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IRS Issues International Software Transfer Regulations

New Rules Govern Classification of International Transactions Involving Computer Programs

BY DAVID R. COOPER (CONTRIBUTING EDITOR)

The IRS has issued final regulations on the tax treatment of certain international transactions involving the transfer of computer programs. T. D. 8785, 1998-42 I.R.B. 5 (October 19, 1998). In essence, the regulations provide detailed rules for classifying the transactions as sales or licenses of copyright rights, sales or leases of copyrighted articles or the provision of services for purposes of their tax treatment under the Internal Revenue Code and U.S. income tax treaties.

The new rules apply to a variety of cross-border computer software transactions. Although the new rules fit within the existing source of income rules under §861 of the Code, they have broad implications for other aspects of international tax practice, including the foreign tax credit, controlled foreign corporations, transfer pricing, foreign personal holding companies and foreign trusts. This article examines the new rules in detail.

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Canada Adopts Aggressive Penalties for "Improper" Transfer Pricing

Action Seen as Response to U.S. Policy of Imposing Penalties of up to 40 Percent of Underpayments

BY STEVEN P. HANNES (MCDERMOTT, WILL & EMERY)

The U.S. Congress enacted two transfer pricing penalties: the transactional penalty and the net adjustment penalty. Both penalties are 20 percent of the tax underpayment related to a transfer pricing adjustment made by the IRS. *See* §6662 of the Internal Revenue Code. Both penalties rise to 40 percent of the underpayment if a taxpayer's transfer price is 400 percent or more (or 25 percent or less) of the correct amount under §482 of the Code. The penalties also rise if the net adjustment to taxable income exceeds the lesser of $20 million or 20 percent of the taxpayer's gross income. The imposition of these penalties under U.S. law has led to comparable actions by the tax authorities in some of our largest trading partners.

In June 1998, the Canadian government adopted legislation that imposes a penalty on transfer pricing between related parties that is not considered arm's length for Canadian income tax purposes. The penalty will apply if Rev-

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Intellectual Property

The IRS recently issued final regulations that provide detailed rules for classifying international transactions involving the transfer of computer programs. The new rules characterize the transactions as sales or licenses of copyright *rights*, sales or leases of copyrighted *articles* or the provision of services, for purposes of their tax treatment under the Internal Revenue Code and U.S. income tax treaties. ***Strategies*** examines how the new rules distinguish between transfers of copyright rights and transfers of copyrighted articles, based on the type of rights being transferred. *Page 1*

Procedural Issues

The IRS Reform Act of 1998 requires that the same interest rate apply to tax underpayments and overpayments that are outstanding with respect to the same taxpayer at the same time. The new provision, §6621(d) of the Internal Revenue Code, incorporates the principle of "global netting," which happens when overpayments and underpayments are offset ("netted") against each other. Our ***Planning Advisory*** looks at the genesis of this new Code section. *Page 3*

Transfer Pricing

The U.S. has two transfer pricing penalties, the transactional penalty and the net adjustment penalty, under §6662 of the Internal Revenue Code. Tax authorities in U.S. trading partners, including Brazil, Mexico, Canada and the United Kingdom, have responded with similar rules. ***Strategies*** reviews the new Canadian legislation that imposes a relatively harsh penalty on improper transfer pricing between related parties. *Page 1*

Snapshots

The 1998 IRS Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*, contains several changes of interest to tax practitioners; the IRS Advance Pricing Agreement (APA) program may be affected by the agency's extensive reorganization, which is now underway. *Pages 15-16*

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The new rules have broad implications for other aspects of international tax practice, including the foreign tax credit, controlled foreign corporations, transfer pricing, foreign personal holding companies and foreign trusts.

Background and Scope of the New Rules

The new rules, found at §1.861-18 of the Income Tax Regulations, classify transactions in computer programs for certain international provisions of the Code. They also apply to the interpretation of U.S. tax treaties. Among other things, U.S. tax treaties provide that terms not defined in the treaty are defined by reference to domestic (U.S.) law.

The rules are limited to classifying transactions involving the transfer of computer programs. Generally, these transactions involve the transfer (by sale, lease or license) of computer programs abroad by a U.S. taxpayer. The new rules do not cover the transfer of other types of digitized information.

Section 1.861-18 of the Regulations distinguishes between transfers of copyright rights and transfers of copyrighted articles based on the type of rights being transferred. The regulations recognize that computer programs are subject to copyright protection under both U.S. and foreign law. *See, e.g.*, Copyright Act of 1976, §101 *et seq.* and EC Directive on Legal Protection of Computer Programs, Council Directive 91-250, 1991 J.O. (L 122). According to the IRS, copyright law should be a factor in classifying transactions for tax purposes, but should not be determinative.

Copyright law grants certain exclusive rights to a copyright owner. Section 1.861-18 classifies a transaction as the transfer of a copyright *right* if the transferee acquires one or more of the rights identified in the regulations (discussed more fully below). If the transferee acquires a copy of a computer program, but does not acquire any of the rights identified in the new rules, the transaction is classified as the transfer of a copyrighted *article*. Transfers of copyright rights are further classified as sales or licenses (generating royalty income). Transfers of copyrighted articles are further classified as sales or leases (generating rental income).

Section 1.861-18(a)(3) defines a computer program as a set of statements or instructions to be used directly or indirectly in a computer to bring about a certain result. The definition includes a database or similar item only if it is incidental to the operation of the program. The definition of a computer program also includes any media, user manuals or documentation that are incidental to, and routinely transferred along with, the program.

The new rules do not define the term "computer." The definition of the term "software" is based on the definition in the Copyright Act of 1976. That Act also does not define the term "computer."

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Planning Advisory

Navigating the Global Netting Rules

Uncertainties Abound in Interest Rate Calculation Process Under New Law

BY JAMES E. SALLES (CAPLIN AND DRYSDALE)

The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, mandates that the same interest rate apply to tax underpayments and overpayments that are outstanding with respect to the same taxpayer at the same time. Congress thus responded to pressure to alleviate the burden facing taxpayers that simultaneously owed, and were owed, money in different tax accounts. The new provision, §6621(d) of the Internal Revenue Code, generalizes the principle (although not the precise rules) that has long since applied when particular overpayments and underpayments are offset ("netted") against one another. This is frequently referred to as global netting.

As usual, the devil lies in the details of implementation. Congress evidently intended to simplify the administration of §6621(d) by providing the IRS with some flexibility to design substantive rules within the limits of its existing management structures and computer systems and by requiring taxpayers seeking retroactive application of the new provision to notify the IRS within a limited window period. Both efforts seem to have backfired badly, compounding rather than reducing confusion.

The deceptively simple Code provision involves three key concepts. A net interest rate of zero is prescribed for the future on overlapping tax underpayments and overpayments. Then, a transition rule provides that this "global netting" will be applied retroactively, if the relevant statutes of limitation are open and the taxpayer files a request reasonably identifying the overpayments and underpayments that it wants netted by December 31, 1999.

Basic questions remain about all of these issues. How will a net interest rate of zero translate into interest to be assessed, allowed or abated? What exactly are the applicable statute(s) of limitation? Will some taxpayers that would benefit from retroactive relief be able to make the necessary reasonable identification before December 31, 1999? A hurried technical correction in recent legislation only created further confusion about the statute of limitations and failed to provide further guidance on the other issues.

This confusion is not that remarkable, given that both the original provision and the technical correction represented last minute legislation drafted under enormous time pressure. The staffers who drafted the changes could not reasonably be expected to grasp the finer points about how they might play out in the highly technical process of resolving multi-year settlement computations.

Corporations do not usually face a deductibility issue, but are subject to a possible sourcing problem. Refund interest will be U.S. source income, whereas interest *deductions* normally must be apportioned between U.S. and foreign source income.

However, the changes leave the IRS struggling to issue guidance that is both workable and consistent with existing authorities on such things as the statute of limitations, while taxpayers are left guessing about how they can file a claim and the likely dollar impact of the new provision. The prospects seem fair for further legislative efforts to clarify the "clarification" of the statute of limitations issue and to extend the December 31, 1999 deadline, expressly provide for protective identifications, or both.

The first part of this article reviews the background of global netting. The second part, to be included in the next issue of *Strategies*, discusses the major issues that are likely to arise in developing guidance under the existing provision and in any possible legislative revisit of the issue.

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If a corporate taxpayer is in a chronic excess foreign tax credit position, the portion of the deduction allocated against foreign source income may produce only a deferred benefit, or none at all, if it only serves to save foreign tax credits that are fated to expire unused.

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Section 1.861-18 applies to related and unrelated parties. The relationship between the parties generally does not affect the character of a transaction under the new rules. Of course, if the parties are related for purposes of §482 of the Code, that section may apply in determining the correct price for a transfer abroad of computer programs.

The regulations under §1.861-18 are limited to classifying transactions in computer programs. They do not cover transactions involving the transfer of other types of digitized information.

The new rules became effective on October 2, 1998. (The IRS had published proposed regulations on November 13, 1996. REG-251520-96, 1996-2 C.B. 511, 61 Fed. Reg. 58152.) They apply to transactions occurring in connection with contracts entered into on or after December 1, 1998.

There are also special transition rules. You may elect to apply §1.861-18 to transactions occurring in connection with contracts entered into in tax years ending on or after October 2, 1998. You may also elect to apply the regulations to transactions occurring in tax years ending on or after October 2, 1998, pursuant to contracts entered into before that date. However, in this case, you can take advantage of the transition rules only if you would not have to change your method of accounting or, if you had to change your accounting method, the resulting adjustment under §481 of the Code would be zero.

Example of a Simple Transfer Abroad of a Computer Program

A, a U.S. corporation, owned the copyright to a computer program, Program X. A copied Program X on disks and placed them in boxes covered with a wrapper that included what is generally called a "shrink-wrap license." The license is perpetual. The disks were made available for sale to the public outside of the U.S.

Under this license, reverse engineering, decompilation or disassembly of the computer program is not allowed. The transferee received the right to use the program on two of its own computers, provided that only one copy was in use at any one time. It also received the right to make one copy of the program on each machine as an essential step in using the program. The transferee could sell the copy as long as it destroyed any other copies it made and imposed the same licensing terms and conditions on the buyer. P, a resident of a foreign country, purchased one disk containing Program X.

Under §1.861-18, the shrink-wrap label license is not determinative of what rights were transferred to P. Under §1.861-18(c)(2), no copyright *rights* were transferred to P in this transaction. P received a copy of the program, however. Thus, P received a copyrighted *article*. P became the owner of the copyrighted article. Thus, the transaction involved the sale of a copyrighted article and not the grant of a lease of Program X by A to P.

Sourcing Rules

Generally, under current U.S. rules, the source of income from sales of property depends to varying degrees on both the type of property and, for inventory property, the place of sale. The place of sale generally is determined by the place where title to the property passes. *See* §1.861-7(c).

The regulations provide specific sourcing rules for income derived from the transfer abroad of computer programs. Income from transactions that are classified as sales or exchanges of copyrighted articles is sourced under §§861(a)(6), 862(a)(6), 863, 865(a)-(c) or 865(e), as appropriate. Income from the sale or exchange of a copyright right is sourced under §§865(a), (c)-(e) or (h), as appropriate. Income from either leasing a computer program or licensing copyright rights in a computer program is sourced under §§861(a)(4) or 862(a)(4), as appropriate.

The parties to a transaction in most instances may agree on where title passes for sales of inventory property. Any income from the electronic transfer of computer programs that constitutes inventory property, classified as sales of copyrighted articles, would be sourced under similar principles.

Effect of Foreign Law

Certain terms taken from copyright law are specifically defined in the regulations. Unless specifically defined in the regulations, legal standards that have been culled from copyright law are given the same interpretation as under U.S. copyright law. However, factual predicates for applying the standards may be provided by reference to foreign copyright law.

For example, if you had to determine whether a transferee acquired the right to create a derivative work based on a computer program protected under French copyright law, the facts of the case (*i.e.*, the rights that the transferee could exercise) would be determined under French law and the agreement between the parties involved. However, whether or not the transferee's rights constituted the right to create a derivative work for purposes of §1.861-18 would be determined by comparing the rights created under French law and the agreement between the parties to the definition of the right to create a derivative work under U.S. law.

Section 1.861-18 does not change certain rules relating to the foreign tax credit under the Internal Revenue Code. Specifically, the new rules do not modify the requirement, under §1.901-2(e)(5), that the substantive and procedural provisions of foreign law (including applicable tax treaties) determine a taxpayer's liability for foreign taxes. Further, the regulations under §904 of the Code recognize that a creditable foreign tax may be imposed on an item of income that is taxed at a different time or in a different manner in a foreign country than in the U.S. *See* §1.904-6(a)(1).

Classifying Copyright Rights

Section 1.861-18(c)(2) describes four copyright rights:

1) the right to make copies of a computer program for distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;
2) the right to prepare derivative computer programs based upon a copyrighted computer program;
3) the right to make a public performance of a computer program; or
4) the right to publicly display a computer program.

If the transfer of a computer program results in the transferee acquiring any one or more of the four rights listed above, then the regulations classify the transaction as a transfer of a copyright right.

A substantial right to make a derivative work is treated as the transfer of a copyright right, regardless of whether it is coupled with the right to distribute the derivative program to the public. According to the IRS, this is consistent with copyright law, generally. Although the right to make copies of a work generally constitutes the transfer of a copyright right only if it is coupled with the right to distributed the copies to the public, the regulations treat the right to make copies differently from other rights because of the unique character of computer programs, including the ease by which they can be copied.

The regulations disregard a *de minimis* right to make a derivative work. Section 1.861-18(c)(1)(ii) provides that the *de minimis* transfer of a copyright right will not be considered in determining whether a transaction constitutes the transfer solely of a copyrighted article. For example, the right to use software development tools to create an insubstantial component of a new program would be a *de minimis* copyright right. The right to modify the source code to correct minor errors and make minor adaptations to a computer program would also be a *de minimis* copyright right.

Classifying the Transfer of Software Development Tools

A, a U.S. corporation, transferred a disk containing Program Y to E, a foreign corporation, in exchange for a single fixed payment. Program Y is a computer development program, which is used to create other computer programs. It consists of several components, including libraries of reusable software components that serve as the general building blocks in new software applications. No element of the libraries is a significant component of any overall new program. Because a computer program created with the use of Program Y will not operate unless the libraries are also present, the license agreement between A and E granted E the right to distribute copies of the libraries with any program developed with Program Y.

No non-*de minimis* copyright rights described in §1.861-18 passed to E in this transaction. The right to distribute the libraries in conjunction with the programs created using Program Y was a *de minimis* component of the transaction. Because E received a copy of the program, under the new rules, it received a copyrighted article. E became the owner of a copyrighted article. Thus, under the new rules, the transaction involved the sale of a copyrighted article and not the grant of a lease by A to E.

Nevertheless, the new rules do not go so far as to say that when no independent value attaches to the right to prepare derivative computer programs, that right must be treated as *de minimis*. The IRS believes that in most cases the right would be *de minimis*, but this might always not be true.

Some commentators urged the IRS to take the position that the right to publicly perform or display a computer program should not be considered the transfer of a copyright right, if the performance or display was limited to the advertisement of a copyrighted article and did not permit the public display of the entire article. The IRS did not adopt this recommendation. Instead, it said that, at the present time, it would continue to follow traditional copyright law with respect to these rights. However, it noted that in many cases the transfer of a right for public display or performance of a computer program, such as marketing or advertising the program, would be considered a *de minimis* grant of a copyright right under §1.861-18(c)(1)(ii). Thus, the transaction would not result in the transfer of a copyright right.

With respect to the distribution of a computer program to employees, §1.861-18(g)(3) provides

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If the transferee acquires a copy of a computer program, but does not acquire any of the copyright rights identified in the new rules, the transaction is classified as the transfer of a copyrighted *article*.

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that distribution to the public does not include distribution to related persons, which includes employees. Specifically, a related person is defined as a person who bears a relationship to the transferee, which is specified in §§267(b) or 707(b) of the Code. This covers distributions to certain identified persons or to those with a legal relationship to the original transferee.

The number of employees or independent contractors who are permitted to use a computer program in performing services for a transferee is not relevant. The examples accompanying the regulations clarify that the number of permitted users, which includes the transferee's employees, within a group of related persons is not taken into account in determining whether the transferee has the right to distribute copies of the program to the public.

Generally, under existing regulations, the source of income from sales of property depends to varying degrees on both the type of property and, for inventory property, the place of sale. The place of sale generally is determined by the place where title to the property passes. The new rules provide specific source of income rules for transfers abroad of computer programs.

Transferring Copyright Rights: Sales or Licenses?

In classifying a copyright right as a sale or license, the regulations look to whether "all substantial rights" in the copyright right have been transferred. The regulations do not change the generally applicable all substantial rights test used in determining whether the transfer of an intangible, including copyright rights, is a sale or a license of the intangible.

Further, according to the IRS, the all substantial rights test in the regulations under §1235 (which provides a safe harbor for patent transfers) reflects the test as it is applied in case law, generally, and therefore is an appropriate standard to apply to the transfer of copyright rights. However, the IRS also notes that, in applying the all substantial rights test to transactions involving computer programs, other case law may be relevant.

Definition of a Copyrighted Article

If the transfer of a computer program involves only a *de minimis* copyright right, then it is classified as the transfer of a copyrighted article. Electronically transferred copies also constitute the transfer of a copyrighted article. Section 1.861-18(g)(2) provides that the physical or electronic medium used to effect the transfer of a computer program will not be taken into account in making the classification. The examples accompanying the regulations specifically conclude that the electronic transfer of software can constitute the transfer of a copyrighted article.

The new rules treat a non-sale transfer of a copy of a computer program as a lease, as opposed to characterizing the transfer as a license. Any income tax consequences from the lease characterization would result from applying generally applicable tax law to the lease transaction. In determining whether the transfer of a copyrighted article results in a sale or a lease, the new rules look to whether the benefits and burdens of ownership were transferred.

Certain practices used to control software piracy are also analyzed under the benefits and burdens test. For example, the requirement that a transferee contact the transferor and pay an annual fee might be relevant in determining whether a transaction results in the sale or lease of a computer program. In applying the benefits and burdens test, taxpayers must consider all of the facts and circumstances of the particular transaction. The requirement that the transferee contact the transferor and pay an annual fee might not result in characterizing the transaction as a lease if other significant benefits and burdens of ownership have passed to the transferee.

Finally, according to the IRS, decompiling a computer program (*i.e.*, reverse engineering or reconstructing the source code from the object code) can result in the creation of a derivative work. Under the new rules, the right to create a derivative work is a copyright right. Thus, a prohibition on reverse engineering a computer program could be relevant in determining whether a copyright right or a copyrighted article has been transferred abroad.

Using Multiple Copies of Computer Programs in Your Business

A, a U.S. corporation, transferred a disk containing Program X to E, a foreign corporation. A granted E the right to load Program X on 50 individual workstations for use by E's employees in return for a one-time, per-user fee (generally referred to as a site license or enterprise license). If additional workstations were introduced later, E could load Program X on the machines for additional one-time, per-user fees. The license that granted E the right to operate Program X on 50 workstations also prohibited E from selling the disk (or any copies of it) or reverse engineering the program.

The grant of a right to copy a computer program, unaccompanied by the right to distribute copies to the public, does not constitute the transfer of a copyright right under §1.861-18(c)(2). Thus, this transaction involved the transfer of copyrighted articles (50 copies of Program X). E became the owner of these articles. Thus, there was a sale of the copyrighted articles, rather than the grant of a lease, by A to E. Notwithstanding the restrictions on sale, other factors (such as the risk of loss and the right to use the copies in perpetuity) outweighed the restrictions placed on the right of sale. The result would be the same if E copied Program X on an unlimited number of workstations; if an unlimited number of E's employees used Program X on a LAN; or if E copied Program X on LANs maintained by related companies, as defined in §1.861-18(g)(3).

Transferring Services and Know-How

The purpose of the new rules is only to *classify* certain international transactions involving computer programs. Once the character of a transaction is determined under the regulations, the tax on any income arising from the transaction is determined under other Code sections. Thus, the relevance of the distinction between services and know-how is determined under other Code sections.

In making this determination, the IRS directs taxpayers to compare §§861(a)(3) and 862(a)(3) (looking to the place of performance in sourcing income from services) with §§861(a)(4) and 862(a)(4) (sourcing income derived from the transfer of certain know-how based on where the know-how is used). The distinction between services and know-how might also be relevant under income tax treaties. *See, e.g.*, Article 8 (Business Profits) and Article 14 (Royalties) of the U.S.-Japan tax treaty.

The regulations do not require that know-how not be copyrightable as a prerequisite to being treated as know-how under §1.861-18. The IRS has made this point to eliminate any inference that only orally transmitted information can be classified as know-how.

The regulations also add to other requirements. First, know-how is covered by §1.861-18 only if the information being transferred is: related to computer programming techniques; furnished under conditions preventing unauthorized disclosure; specifically contracted for between the parties; and considered property subject to trade secret protection. Second, the know-how being transferred abroad is considered a property interest under applicable law only if it is specifically contracted for between the parties involved in the transaction. ❑

The parties to an international transaction in most instances may agree on where title passes for sales of inventory property.

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The Problem

When a taxpayer both owes money to, and is owed money by, the IRS, it is generally better — sometimes a lot better — not to have to pay or receive interest at all than to have to pay interest on the deficiency and receive interest on the overpayment. There are a number of reasons for this.

Since the Tax Reform Act of 1986, the basic rate of interest that the IRS pays on tax overpayments has been one percent less than it charges on underpayments.

Different Rates. Since the Tax Reform Act of 1986, the basic rate of interest that the IRS pays on tax overpayments has been one percent less than it charges on underpayments. This differential will be eliminated for individuals, but not corporations, starting next year. Two other provisions that are applicable only to corporations can further widen this differential.

Since 1991, a "hot interest" rate of two percent above the normal underpayment rate has applied to large (over $100,000) underpayments by corporations, beginning 30 days after the taxpayer receives a 30-day letter or equivalent notice. Since 1995, a special rate of one and one-half percent *below* the normal rate applicable to overpayments (sometimes referred to as "GATT interest" after the legislation in which it made its appearance) has applied to overpayments by corporate taxpayers exceeding $10,000. Unlike hot interest, the GATT interest rate applies for the entire life of the overpayment, although only to the portion exceeding $10,000. Thus, corporate taxpayers commonly face an interest rate differential of up to four and one-half percent.

Other Tax Consequences. For individuals, interest paid on a tax refund is naturally taxable income, while interest paid on a deficiency has not been deductible. *See* §1.163-9T(b)(2)(i)(A) of the Income Tax Regulations. (The Tax Court in *Redlark v. Commissioner*, 106 T.C. 31 (1996), *rev'd and rem'd*, 141 F.3d 936 (9th Cir. 1998), invalidated the regulation so far as it applied to interest on deficiencies attributable to an individual's trade or business. However, the Ninth Circuit, on appeal, and the Eighth Circuit in *Miller v. U.S.*, 65 F.3d 687 (8th Cir. 1995), upheld it. Full treatment of this controversy is outside the scope of this article.)

Corporations do not usually face a deductibility issue, but are subject to a possible sourcing problem. Refund interest will be U.S. source income, whereas interest *deductions* normally must be apportioned between U.S. and foreign source income. If a corporate taxpayer is in a chronic excess credit position, the portion of the deduction allocated against foreign source income may produce only a deferred benefit, or none at all, if it only serves to save foreign tax credits that are fated to expire unused. This problem is not new, but has been dramatically exacerbated since the Tax Reform Act of 1986 brought lower marginal tax rates, accompanied by stricter basket rules under section 904(d) and a requirement to apportion interest deductions according to assets.

Example of Offsetting

In 1998, a corporate taxpayer is determined to have an underpayment of $1,000,000 for its taxable year 1993, an overpayment of $2,000,000 for 1994, and an underpayment of $3,000,000 for 1995. Assume that in each case interest runs from the due date (March 15 of the following year) with no hot interest or retroactive global netting. Assume also that the taxpayer pays the net amount due on December 31, 1998.

With an offset, the $1,000,000 underpayment for 1993 accrues about $85,000 in interest through March 15, 1995; $1,085,000 of the 1994 overpayment is credited to the 1993 account as of that date, leaving a net credit balance of $915,000 to accrue $79,000 in refund interest over the following year. That balance is credited against the $3,000,000 underpayment for 1995, and thereafter only the net debit balance of $2,006,000 accrues interest.

The taxpayer ultimately pays $633,000 in interest and receives $79,000, for a net cost (before tax effects) of $554,000. Without offsets, the separate balances accrue $1,335,000 in underpayment interest and $690,000 in overpayment interest, for a net out-of-pocket cost of $645,000. The savings are a lot more dramatic if hot interest is involved or (on a tax-effected basis) if the deduction for interest paid does not translate into a current reduction in tax for one or another reason.

Offsets and Interest Tolling

The Internal Revenue Code and IRS practice offer some relief from these problems in the common case where income tax years involving both overpayments and underpayments are resolved as part of a single audit cycle.

Interest Tolling Provisions. Section 6402 provides that the Secretary may credit the amount of an overpayment, including any interest allowed on it, against any tax liability on the part of the person who made the overpayment. The offsets benefit taxpayers because when an overpayment is offset against an underpayment, interest is tolled for the overlap period during which interest would have run on each separately had they not been offset.

Section 6601(f) provides that if any portion of a tax is satisfied by crediting an overpayment, then no interest will be imposed for any period during which, if the credit had not been made, interest would have been allowed on the overpayment. Section 6611(b)(1) provides that a credit will stop bearing interest as of the due date of the amount against which the credit is taken.

In reality, credits or debits to an account will not be in the same amount as the underlying deficiency or overpayment of tax because of the need to consider interest previously paid or allowed. They will frequently be broken down into segments that are taken into account for interest computation purposes on a variety of different dates, depending on previous activity in the account and whether carrybacks are involved.

"Debit" is used as shorthand for the creation or increase of an underpayment, or the reduction of an overpayment, whether due to an increase in tax liability or a refund or credit to another account. "Credit" refers to the creation or increase of an overpayment, or the reduction in an underpayment, due to a decrease in liability or a payment or credit for another year.

The date when a debit or credit arises or is first taken into account for interest purposes (sometimes referred to as the availability date) is central to any interest computation. A full discussion of these issues is outside the scope of this article. However, the basic principle is that the taxpayer owes interest while a tax liability is due

Example of Limitations on Offsets

It is determined in 1998 that a corporate taxpayer has a $1,000,000 general deficiency for the 1991 tax year. A general deficiency is a deficiency of tax before considering the effect of carrybacks. A carryback is allowed from 1994 that would reduce the 1991 tax by $3,000,000. In the simplest case, restricted interest will run on the resulting potential deficiency from March 15, 1992, until March 15, 1995. If the same taxpayer is allowed a $500,000 overpayment for 1992, the IRS will not offset that overpayment against the potential deficiency for 1991 because, *as of 1998*, both accounts show credit balances.

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and unpaid. The IRS owes interest while it has the use of the taxpayer's money and it has not been applied against a tax or other liability, except where the Code provides otherwise.

Credits from a subsequent payment of tax and interest arise on payment. Debits resulting from a refund are likewise given effect as of the date of the refund. Thus, if an overpayment per return or quickie carryback is refunded without interest, the corresponding portion of a subsequently determined underpayment only bears interest from the date of the actual refund. Rev. Rul. 88-98, 1988-2 C.B. 356 (situation 3). If the refund is with interest, the total amount is in effect taken into account on that date. *See* Rev. Proc. 94-60, 1994-2 C.B. 774 (Technically, the IRS charges the same interest previously allowed).

The big problems show up when liabilities for income tax for different years or for different types of tax are not part of the same audit cycle or are processed separately. For example, if a taxpayer resolves its 1990-92 audit cycle in 1997, receiving an overall refund, and its 1993-95 cycle in 1998, which requires it to pay tax plus interest, the tolling provisions are of no help.

Debits arising from a credit to another year are given effect on the due date of the liability to which the credit is applied, (*e.g.*, an estimated tax payment). *Avon Products, Inc. v. U.S.*, 588 F.2d 342 (2d Cir 1978); Rev. Rul. 88-98, *supra* (situations 1 and 2). Disputes persist about the payment the credit is applied to, *compare* Rev. Rul. 88-98 *with Sequa Corporation v. U.S.*, 1998 WL 307379 (S.D.N.Y. 1998).

Changes in tax liability that are the result of a loss or credit carryback are given effect on the due date for the return for the year in which the loss or credit originates. *See* §§6601(d) and 6611(f), *as amended by* the Taxpayer Relief Act of 1997, Pub. L. No. 105-34. Before this law was enacted, there was no express provision for foreign tax credits. *Compare Fluor Corporation v. U.S.*, 126 F.3d 1397 (Fed. Cir. 1997), *cert. denied*, 118 S.Ct. 1057 (1998) *with Intel Corp. v. Commissioner*, 111 T.C. 90 (1998).

Limitations. Much obviously depends on exactly what overpayment is offset against exactly what underpayment. Offsets under §6402 are discretionary with the IRS, but in practice are routinely done when multiple years are resolved at the same time. However, taxpayers can only designate the application of voluntary payments of tax and the weight of authority is that offsets under §6402 are involuntary.

This means that the precise pattern of offsets will be determined under IRS rules. For example, overpayments will ordinarily be applied to the earliest deficiency first and will not be applied to a transient or potential deficiency that has since been eliminated by a carryback or a subsequent payment. (See example on preceeding page.)

Specific examples aside, existing offset procedures are generally fairly efficient at eliminating the running of interest on overlapping overpayments and underpayments in a typical multiple-year income tax settlement.

Sequential Settlements: the Northern States Problem. The big problems show up when liabilities for income tax for different years or for different types of tax are not part of the same audit cycle or are processed separately. For example, if a taxpayer resolves its 1990-92 audit cycle in 1997, receiving an overall refund, and its 1993-95 cycle in 1998, which requires it to pay tax plus interest, the tolling provisions are of no help. The overpayments have not been credited against the underpayments even though they were outstanding and separately accruing interest over several years.

Northern States Power Co. v. U.S., 73 F.3d 764 (8th Cir. 1996) illustrates this problem. Northern States paid asserted deficiencies for its taxable years 1980, 1981, 1983 and 1984 (with interest) in 1990. Outstanding refund claims were settled in 1994, producing overpayments for 1980-84. The overpayments for 1980, 1983 and 1984, were in amounts less than the amount of the previously determined deficiencies, so only arose for purposes of interest computation when the prior payments were made. However, for 1981 and 1982, the overpayments arose earlier, possibly as far back as the return due date. The taxpayer requested that these credits be transferred to the accounts for the other years to reduce the deficiency interest in those accounts. The IRS refused to do this because, as of 1994, all five accounts were overpaid. The court upheld the IRS' position. Thus, the taxpayer lost $460,000 in net interest.

Over the years, well-advised taxpayers that have a hint of the likely outcome of subsequent audit cycles have resorted to various methods to

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deal with this problem. One tactic is to request that a credit resulting from one audit cycle be transferred to another year as a payment on account under Rev. Proc. 84-58, 1984-2 C.B. 501. Under that procedure, payments of tax and interest can be made on account of tax years for which the IRS has made a written assertion of liability for additional tax (*e.g.*, in an outstanding 30-day letter).

However, the allowance of a credit, as opposed to a refund, remains discretionary with the IRS. In any event, this tactic cannot be used when there has not yet been a written assertion of liability for any other year as of the time the overpayment is processed. Taxpayers may also try to combine separate administrative cases so that they can be resolved at once, maximizing potential offsets. Again, this depends on the existence of the right facts, careful calculations and the willingness of IRS officials with jurisdiction over the relevant cases to work with the taxpayer.

Global Netting: the Concept

The netting problem seems first to have hit Congress' radar screen in 1986, when the interest differential was first established. The conference report stated:

> The IRS can at present net many . . . offsetting overpayments and underpayments. Nevertheless, the IRS will require a transition period during which to coordinate differential interest rates. The Senate amendment, therefore, provides that the Secretary of the Treasury may prescribe regulations providing for netting of tax underpayments and overpayments through the period ending three years after the date of enactment of the bill. By that date, the IRS should have implemented the most comprehensive netting procedures that are consistent with sound administrative practice. H. R. Rep. No. 841, 99th Cong., 2d Sess. (vol. II) 785 (1986).

This schedule proved a bit optimistic. When Congress successively widened the differential in 1990 and 1994, it was reduced to reiterating that the Secretary should implement the most comprehensive crediting procedures under §6402 that are consistent with sound administrative practice. In 1994, Congress added, with a trace of impatience, that the Secretary should do so as rapidly as practicable. However, at this stage, Congress evidently envisioned more systematic and consistent offsets rather than an expansion of the principle to equalize interest rates when there was no actual offset.

The allowance of a credit, as opposed to a refund, remains discretionary with the IRS.

Global netting, strictly speaking (*i.e.*, the taking into account contemporaneously existing offsetting balances regardless of whether there is any actual offset) surfaced during consideration of the Taxpayers Bill of Rights 2 ("TBOR2") provisions. The House-passed version of the Balanced Budget Act of 1995 required that Treasury conduct a study of the manner in which the IRS has implemented the netting of interest on overpayments and underpayments and of the policy and administrative implications of global netting. The provision was dropped from the stripped-down conference bill, which was in any event vetoed by the president.

Following the veto, the IRS issued a laundry list of administrative initiatives to enhance taxpayer rights, including a formal study of issues relating to the IRS' interest netting procedures. The IRS then issued a notice inviting comment on the legal, policy and administrative issues implicated in global netting. The Eighth Circuit's decision in *Northern States* further raised the profile of the issue.

Well-advised taxpayers that have a hint of the likely outcome of subsequent audit cycles have resorted to various methods to deal with this problem. One tactic is to request that a credit resulting from one audit cycle be transferred to another year as a payment on account.

In July 1996, Congress passed TBOR2 as freestanding legislation, reinstating the mandate for a study, which Treasury had announced its intention to complete by October 1. The report actually appeared in April 1997. It concluded that, practical problems aside, the IRS lacked the authority to conduct global netting because the statutory provisions providing for interest were specific and the IRS could not perform an offset under §6402 when there were no balances to offset. The stage was thus set for congressional consideration of the issue.

In the next issue of ***Strategies***, we will look at the major issues that are likely to arise in developing guidance under the existing provision and in any possible legislative revisit of the issue. ❑

Penalties **from page 1**

enue Canada makes an adjustment to a taxpayer's transfer prices for goods, services, intangibles, etc., above a specified threshold, unless the taxpayer meets certain strict exculpatory conditions. Once the threshold has been exceeded, the full adjustment is subject to the penalty.

Consequently, the threshold establishes only a modest "on-off" switch for applying the penalty and does not offer, in any comprehensive sense, a safe harbor for taxpayers. The amount of the penalty can be large. It also can be imposed on a taxpayer even if the taxpayer does not face any underlying Canadian income tax liability (*e.g.*, because of loss carryovers or research tax credits). The penalty will apply to tax years beginning in 1999 and thereafter.

The U.S. Congress enacted two transfer pricing penalties: the transactional penalty and the net adjustment penalty. The imposition of these penalties has led to comparable actions by the tax authorities in some of our largest trading partners.

This article describes how the Canadian transfer pricing rules work and how to reduce your exposure to the new penalty for "improper" transfer pricing. Additionally, the article discusses developments concerning the pricing methods that are acceptable in Canada and how taxpayers can benefit from what initially may seem to be only negative changes in Canadian tax law.

Background

As mentioned above, several years ago the U.S. Congress enacted penalties to enforce the transfer pricing rules under U.S. tax law, including §482 of the Code. Thereafter, the IRS issued new regulations concerning the transfer pricing methods that are acceptable in the U. S. The Organization for Economic Cooperation and Development ("OECD") also issued its own guidelines on transfer pricing.

Various countries reacted to these developments by adopting penalties and elaborating on their rules that establish the acceptable methods for determining prices in transactions involving related parties. Some countries thought the U.S. penalties might pressure taxpayers into sourcing more related party profits in the U.S. than would be justified by the economic nature of the transactions involved. Thus, they viewed their transfer pricing penalties as providing a counter balance to the moves by the U.S. Congress and the IRS. Brazil, Mexico, Canada and, most recently, the United Kingdom, have all reexamined their rules for acceptable transfer pricing methods and have imposed new penalties on taxpayers for using improper methods.

The Canadian Penalty

Canada, in adopting its penalty this year, took an unusual and harsh position. The size of the penalty is based on the amount of the erroneous transfer price determined on audit by Revenue Canada. It is not based on the amount of any additional Canadian income tax collected by Revenue Canada after adjusting the transfer price. The 10-percent penalty works as follows:

If Revenue Canada succeeds in making a transfer pricing adjustment of $10 million, the amount of the penalty is $1 million, even if there is no Canadian income tax due before or after the adjustment. By contrast, under U.S. law, penalties apply only if an IRS adjustment increases the amount of U.S. income tax due. As noted above, depending on the amount of the adjustment, the U.S. penalties can be either 20 or 40 percent of the additional tax liability imposed by the IRS as a result of adjusting the transfer price.

Beginning in 1999, the Canadian transfer pricing penalty will apply even if, overall, the transfer pricing methods applied to a taxpayer's trade flows meet the arm's length standard. For example, if Revenue Canada determines that a Canadian taxpayer sold goods to a foreign affiliate at too low a price, but was later over-compensated by that same affiliate for services provided by the Canadian company, a set-off will be allowed in computing Canadian tax liability (if Revenue Canada considers it appropriate under the circumstances).

The set-off will be allowed only if the taxpayer made reasonable efforts to use the arm's length standard and prepared documentation concerning the transactions for which the set-off is desired (services income in our example above). One might ask: how realistic is it to believe that a taxpayer will leave too much profit in Canada in connection with a flow of trade for which it made reasonable efforts and prepared the proper docu-

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mentation, but leave too little profit in Canada on a trade flow for which it did not meet the reasonable efforts standard?

Thus, one strategy for addressing your exposure to the Canadian transfer pricing penalty is to make reasonable efforts to determine arm's length transfer prices for all significant trade flows with your affiliates. The proper documentation of the transactions and the pricing, which is a prerequisite to any claim that you made reasonable efforts, must be completed on or before the due date of your return. Additionally, you must give the documentation to Revenue Canada within three months of being served of a written request for it.

In analyzing whether you made reasonable efforts, you might want to weigh the cost of preparing the documentation against the significance of the transactions in question. The Canadian rules appear to expect that the documentation will be prepared as part of the normal price determination for business purposes and not merely as an *ex post facto* justification for your transfer pricing methods.

In considering whether to initiate a documentation project intended to avoid the penalty, it is important to distinguish between analyzing available transfer pricing options and selecting the best pricing strategy (tax planning) *versus* documenting, after the fact, the transfer pricing methods you actually used. A company that merely documents its current pricing methods without first considering alternative strategies might miss opportunities or create a road map for Revenue Canada (and the IRS) to use to support a transfer price adjustment on audit.

Various countries were concerned that the U.S. transfer pricing penalties might pressure taxpayers into sourcing more related party profits in the U.S. than would be justified by the economic nature of the transactions involved. They viewed their own transfer pricing penalties as offering a counter balance to the moves by the U.S. Congress and the IRS.

Transfer Pricing Strategies

The transfer pricing rules in the U.S. and Canada authorize, if not encourage, a thoughtful evaluation of the different strategies available to transfer goods, services, intangibles and other items between affiliates. There are a variety of important questions to consider in evaluating your strategies. For example, which of your affiliates should own any intangibles and which

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ones should assume inventory, volume and marketing risks? Keep in mind that minor amendments to contractual relationships between affiliates can create significant shifts in prices and profits over time.

The IRS is likely to request copies of the documentation prepared for Canadian tax purposes.

Further, small changes in contracts, structures and transactions that modify your transfer pricing methods can favorably affect an affiliated group's overall income tax burden and have other important positive consequences, such as reducing customs duties and excise taxes. In short, although the adoption of a tough penalty on transfer pricing errors (notwithstanding NAFTA) is hurdle for taxpayers to overcome, many companies are discovering that a strategic evaluation of their transfer pricing methods can significantly benefit their entire corporate group.

If Revenue Canada succeeds in making a transfer pricing adjustment of $10 million, the amount of the penalty is $1 million, even if there is no Canadian income tax due before or after the adjustment. By contrast, under U.S. law, penalties apply only if an adjustment by the IRS increases the amount of U.S. income tax due.

You should prepare the appropriate materials documenting your transfer pricing practices only after you have finished your strategic analysis and planning and have made your choices about the methods you intend to use. For the documentation to be successful, it should be supported by an analysis that clearly demonstrates why your pricing methods are the most appropriate under the circumstances.

Other Strategies and Considerations

There are other reasons why you might need to carefully examine your company's current transfer pricing methods before documenting them for penalty purposes. There may be important differences between what the contracts with your affiliates say and how the transactions are actually implemented. This sort of a difference can only help any challenge by the tax authorities. Further, you should consider whether documenting current transactions and pricing methods might create problems and encourage adjustments on audit for earlier tax years. For these reasons and others (*e.g.*, limited tax department resources), many companies have found that it is not always appropriate or possible to prepare anti-penalty documentation.

For Canadian companies engaged in cross border transactions with companies in jurisdictions that also have tough transfer pricing penalties and audit exposure, it is essential to coordinate the planning and documentation of their transfer pricing methods. The IRS, for example, is likely to request copies of the documentation prepared for Canadian tax purposes. Similarly, the IRS is ready to provide Revenue Canada with documentation taxpayers have prepared to avoid U.S. transfer pricing penalties.

In 1997, Revenue Canada issued a draft information circular explaining the transfer pricing methods that are acceptable in Canada. The draft should be revised and issued in final form soon. Most commentators expect that the final circular will closely follow the OECD preference for traditional transfer pricing methods such as the Comparable Uncontrolled Price Method, Resale Price Method and Cost Plus Method. Profit methods, such as the U.S. Comparable Profits Method (CPM), are likely to be viewed unfavorably. However, taxpayers should carefully scrutinize the final Canadian government circular to determine which profit methods will be acceptable in Canada and how they might differ in substance from the U.S. CPM. The final circular should also explain the technical requirements for each acceptable transfer pricing method.

Conclusion

The Canadian government's focus on transfer pricing methods is significant. Canada is being aggressive with respect to penalties. However, there is a silver lining to this cloud. Canadian multinationals will find that evaluating, clarifying and changing their transfer pricing methods can offer earnings per share benefits in many cases. Certainly, that has been the experience of U.S. multinationals. Also, anti-penalty documentation can take place in a manner that will be most helpful to the corporate group. Based on the U.S. experience, the technical issues involved in using acceptable transfer pricing methods are manageable and should be kept in perspective. ❑

Multinationals will find that evaluating, clarifying and changing their transfer pricing practices can offer earnings per share benefits in many cases. Also, anti-penalty documentation can take place in a manner that will be most helpful to the corporate group.

Snapshots

Changes to Note in Preparing 1998 Form 1120-F, U.S. Income Tax Return of a Foreign Corporation

The 1998 IRS Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*, contains several changes for tax practitioners to note.

For tax years beginning after 1997, the new principal business activity (PBA) codes used to complete Form 1120-F are now based on the North American Industry Classification System (NAICS). The NAICS was developed by the statistical agencies of Canada, Mexico and the U.S. in cooperation with the U.S. Office of Management and Budget. NAICS-based codes replace the PBA codes previously based on the Standard Industrial Classification (SIC) system.

The list of principal business activities and their associated codes are designed to classify an enterprise by the type of activity in which it is engaged to facilitate the administration of the Internal Revenue Code.

Additionally, the Taxpayer Relief Act of 1997 made changes in the tax law for corporations, which may affect foreign corporations that are required to complete and file Form 1120-F. Among other things:

- For tax years beginning after December 31, 1997, corporations may be entitled to an increased charitable contribution deduction for gifts of computer technology and equipment to schools.
- Certain corporations may take a qualified zone academy bond credit under §1397E of the Code. For more information, *see* IRS Form 8860, *Qualified Zone Academy Bond Credit*.
- For tax years beginning after December 31, 1997, the alternative minimum tax has been repealed for companies that qualify as "small corporations." For more information, *see* Form 4626, *Alternative Minimum Tax – Corporations*.
- The Taxpayer Relief Act of 1997 also changed the year to which unused general business credits may be carried. Unused general business credits that arise in tax years beginning after 1997 are carried back one year and then forward to each of the 20 years following the unused credit year.

Form 1120-F is used to report the income, gains, losses, deductions and credits, and to figure the U.S. income tax liability of, a foreign corporation. Generally, every foreign corporation files a Form 1120-F if, during the tax year, the foreign corporation:

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For tax years beginning after December 31, 1997, the alternative minimum tax has been repealed for companies that qualify as "small corporations."

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- engaged in a trade or business in the U.S., whether or not it had income from that trade or business;
- had income, gains or losses treated as if they were effectively connected with that U.S. trade or business; or had income from any U.S. source, even if the income is tax exempt under an income tax treaty or a section of the Internal Revenue Code.

IRS Reorganization May Affect APA Program

The IRS Advance Pricing Agreement (APA) program may be affected by the agency's extensive reorganization, which is underway now. The reorganization is a result of demands by the U.S. Congress and the IRS Commissioner that the agency become more "taxpayer friendly."

As part of the reorganization, the IRS is considering whether to move the APA program from the Office of the Associate Chief Counsel (International), which answers directly to the Treasury Department, to the Office of the Assistant Commissioner (International), which falls within the existing IRS operating structure. It is possible, but unlikely, that the APA program could disappear as a separate operating function.

A key question for IRS senior managers is whether the APA program should be conducted by ir examiners, who are under the authority of tl Commissioner, as part of their obligation to provide services to taxpayers. If this were to occur, the APA program might disappear, in the sense that it would become just one of the examiners' many functions.

The IRS reorganization will eliminate existing geographical divisions within the agency and replace them with four major operating divisions. The Service is already recruiting for senior leadership positions for two newly created divisions – the Middle Market/Large Corporation (MM/LC) unit and the Tax Exempt unit. The MM/LC unit will have responsibility for the agency's international activities, according to an IRS press release issued on December 1, 1998.

The APA program has a history of being targeted for relocation and/or reorganization. In 1993, the IRS created an APA Policy Board, which included the Associate Chief Counsel (International), the Assistant Commissioner (International) and the Assistant Commissioner (Examination). This Board became responsible for overseeing the APA program.

One recurring issue has been whether the operational aspects of the program are more important than its legal aspects. For example, the Chief Counsel's office is responsible for issuing private letter rulings. APAs, like private letter rulings, require a technical review of the law and careful application of the law to the facts involved in a particular transfer pricing method or practice.

It is unlikely that any changes in the administration of the APA program will happen soon. The IRS is not expected to have the details of its reorganization plan worked out until at least April 15, 1999. ❑