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Cono R. Namorato

Cono R. Namorato Sets the Record Straight for Corporate Tax Counsel & Corporate Tax Directors

After serving two years as the Director of the Internal Revenue Service's Office of Professional Responsibility ("OPR") and Senior Advisor to the Commissioner of the Internal Revenue Service, I have rejoined the law firm of Caplin & Drysdale ("C & D"). It goes without saying that it is great to be back at C & D. Prior to serving as the Director of OPR, I spent twenty-five years representing corporations and individuals, including corporate executives and senior public officials, in potential or ongoing criminal tax investigations, complex civil IRS audits, and voluntary disclosures. I also represented practitioners with sensitive legal and ethical problems and directed complex internal investigations into possible financial fraud. Before joining C & D in 1978, I spent ten years in the Department of Justice where I served as Chief of the Criminal Section and Deputy Assistant Attorney General in charge of criminal tax enforcement for the United States.

My recent government service proved to be extremely satisfying and educational. During my tenure as the Director of OPR, I quickly learned there were many misunderstandings among tax professionals in the private sector concerning their ethical responsibilities and how their conduct fit into the larger picture of corporate America. First and foremost, tax professionals need to understand their ethical obligations to their clients as well as the consequences of their failure to comply. This is especially true given the current enforcement-driven environment that exists in the United States. With the passage of Sarbanes-Oxley, the American Jobs Creation Act of 2004 ("Jobs Act"), and now the Pension Protection Act of 2006, it is more important than ever for all tax professionals to stay involved in local bar associations and keep up-to-date on their evolving ethical responsibilities.

Second, all tax practitioners need to be aware of the rise in cross-organizational investigations. In the past, departments within one government agency were slow to share information with one another. However, these days with the increased emphasis on enforcement and vastly improved technology, government departments and agencies have been efficiently sharing information and making substantial strides in their enforcement activities. Much of this information sharing has been a direct result of IRS Commissioner Mark Everson's plan to have the IRS run as a well-oiled machine in the enforcement arena. It should come as no surprise, therefore, that OPR has been at the forefront of many of these investigations.

Over the past few years, professional conduct has been under intense scrutiny by many government agencies, and their investigations have specifically targeted the actions of accountants, lawyers, and officers in major corporations. First there was Arthur Anderson, then Enron and, most recently, the deferred prosecution of KPMG along with the ongoing prosecution of several former KPMG partners and employees. All of these cases involve repeated allegations of professional misconduct. Whether they were accountants, lawyers, or corporate officers, one thing is certain--at some point, these individuals lost their perspective and ignored their professional responsibility obligations.

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While these investigations raise several issues concerning tax enforcement that deserve substantial discussion, I will focus on the IRS Office of Professional Responsibility's jurisdiction over tax professionals in corporations. An area that needs particular attention is the misconception that exists among tax professionals in firms, corporations, and other similar entities that they are not subject to Circular 230.

Clearly, Circular 230 provided the OPR with jurisdiction over attorneys, Certified Public Accountants, enrolled Agents, and Enrolled Actuaries. In the past, however, OPR limited its interpretation of jurisdiction over practitioners to include only those individuals it could demonstrate had actually practiced before the IRS. This created a misunderstanding that OPR does not have jurisdiction over in-house counsel, tax counsel, tax directors, and other corporate employees. But the Jobs Act clarified that OPR's jurisdiction includes all practitioners who write tax opinions. Not only did the Jobs Act clarify the jurisdictional questions that once existed for OPR, it also helped define what constitutes practice before the IRS. This, along with the Jobs Act's granting OPR the ability to issue monetary sanctions against a practitioner and the practitioner's employer for misconduct, has encouraged the practitioner community to re-examine its ethical obligations and to become familiar with the new regulations that have been added to Circular 230 in the past few years.

To be clear--the IRS's Office of Professional Responsibility *does* have jurisdiction over tax counsel, tax directors, and other organizational employees. OPR's jurisdiction over these practitioners does not come from the Jobs Act but from section 10.7 of Circular 230, which specifically provides these tax professionals with "limited practice" and gives the OPR broad latitude with respect to the regulation of their conduct. Under section 10.7(c), the following individuals may represent an entity before the IRS: a regular full-time employee of an individual employer may represent his or her employer; a general partner or a regular full-time employee of a partnership may represent the partnership; and a bona fide officer or a regular full-time employee of a corporation (including a parent, subsidiary, or other affiliated corporation), association, or organized group may represent the corporation, association, or organized group. Further, under Circular 230 section 10.7(c) (2), OPR can deny any of the aforementioned individuals the ability to engage in practice before the IRS on behalf of his or her employer when he or she is under suspension or disbarment from practice before the IRS or when he or she has engaged in conduct that would justify censuring, suspending, or disbarring a practitioner from practice before the IRS. Of course, such a denial would only come after the practitioner was given notice and the opportunity to be heard at a conference with OPR.

The recent passage of tax legislation and the focus on enforcement should raise serious concerns in businesses and corporate tax departments. In the past, tax professionals in corporations and other business organizations were not necessarily concerned with the misconduct of other tax practitioners in the professional community or with the OPR for that matter. Now, with the passage of the Jobs Act and the introduction of monetary penalties and other sanctions that can be imposed not only on an individual but on an entity as well, many practitioners have rightfully begun to take notice.

For more information concerning defending against corporate criminal investigations, charges of professional misconduct, the IRS's Office of Professional Responsibility or Circular 230, please contact Cono R. Namorato at crn@capdale.com or 202-862-5090.

continued on next page

Last-Minute Changes and Partial Delays under New Intercompany Services Rules

Some holiday wishes were granted . . . On December 21, the IRS issued a Notice partially modifying the effective date of the impending intercompany services regulations under Code section 482. Some clarifications to the substantive provisions were also announced.

Partial Delays for "SCM"

The "partial modification" to the effective date rules delays for one year the new "Services Cost Method" (SCM). SCM, which embodies the rules permitting taxpayers to charge certain intercompany services at cost, is a core element of the new regulations. However, it is in need of significant interpretative clarification and also requires extensive analysis and procedural undertakings by taxpayers to achieve compliance. SCM, along with the rest of the regulations, was scheduled to go into effect for taxable years beginning after December 31, 2006, i.e., on January 1, 2007 for calendar year taxpayers. That date has now been extended to taxable years beginning after December 31, 2007 (though taxpayers may opt into SCM earlier if they wish).

For the current year, taxpayers can continue to use the old regulations for identifying which services are eligible to be priced on a cost-only basis without a mark-up (often referred to as the "cost safe-harbor"). The only caveat is that, in addition to the requirements of the old regulations (including its "non-integral" test), the services must satisfy one requirement of the new regulations, the so-called "business judgment rule." That rule requires that the taxpayer reasonably conclude, in its business judgment, "that the covered 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, the recipient, or both." There may well be substantial overlap between these concepts and the non-integral test.

In effect, the IRS approach amounts to a type of "residual" method for 2007 --figure out what qualifies for the old cost safe-harbor, and then everything else is subject to the new rules. One open question is whether it is first necessary to apply the new regulations' "direct benefit" standard for defining a chargeable service, or whether old-law standards also apply (for example, the definition of non-chargeable "shareholder activities").

Revised List of Specified SCM-Eligible Services

The one-year grace period will undoubtedly be helpful to taxpayers in continuing to assess the applicability of the SCM and to plan its implementation. Further help in this regard accompanied the IRS Notice, in the form of a revised and expanded Revenue Procedure that identifies the "specified covered services" that are automatically eligible for SCM (subject to the business judgment rule). The IRS heeded input from taxpayers and added a number of new broad categories (such as health, safety, environmental and regulatory affairs) and detailed activities. Moreover, each category was expanded to include "other activities similar to those specified in" the preceding listed categories. The latter feature will partially assuage the concerns of those who sought to have the IRS turn the list into a functional/departmental list, instead of an activities-based list.

The IRS has solicited further comments on the list, and contemplates a further revision toward the end of 2007. (The IRS also hopes to finalize the regulations, which were issued in "temporary" form until July 2009, in the same time frame.) It remains to be seen, however, whether the specified covered services route will prove sufficiently practical for use by many taxpayers, or whether taxpayers will opt for economic studies to satisfy the alternative "low margin covered services" test (i.e., showing that a median comparable mark-up would not exceed 7%).

Penalty Liberalization

In the holiday spirit, the IRS also relaxed application of the Code's penalty rules for the one-year period. During this period, valuation misstatement penalties under section 6662(e) and (h), *inter alia*, will not apply if the taxpayer makes reasonable efforts to comply with the regulations (as modified by the Notice) and the documentation

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provisions. In this context, the IRS will take into consideration that taxpayers may not have all their intercompany agreements in place and may be implementing changes to their accounting systems. Note: this relief does not apply to transactions being evaluated under the old cost-only rules pursuant to the Notice, thus imposing a higher standard on interpreting the business judgment rule for that purpose.

Clarifications to Regulations

Clarifications to the new services regulations reflected in the IRS Notice include:

- SCM is elective at the option of the taxpayer, through a statement in the taxpayer's books and records.
- The business judgment rule is to be applied on a controlled group, not company-by-company, basis, thus allowing dedicated services subsidiaries to use SCM.
- The concept of "Shared Services Agreements," which provides a simplified method for handling SCM services, is extended to non-SCM services, subject to use of the more robust analysis required under the non-SCM rules for determining charges, benefits and allocation keys.

The Year Ahead

Limitation of the effective date modification to SCM means that taxpayers will still have to struggle, for the new year, with some tricky questions under the new regulations -- such as the "benefit" concept for defining services, "robust" analysis techniques and transfer pricing methods for non-cost-only services, integrated transactions and imputed agreements. At the same time, the IRS must finish its own thinking on these and other knotty issues under the temporary regulations. It is clear that the IRS will be evaluating the important question of where the line falls between specified covered services in the Revenue Procedure list and transactions that are nevertheless excluded from SCM eligibility (e.g., distribution, manufacturing, purchasing, and financial transactions).

Hopefully the IRS's refined interpretations will be issued early enough in 2007 for taxpayers to incorporate into their compliance analysis and planning.

For more information, please contact Patricia Lewis at 202-862-5017 or pgl@capdale.com.

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