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PAY IMMEDIATE ATTENTION TO FAR-REACHING REGULATIONS ON INTERCOMPANY SERVICES

After almost forty years, the IRS has updated the section 482 regulations governing intercompany services (Temp. Reg. § 1.482-9T). The New Regulations improve upon regulations proposed in 2003 (the "Proposed Regulations") that encountered serious criticism from the business community. Since most multinational businesses entail some cross-border intercompany services – and since the New Regulations are quickly effective, beginning January 1, 2007 for calendar year taxpayers – the new rules require close immediate attention.

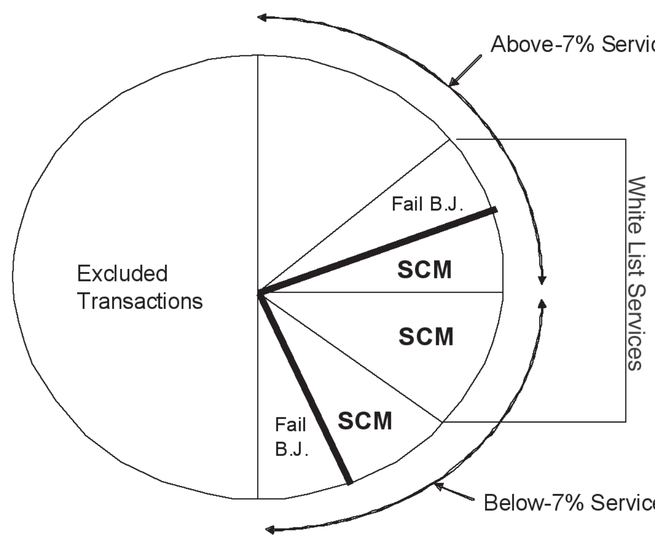
Services Cost Method – A Must-Read Feature

The most dramatic improvement from the Proposed Regulations is the replacement of the much-maligned "Simplified Cost Based Method" (SCBM) with the "Services Cost Method" (SCM). SCBM had substituted a complex, graduated-rate approach for the Old Regulations' cost-only safe harbor for "non-integral" services. The New Regulations restore the cost-only approach for a reasonably broad category of back-office services, and in some respects move past the Old Regulations' often imponderable "non-integral" requirement and the related "peculiarly capable"/"significant element" concepts.

SCM applies to services that:

1. Are not "excluded transactions" (e.g., manufacturing, construction, distribution, R&D, financial transactions, and insurance);
2. Are either:
   A. "Specified covered services" (a 'White List' of common support services, as specified in a published revenue procedure); or
   B. "Low margin covered services" (services for which the median comparable markup does not exceed 7%);
3. Pass the 'business judgment' test – The taxpayer must reasonably conclude in its business judgment that the services do not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the renderer and/or the recipient;
4. Are covered by adequate books and records.

Visually, the telescoping effect of these rules can be illustrated as follows:



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Pending future modification, the White List is fairly narrow and may pose segregation issues, and the business judgment test could lead to differences of opinion on audit. But SCM is a welcome addition to the transfer pricing lexicon and surely must be carefully evaluated by all taxpayers. Moreover, to avoid any inadvertent election or rejection of the SCM, taxpayers should be very explicit – whatever their choice – in pertinent documentation.

Shared Services Arrangements ("SSAs")

SCM opens the door to a useful innovation – cost-sharing arrangements for services. Foreshadowed by the permissive "cost contribution arrangements" under the OECD Guidelines, the requirements for SSAs are relatively simple:

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- There must be at least two participants
- The subject services must constitute "covered services" eligible for SCM
- All controlled taxpayers that reasonably anticipate a benefit from the covered services must participate, and
- At least one participant must benefit from each covered service (or reasonable aggregation of services).

Under an eligible arrangement, the costs of the services are allocated among the participants in proportion to their respective shares of the reasonably anticipated benefits (whether or not in fact realized). Deference is given to the taxpayer's "reasonable conclusion" as to the reliability of the measurement keys. Aggregation of covered services is permitted for allocation purposes and need not follow the same groupings used for evaluating low-margin services. The key advantages of an SSA are these liberalized tracking and allocation provisions.

Rules for Cost-Based TPMs

SCM, SSAs, comparable profit method analyses using the favored net-cost-plus profit level indicator, and other cost-based transfer pricing methodologies are based on "total services costs." Stock-based compensation is explicitly required

Other New Provisions

These are long and detailed rules, including many examples. New concepts to be studied include:

- "Direct benefit" test for charging out headquarter services
- "Sole-effect" test for inallocable "shareholder activities"
- Inallocable "passive association" benefits
- Contingent payment arrangements
- New specified pricing methods (in addition to SCM) that parallel those for transfers of intangible and tangible property; unclear role of the residual profit split method
- Alternative approaches to pricing passed-through third-party services

Imputed Agreements –Lurking Considerations

Despite various criticisms, the New Regulations adopt the Proposed Regulations provisions that permit the IRS to review controlled parties' dealings and impute agreements between them to more accurately reflect the economic substance of their conduct, even if contrary to express contractual agreements. The IRS's preamble to the New Regulations stresses that the IRS can only impute different arrangements if the taxpayer fails to specify contractual terms or if the specified terms do not accord with economic substance. However, the IRS's authority is not meaningfully hobbled, and the potential scope and threat of its imputation powers remain.

Integrated Transactions – The Sleeping Giant

In the case of transactions which combine different elements, the New Regulations look first to whether there are sufficiently similar features in comparable transactions that can be used to evaluate the transaction as a whole. Significantly, the preamble states that "if a taxpayer structures a transaction so that it constitutes a controlled service, the transaction will generally be analyzed under the principles of" the services regulations, without regard to other provisions of the section 482 regulations. Services transactions with an intangible property element must run an additional gauntlet: any "material element" relating to intangible property must be corroborated or determined under the section 482 intangibles pricing rules.

Intangibles – Clarified Approaches

The New Regulations also address certain threshold concepts in pricing intangibles (Temp. Reg. § 1.482-4T). Despite some criticism, the New Regulations continue the rule that legal ownership of intangibles is usually the foundation for assessing appropriate transfer pricing. The restated rules stress the ability to slice up an intangible into separate items of intangible property for transfer pricing purposes, for example, (a) a trademark itself and (b) discrete license rights thereunder. The modified rules also adopt a "contribution" approach that requires payment for activities that increase the value of an intangible owned by a related party (replacing the much-debated 1994 "cheese examples"). That compensation may variously be embedded within the terms of another transaction, stated separately, or applied to reduce another payment. The IRS preamble notes "heightened deference" to taxpayers' contractual arrangements.

Effective Date Rules and Considerations – Tough Choices

The Temporary Regulations are effective for taxable years beginning after December 31, 2006, and remain in effect until July 31, 2009. Given the broad scope of the rules, the close-at-hand effective date affords precious little time for the necessary comprehensive review – particularly with further

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last-minute changes (including finalization of the White List) possible under the proposed regulation comment process.

Conclusions

The IRS has tried hard to make the services regulations more user-friendly in routine situations. Eligibility for SCM and SSAs, however, needs considerable broadening to make practical sense for many taxpayers. It seems inevitable that fewer services will be chargeable at cost than under current rules, that more "robust" economic analyses will be needed, and that taxpayers must undertake considerably more work and prepare considerably more documentation than seen in typical current levels of section 6662(e) compliance with respect to services. Advance Pricing Agreements (APAs) with the IRS deserve serious consideration as an efficient way to achieve more certainty under the new rules.

Important tips for taxpayers include:

- Move quickly to inventory, categorize, and review all intercompany service arrangements, identifying pertinent corporate objectives and using an evaluation template.
- Comprehensively review existing contracts and/or create new ones to ensure they clearly establish responsibilities, risks and intended relationships. Contract revisions may be needed on an expedited basis to support consistent foreign treatment. The importance of specific contracts cannot be overstated, as the New Regulations in key areas (intangibles, integrated transactions, and imputed transactions) rely on and largely defer to taxpayers' contractual arrangements.
- Watch for additional guidance on the New Regulations, as there are many issues that still need clarification.
- Consider providing comments for the IRS hearings if you are encountering legitimate interpretation or implementation problems.

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NEW PENALTIES FOR TAX-EXEMPT ENTITIES AND MANAGERS

On May 17, 2006, President Bush signed into law the Tax Increase Prevention and Reconciliation Act ("TIPRA" or "the Act"). TIPRA, combined with existing laws, is poised to inflict potentially devastating penalties on the tax-exempt world. TIPRA's new disclosure and participation provisions for "prohibited" transactions present many serious, potential pitfalls for tax-exempt entities and their managers.

TIPRA takes listed, confidential, and contractual protection transactions that are potentially abusive and "reportable" for all tax return filers and makes them "prohibited" transactions for nearly all tax-exempt entities. New disclosure requirements are imposed on parties (or their managers) for "prohibited" transactions involving tax-exempt entities. In addition, the Act imposes stiff new penalties on tax-exempt entities and "managers" (a term that includes directors and officers) that participate in or fail to report involvement in abusive or potentially abusive transactions. The new TIPRA-prescribed penalties relating to "prohibited" transactions are imposed in addition to the consequences already assessed for "reportable" transaction violations under current law.

Disclosure Requirements and Penalties

TIPRA requires nearly all tax-exempts to report their participation in a "prohibited" transaction to the IRS. If an Indian tribe or section 501(c), 501(d), or 170(c) organization fails to report, the entity must pay $100 for each day the failure continues, up to a $50,000 maximum. The same monetary penalties are applicable should a tax-favored savings arrangement, such as an IRA or pension plan, fails to report. However, the IRS may not impose this penalty if there is a reasonable cause for the entity's failure to disclose.

The new law also states that the IRS may "make a written demand" for information on tax-exempt entities and managers. An entity and/or manager is fined $100 per day, up to a $10,000 maximum, for disregarding the demand. Again, the IRS may not impose this penalty if there is a reasonable cause for the failure to comply.

Additionally, TIPRA requires taxable parties to a "prohibited" transaction to inform any tax-exempt parties of the transaction's "prohibited" status. However, taxable parties are not required to do so before the tax-exempt entity becomes a party. A tax-exempt entity may thus unwittingly involve itself in a "prohibited" transaction and incur the accompanying reporting obligations and penalties for failure to report. Such involvement may also expose the tax-exempt to TIPRA's "prohibited" transaction participation penalties.

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Participation Penalties

TIPRA's participation provisions apply to a smaller subset of tax-exempts—only Indian tribes and organizations (including managers) described in sections 501(c), 501(d), and 170(c) may be subject to TIPRA participation penalties. These tax-exempt entities and their managers are penalized merely for participation in "prohibited" transactions, regardless of whether the transaction resulted in a substantial understatement of tax liability. There is no reasonable cause exception for tax-exempts and managers involved in such "prohibited" transactions.

The amount of the penalties differs depending on whether the entity knew or had reason to know of a transaction's "prohibited" status. For tax-exempts that unknowingly participate in a "prohibited" transaction, the annual penalty is the highest corporate tax rate (currently 35 percent) multiplied by the greater of either (1) the entity's net income that is attributable to the "prohibited" transaction, or (2) 75 percent of the proceeds received by the entity as a result of the "prohibited" transaction. For tax-exempts that "knew or had reason to know" that a transaction was "prohibited," the annual penalty is increased to the greater of all of the entity's net income, or 75 percent of the proceeds, attributable to the "prohibited" transaction.

These organizations are also penalized if they participate in a transaction that is not "prohibited" at the time they enter into the transaction, but is subsequently listed by the IRS and thereafter deemed to be "prohibited." This penalty is imposed only on income resulting from participation after the date on which the transaction was deemed prohibited. In addition, managers of these tax-exempts must pay a $20,000 fine if the IRS determines that the manager approved (or otherwise caused) an entity's involvement in a "prohibited" transaction and "knew or had reason to know" that the transaction was "prohibited."

TIPRA's new disclosure and participation provisions for "prohibited" transactions present many serious, potential pitfalls for tax-exempt entities and their managers.

For more information on this new legislation please contact Chris S. Rizek at (202) 862-8852 or csr@capdale.com, or Kevin E. Thorn at (202)-862-5076 or ket@capdale.com.

Recent Regulations on Foreign Tax Credits and on Foreign Exchange Gain or Loss from Branch Transactions

"Technical Taxpayer" Rule: There has been much discussion about the meaning of "legal liability" and "joint and several liability" under the current section 901 regulations, especially in the context of foreign consolidated groups. The recent proposed regulations rewrite these rules and address the fact pattern that the government litigated in Guardian Industries Corp. & Sub.'s v. U.S., 65 Fed. Cl. 50 (2005), which the government has appealed.

"10/50 Regulations": The IRS and Treasury also recently issued temporary and proposed regulations relating to non-controlled section 902 corporations (also known as "10/50 corporations"). The preamble states that the IRS and Treasury have declined to exercise their regulatory authority under section 904(d)(4)(C)(i)(II), which relates to distributions of pre-acquisition earnings and profits.

Section 987 Regulations: In addition, the IRS and Treasury recently issued proposed regulations under section 987, relating to foreign currency gain and loss resulting from branch transactions. Prop. Treas. Reg. § 1.987-1 et seq. The proposed regulations do not apply to "banks, insurance companies, or similar financial entities," and the preamble requests comments from such entities.

Regarding any of the above recent regulations, please contact Rebecca Rosenberg at 202-862-7811 or rir@capdale.com.

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