Dissent

Judge Noonan dissented from the majority opinion. His dissent focuses on concerns about the majority's use of a single canon of construction to reach a "pat" solution, without considering the underlying purpose of the regulation. Judge Noonan stated, "The canons are 'tools designed to help courts better determine what Congress intended, not to lead courts to interpret the law contrary to that intent.'" Judge Noonan then proceeded to raise three specific concerns.

First, Judge Noonan stated that "the purpose of the regulation is paramount," observing that the purpose "is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions. The regulations are not to be construed to stultify that purpose. If the standard of arm's length is trumped by 7(d)(1) the purpose of the statute is frustrated." Thus, the dissent concluded that the majority's holding interprets the law contrary to the intent of its maker.

Second, Judge Noonan cited a basic canon of construction applicable to a case "in which the complex statutory and regulatory scheme lends itself to any number of interpretations. We resolve the inconsistencies against the government." He added, "If the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer." Judge Noonan noted that this canon is not a concession to taxpayers, but is just one application of the broader principle that legal documents are construed against the drafter.

Finally, Judge Noonan pointed out that the Treasury Department's own actions in negotiating and explaining the Treaty undercut the argument for a non-arm's length result. Judge Noonan quoted both the Treaty provisions calling for application of the arm's length standard and the explanation of those provisions in the Treasury Department's Technical Explanation. He observed, "No fewer than five times, the Explanation refers to the arm's length standard as decisive." Judge Noonan viewed the Treaty provisions and the Explanation as guides that reveal what Treasury had in mind in issuing the regulations.

Judge Noonan sharply criticized the majority's reasoning. He probably best summed up his criticism by noting that perhaps the court should have held, "[W]hen the Commissioner talks out of both sides of his mouth, his speech is unintelligible and his regulations are unenforceable."

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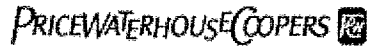
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May 22, 2009

PKN Alert United States - President Obama's proposal to limit shifting of income through intangible property transfers

The Obama Administration's recent budget proposals recommend one direct change to the section 482 transfer pricing rules. This proposal would seek to broaden the definition of intangible property to include goodwill, going concern value, and assembled workforce for purposes of both the transfer pricing rules and the rules related to outbound non-recognition transfers of such property. The proposal would also modify principles for valuing transferred intangible property by imposing a "highest and best use" standard and permitting aggregate valuation of transferred intangibles.

Under current U.S. law, the term intangible property is defined by reference to a lengthy laundry list of items. That list includes, patents, formulas, processes, know how, copyrights, trademarks, trade names, brand names, franchises, contracts, methods, programs, and a number of additional items. The relevant laundry list, contained in section 936(h)(3)(B) of the Internal Revenue Code, concludes by adding as the final element of the list "any similar item." The statute adds the further gloss that the item of intangible property must have "substantial value independent of the services of any individual."

When one related party makes an item of intangible property from the list available to another related party, section 482 requires arm's length compensation for such property. When a taxpayer transfers an item of intangible property to an affiliated foreign corporation in a transaction otherwise qualifying for non-recognition treatment under the IRC, section 367(d) requires the transferor to include in its income annual payments over the useful life of the intangible asset, reflecting the value of that intangible property. In both cases, the commensurate with income principle applies permitting periodic adjustment of the amounts required to be paid.

The laundry list definition of intangible property does not, however, specifically include "goodwill, going concern value, or workforce in place." When section 367(d) was adopted in 1984, Congress specifically indicated in legislative history language that its provisions were not to apply to goodwill and going concern value developed by a foreign branch. As a result, the regulations under 367(d) specifically exclude "foreign goodwill and going concern value" from the periodic income inclusion requirement.

These provisions have given rise to significant high stakes controversy. Taxpayers in some instances have sought to take advantage of the section 367(d) exception for transfers of foreign goodwill and going concern value in connection with capital contributions or reorganization transactions. In other situations taxpayers have sought to narrow the scope of the classes of intangible property for which payment is required under section 482 by arguing that goodwill, going concern value, an assembled workforce, and similar assets are not intended to come within the definitional scope. The IRS has responded

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by arguing, particularly in the context of cost sharing buy-in payments and conversion of former section 936 possessions corporation subsidiaries to CFC status, that the foreign goodwill and going concern exception is very narrow, and that most intangible assets fall within the scope of the laundry list definition, at least as "any similar items." TAM 200907024 provides the most elaborate description of the IRS position under section 367(d). The new cost sharing regulations also specifically require compensation for assembled workforce intangibles made available under a cost sharing arrangement.

An important case raising this definitional controversy was recently filed in the U.S. Tax Court. In that case, Western Union, the cash transfer business, transferred contracts with unrelated local country agencies to a foreign subsidiary in a non-recognition transaction. The taxpayer took the view that most of the value of this "network" constituted foreign goodwill and going concern value within the meaning of the section 367(d) exception and that no current income inclusion was required. The IRS has taken the position that the transfer of the foreign agency network is not a goodwill transfer and has asserted that the network had a value of more than \$2.5 billion dollars, an amount that should be included in U.S. taxable income over the network's projected useful life. The Western Union facts appear to have been the subject of TAM 200907024. Numerous additional matters raising the same issue - the definition of intangible property and the treatment of transferred goodwill - are currently actively under audit.

The Administration's legislative proposal apparently seeks to eliminate the definitional confusion by broadening the definition of intangible property to specifically include goodwill, going concern value, and assembled workforce. While the scope of the provision is not entirely clear, it would appear to eliminate the exception from section 367(d) for transfers of foreign goodwill and going concern value and would also apparently make it clear that for both section 482 and section 367(d) purposes, the definition of intangible property includes these types of assets.

Building on the principles set out in the recent cost sharing regulations, the Administration's proposal would also modify the principles for valuing intangible assets. In particular, the Administration's proposal would make it clear that the IRS has the ability to value transferred intangibles on an aggregate basis. This change would undoubtedly lead to greater IRS reliance on discounted cash flow valuation models that have the effect of treating all residual value in a business as intangible property to be compensated without the need to associate values with specific assets. At times, the IRS interprets these methodologies in a manner that reduces the licensee/transferee to the earnings status of a provider of routine contract manufacturing or marketing services. The income method, controversially made the cornerstone of intangible property valuation in the cost sharing context, would appear likely to take on even greater importance in other contexts under the Administration's proposal.

The proposal also suggests that intangibles would be required to be valued according to their "highest and best use." While rather vague, this change would seem to be directed at requiring, as do the cost sharing regulations, that taxpayers take into account their "reasonably available" business opportunities in valuing intellectual property. It might also serve as a basis for disregarding observable arm's-length transactions in favor of the results of theoretical

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models. This new definition put forth in the Green Book proposal for valuing intangibles may deviate significantly from the concept of Fair Market Value (FMV) generally used in valuation contexts. This could lead to greater controversy with other countries if the IRS prescribes an extreme point in the range of arm's length values by stipulating the "highest and best use" criteria. In fact, depending on its interpretation, the highest and best use standard may well produce a value higher than any observed in the competitive market place owing to the presence of consumer surplus in all market transactions. The proposal may be an attempt to legislate the IRS's current desire to replace observable arm's-length valuations with the results of specified models.

These proposals collectively will raise the stakes in IP migration transactions. They would give the IRS additional tools to apply in asserting high valuations for transferred or licensed intangibles. They also would have the effect of preventing taxpayers from seeking to exploit differences in the definitional provisions in sections 367(d) and 482 in order to claim a value for transferred intangible property that is substantially lower than the value of the transferred ongoing business.

Certainly, one important question if this proposal advances will be the impact it may have on pending high stakes controversies. The IRS will undoubtedly argue that the principles enunciated in the current proposal are, for the most part, already features of existing law. Taxpayers may argue that the change itself confirms that Congress intended in the past to allow outbound transfers of valuable "soft" intangibles, thus supporting taxpayer positions in litigation.

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