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News on the Transfer Pricing Front

In the first of several important new guidance items expected this year in the transfer pricing arena (others deal substantively with services, intangibles and cost-sharing agreements), the IRS has just updated the procedural rules applicable to requests for advance pricing agreements (APAs) in Revenue Procedure 2004-40. Moreover, the Pacific Association of Tax Administrators (PATA) has just issued operational guidance to be followed by its member countries (the United States, Australia, Canada and Japan) in handling bilateral APAs. These largely positive developments must be considered by taxpayers in assessing the attractiveness of the APA Program. (A current review of the APA Program by the Senate Finance Committee could lead to further procedural changes.)

The **PATA Guidance** is directed at facilitating the competent authority aspect of the APA process, and covers matters such as sharing and simultaneous submission of APA-related information, processing time lines and meeting procedures, reliance on OECD transfer-pricing principles, consultation on APA revisions, cancellations and revocations, limitation on use of taxpayer information, and overall coordination. A key breakthrough is the possibility of some joint meetings with taxpayers at the pre-filing or subsequent fact-finding stage.

Key themes of **Revenue Procedure 2004-40** are:

1. **Injecting More Currency (from a Temporal, not Monetary, Perspective) into the Process.** Several new provisions require updating by the taxpayer during the process and could permit "benchmarking" by the IRS. For instance:
   - Submissions must include an estimate of the dollar value of covered transactions over the proposed term
   - An update on application of the transfer pricing method must be provided shortly after the completion of each year during negotiations
   - Taxpayers may be asked to update data on comparable companies 90 days after each year-end
   - Facts must be fully updated before commencement of competent authority negotiations and before execution of the APA
   - Material must be supplemented if facts or business practices are changing.

   Although recognizing the dynamic nature of business enterprise – which could in some cases be helpful – these new requirements may complicate negotiations by presenting a moving target and enabling closer monitoring of the implications of the transfer pricing methodologies under consideration.
2. **Expediting the Process.** Even though the length of the process is a frequent taxpayer complaint, improvements in this regard are subtle and mostly granular. For example:
   - More information is required from the taxpayer up front, in the belief that this will accelerate IRS evaluation
   - Information, including comparables data, must be submitted in electronic form
   - An explicit provision for expedited processing of APA renewals in limited situations could have a meaningful effect on the attractiveness of APAs if applied liberally by the IRS
   - An express goal is stated to complete unilateral APAs, or competent authority negotiating positions for bilateral APAs, within 12 months. For bilateral APAs, this is the same as the new PATA objective (although longer than the IRS's previous nine month target), and if accomplished would be an improvement over recent APA Office experience. Even more importantly, the PATA Guidance looks to complete resolution within two years after submission of the APA request, which would reflect a dramatic reduction in the competent authority processing time.
3. **Making APAs More Prospective.** A difficulty often encountered with APAs is that the years to be covered are over, or almost over, by the time negotiation of the agreement is complete. The new Procedure addresses this directly in three ways:
   - By prescribing a five-year term in most cases (vs. the prior three-year rule of thumb)
   - By insisting that APAs be negotiated so as to have at least three future years remaining when they are signed (in the case of unilateral APAs) or when the IRS competent authority negotiating position is completed (in the case of bilateral or multilateral APAs)
   - By limiting extensions of the filing date.

   The complexity of a long-term APA in a dynamic business environment suggests the need for creative transfer pricing methodologies and for focus on critical assumptions.
4. **Volume Discount for Multiple APAs.** The IRS user fees are reduced considerably (for big companies, from $25,000 to $7,500 per request) for additional requests included as part of a single filing. This should encourage taxpayers to seek broader coverage of business lines.
5. **Impact of Changes in Law.** The Procedure states that changes in regulations or case law can supersede the provisions of an APA (as can statute or

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treaty changes). The possible implications for companies with existing APAs from upcoming revisions to the regulations for services, intangibles and cost-sharing arrangements pose an immediate concern. The significance of emergent section 482 case law and interpretation of the Procedure's provisions in that regard also need to be considered in designing and negotiating APAs.

6. **Living with APAs.** The Procedure stresses the importance of APA annual reports in various ways (including as possible causes for revision or cancellation of an APA). Provisions regarding income adjustments to meet APA targets are refined and made more consistent with current rules for non-APA transfer pricing adjustments.
7. **Focusing on CSA APAs.** Additional requirements for cost-sharing arrangements (CSAs) focus on current areas of IRS scrutiny, e.g., buy-in payments, stock-based compensation, and regulatory compliance. Favorably, the Procedure suggests that partial APAs can be requested in certain situations, covering either the buy-in transaction or the CSA.
8. **Reiterating Preference for Bilateral APAs.** Several provisions reinforce the IRS' desire for bilateral APAs. One interesting ploy is apparently to deny taxpayer-favorable rollback adjustments in a unilateral APA.
9. **Effective Date.** The new rules generally apply to APA requests and renewals received after August 19, 2004. Taxpayers may also seek agreement to have the new rules apply to an already pending APA request.

For more information, contact Patricia Gimbel Lewis (202-862-5017 or pgl@capdale.com).

Foreign Bank Accounts – Last Chance for Taxpayers?

In the last four years, the IRS has devoted substantial audit and criminal investigation resources to investigate U.S. taxpayers who have used offshore financial accounts, and particularly offshore debit or credit cards, to avoid U.S. tax. Early in 2003, the IRS announced a limited tax amnesty period aimed at bringing such taxpayers back into the system. That program, called the Offshore Voluntary Compliance Initiative ("OVCI"), required taxpayers, among other things, to come forward, file amended returns, and identify individuals who promoted or marketed offshore tax avoidance schemes. The OVCI expired over a year ago, though, and taxpayers who did not take advantage of the amnesty are now subject to civil and criminal investigation. However, the IRS recently began an informal, hybrid initiative offering certain of those taxpayers a last chance to come forward in return for contingent amnesty and civil penalty relief.

The Service's enhanced focus on foreign bank accounts began publicly in the fall of 2000, when it initiated a number of "John Doe" summonses to obtain records of hundreds of thousands of U.S. taxpayers who were using credit cards that clear through tax haven banks. The IRS sought and has received from MasterCard, American Express and Visa records of credit cards issued to hundreds of thousands of U.S. taxpayers by banks in over 30 foreign jurisdictions.

These records have revealed millions of transactions and resulted in hundreds of thousands of investigatory leads, but some of the information reflected the names of nominee entities without identifying the individual taxpayer who actually owned the foreign accounts. Thus, the Service then followed up with summonses to numerous businesses, including airlines, hotels, automobile dealerships, car rental companies, etc., for invoices and other records relating to transactions charged on offshore credit cards. Such records identified the taxpayers who used the cards, and based on this information, the Service has initiated thousands of civil audits and referred dozens of cases to the Criminal Investigation Division.

The OVCI was announced in January 2003, and by the time it concluded, 1,299 U.S. taxpayers participated, including U.S. persons who resided in 48 foreign countries. The Service collected more than $75 million in taxes, and OVCI participants identified more than 400 promoters of offshore tax avoidance schemes, of which 214 were previously unknown to the IRS. However, the number of OVCI participants represented less than 1% of the U.S. taxpayers against whom the IRS has developed investigatory leads as a result of the information obtained through the various summonses. Nonetheless, the leads to those who promote and market offshore tax avoidance schemes have been productive, and the IRS has focused on, and in some cases acted against, hundreds of such promoters and marketers, seeking potential civil penalties or even criminal prosecution.

Taxpayers who did not participate in the OVCI still have the option of making a traditional voluntary disclosure, whereby they would comply with longstanding (but recently modified) IRS procedures for coming clean and avoiding criminal prosecution. However, among other restrictions, the voluntary disclosure policy is not available to such taxpayers once an examination begins.

Another potential vehicle open to a taxpayer who wants to make peace concerning a previously undisclosed foreign bank account is to take advantage of a new IRS initiative, begun without any formal announcement, called the Last Chance Compliance Initiative ("LCCI"). In furtherance of this program, the IRS is sending a form letter to taxpayers who have offshore credit cards or offshore financial accounts but did not participate in OVCI. The letter offers the taxpayer a "last chance" to come forward and avoid a civil or criminal tax examination. There are certain restrictions on participating in the LCCI, and acceptance of the last chance offer entails filing accurate amended or delinquent income tax returns, Foreign Bank Account Registration forms (TD 90-22.1), and information returns for 2000-2003, followed by full cooperation in any IRS examination of those returns. Participation in the LCCI should eliminate the risk of criminal prosecution, and lower to some extent the amount of civil penalties that one would otherwise face, but the IRS will nevertheless impose a civil fraud penalty for at least one year. The last chance letter suggests that taxpayers who decline to participate in LCCI will be audited aggressively.

For further information about how to handle problems concerning previously undisclosed foreign bank accounts, contact Scott Michel (202-862-5030 or sdm@capdale.com) or Richard Timbie (202-862-5042 or ret@capdale.com).

Exempt Organizations—Current Developments

Responding to numerous media reports alleging misbehavior at charitable and other organizations exempt from tax under section 501, Congress and the IRS are taking aggressive steps to address such behavior. At the same time, the IRS and the media are closely watching the political activities of exempt organizations in this presidential election year.

Proposed Restrictions on Charities and Other Exempt Organizations. On June 22nd, the Senate Finance Committee held hearings on "Keeping Bad Things from Happening to Good Charities." For the hearing, committee staff prepared a comprehensive set of proposals for changing the laws that govern charities and other tax-exempt organizations. Proposed changes included prohibiting loans and certain other types of transactions between charities and their directors and officers, requiring all exempt organizations to essentially re-apply for tax-exempt status every five years, requiring CEOs to certify annually that procedures and processes are in place to ensure the accuracy of the information reported to the IRS on Form 990, and imposing additional duties on directors.

Senator Charles Grassley (R-Iowa), Chairman of the committee, stated that he plans to introduce legislation implementing these reforms in the fall of 2004. The committee will also hold a roundtable to discuss the staff proposals on July 22nd. Passage of legislation during this election year is unlikely, but Senator Grassley has stated he will also introduce even more comprehensive legislation in 2005.

Restrictions on Donations and Charitable Giving Incentives. Both the House and the Senate have passed legislation that would reduce the deductions donors of intellectual property and vehicles to charities could claim. Passage of these provisions in some form is likely. At the same time, the CARE Act and its House counterpart that would provide incentives for charitable giving, such as nonitemizer deduction and IRA rollover provisions, continue to remain stalled, with passage unlikely.

Increased IRS Audit Activity. Responding to congressional pressure, the IRS exempt organizations division has stepped up its audit activities. Specific targets are private foundations, with the IRS planning to audit 400 of them this year, and compensation, with a new IRS special compliance unit reviewing Forms 990 specifically for possibly excessive compensation.

The IRS is also continuing its "market segment" audits of a statistically valid sample of particular types of exempt orgaizations. Segments currently targeted include section 501(c)(3) organizations that raise funds for other organizations, private schools, and non-exempt charitable trusts, as well as private foundations, community foundations, universities and hospitals.

IRS Warns About Political Activity and Issues New Guidance. The IRS has issued both its regular warning about political activity by charities and a new warning to all of the national political parties to respect the prohibitions on political activities by charities. The IRS also issued a new ruling on issue ads at the very end of last year. Revenue Ruling 2004-6 provides a detailed set of criteria for determining whether issue ads that mention an incumbent politician who is also a candidate represent partisan political activity.

IRS Issues Guidance on Ancillary Joint Ventures. The IRS issued a ruling this spring on when an ancillary joint venture between a charity and a for-profit party will be considered a related activity for the charity. Revenue Ruling 2004-51 describes a situation where a university and a for-profit entity form an educational joint venture for which each have a 50 percent ownership interest and the university retains exclusive control over the curriculum, training materials, instructors and the standards for successful completion of the seminars. The IRS concluded that given these facts the joint venture is a related activity of the university, so the university's income from the joint venture would not be subject to unrelated business income tax.

For further information about the implications of these developments, contact Lloyd H. Mayer (202-862-5056 or lhm@capdale.com).

Russia – A New Direction for NGOs

Caplin & Drysdale partner Milton Cerny recently returned from Russia where he was advising the Russian Duma and non governmental organizations (NGOs) on specific revisions to the nonprofit tax law. The following article highlights a number of important events that occurred during his trip.

President Vladimir Putin addressed the issues of nonprofits in a speech on May 26, 2004 before the Duma. Putin devoted some time during his address to the question of democracy in Russia, citing his commitment to democracy, the rule of law and the development of a civil society. He also sounded a clear warning to certain NGOs to refrain from opposing Kremlin actions by criticizing the undemocratic selective prosecution and jailing for tax evasion of Mikhail Khordokovsky, the President of Yukos Oil Company, who also happens to be the largest benefactor of NGOs engaged in opposing Putin's style of democracy. The question is what is happening in Russia today and what impacts do the events have on the Russian economy, the rule of law, the nonprofit laws and their administration?

I. Background

The primary legal framework for non-governmental organizations ("NGOs") is found under the general Federal law. Organizations including public associations, mass movements, public foundations and institutions are established as juridical entities. Foundations and public institutions can also be created under either the Law on Public Associations or the non-commercial organization law. Eighty-nine separate territorial jurisdictions also provide certain benefits and restrictions on NGOs.

Under the existing Russian Federal tax laws, NGOs are exempt from income tax on grants, donations or other funding used to support their activities. However, NGOs must pay an income tax on business activities to the same degree and manner as commercial entities. There are exemptions from the value added tax

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("VAT") on the transfer of goods and funds to NGOs that support the organizations statutory goals. A similar exemption is granted from VAT on the distribution of goods and services that are provided free of charge for charitable purposes and activities undertaken by NGOs.

With respect to contributions, commercial corporations do not receive the benefit of any tax deductions for contributions to NGOs but individuals may deduct up to 25% of their taxable income for monetary, but not in-kind gift contributions. However, certain restrictions apply to these donations. First, the beneficiary organization must be either a state subsidized or state owned organization. Second, the donations do not apply to private schools, museums or health care providers. Third, the donations must be made directly to the beneficiary organization and cannot be passed through a re-granting organization.

There is also an exemption from tax for gratuitous assistance provided to the Russian Federation through legal entities conducting humanitarian assistance and technical aid. Foreign contributions to Russian NGOs are allowed under a certification process which confirms the nature of the funds, goods, work and services provided. Exemption from tax and custom duties for such aid assistance is also granted. There are no provisions for recognizing reciprocal cross-border or charitable contributions deductions by donors.

II. Present Legislative System

The Russian Civil Code provides for various forms of non-profit organizations. Pursuant to the Civil Code, these are consumer cooperatives, public and religious organizations (associations), foundations, institutions, unions (associations of legal entities) and other forms permitted by law. In addition to the Civil Code, a large number of other Russian laws regulate the establishment and operation of non-profit organizations. They include the Law on Public Associations, Law on Noncommercial Organizations, Law on Charity and Charitable Organizations, Law on Trade Unions, Law on Consumer Co-operation, the Law on Education, Law on Freedom of Conscience and Religious Associations, Law on Private Noncommercial Associations of Owners of Gardens, Vegetable Gardens and Dachas; Law on Ethnic and Cultural Autonomy; Law on Housing Owners' Associations, and others.

The number of laws on NGOs is growing. The resulting system of various types, subtypes, and subgroups of non-profit organizations is very complicated for the NGO community to comprehend and follow. Accordingly, a restructuring of the various laws under the Tax Code is highly desirable.

III. Recommendations

- Exempt from taxation revenue streams of income generated by fees from the general public that promote educational, religious, social welfare, health care, scientific research and cultural activities that are conducted for the public benefit. Tax unrelated activities that are carried on for the sole purpose of producing income at the same rate as commercial entities.
- Allow tax exemptions for donations and grants from the Profits, Customs and VAT taxes on services and goods that are related to charitable purposes that further the social welfare or public benefit.
- Formulate administrative rules to regulate commercial activities of non-profit organizations.
- Create a tax regime to tax and penalize individuals who use the NGO for their own private benefit through a system of taxes imposed on the insider or the management of the organization that approved the transaction.
- Develop a system of applications and certifications under the Tax Administrator for the tax exemption of public benefit organizations that establishes periodic audits and penalties of organizations that fail to provide transparency of their activities.
- Establish a uniform approach for international organizations and domestic charities exemption based and conditioned on reciprocal rules and privileges under appropriate treaties and protocols.

Conclusion

Russia is a country transforming itself with a vibrant developing economy and confidence in the future, but with investor concerns regarding the operation of the rule of law. Much work still remains to be done to establish a functioning and sustainable civil society in an environment plagued by poverty and terrorism. The specific legislative changes that I have suggested will provide opportunities for growth of the nonprofit sector and engagement with Putin's concept of democracy. There are inherent problems in a "managed democracy." The most obvious ones currently in vogue in Russia are found in the areas of restrictions on freedom of speech and an independent media. The essence of true democracy is based on the right to disagree with those in power. These issues must still be part of the engagement process in developing a civil society based on democratic values and strengthening the rule of law. However, President Putin has presented a blueprint of his vision for Russia and it is up to the nonprofit organizations now to decide whether they will follow a course of confrontation or engagement to build the kind of civil society that they wish to see in Russia.

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