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IRS Launches Settlement Initiative for Certain "Abusive Transactions"

On October 27, 2005, the Internal Revenue Service (IRS) announced a new settlement initiative that provides a limited-in-time opportunity for taxpayers to come forward and settle disputes with the IRS over transactions that the IRS considers abusive. The settlement offer (described in Announcement 2005-80, 2005-46 IRB 1) applies to 21 specific kinds of transactions. A taxpayer that wishes to participate in this new settlement initiative must file an Election Form with the IRS by no later than January 23, 2006.

The IRS says it has already identified more than 4,000 taxpayers that participated in the 21 transactions described in the settlement initiative. Of the 31 transactions that are currently "listed" by the IRS as potentially abusive, 16 are part of the settlement initiative. The other five transactions contained in the settlement initiative are transactions that the IRS has not yet "listed" but is nevertheless concerned about. The transactions included in the settlement initiative are divided into three separate groupings, the difference between them being the amount of the accuracy-related penalty that will apply.

According to the terms of the settlement initiative, taxpayers that choose to participate must concede 100% of the taxes owed, with interest and, depending on the transaction, a penalty of 5%, 10%, or 20%. Fortunately, penalty relief is available for taxpayers that participated in transactions that have already been voluntarily disclosed to the IRS and for transactions where the taxpayer obtained a tax opinion from an independent tax advisor. Settlement is available to any taxpayer who meets the eligibility requirements, regardless of whether the taxpayer was previously known to the IRS. Ordinary tax dispute resolution procedures will continue to be available to taxpayers that do not elect to settle, but the IRS has been very clear in warning that such taxpayers should not expect to achieve a more favorable resolution outside of this initiative.

Any taxpayer that wishes to participate in the October 27, 2005 settlement initiative must file an Election Form with the IRS by January 23, 2006. A list of the transactions that are part of the settlement initiative is available at our firm's website, http://www.caplindrysdale.com/, under the link described as "IRS Settlement Initiative Oct. 27, 2005."

If you have questions about eligibility for the settlement initiative or the transactions covered by the settlement initiative, please contact Chris Rizek at 202-862-8852 or csr@capdale.com, or Kevin Thorn at 202-862-5076 or ket@capdale.com.

Proposed Cost-Sharing Regulations Issued

Long concerned that taxpayers may transfer valuable existing intangibles offshore by making external contributions to cost-sharing arrangements, the Treasury Department issued proposed cost-sharing regulations on August 22, 2005, to ensure that such contributions are at arm's length. (REG-144615-02, 70 Fed. Reg. 51115 (8/29/05).) The main purpose of the proposed rules is to provide guidance on these external contributions and on the methods for valuing them, but the proposed rules also include changes to address other issues encountered in administering the existing regulations. Practitioner response to the proposed regulations has been less than favorable, with speculation that by increasing buy-ins and otherwise eliminating incentives for cost sharing, the regulations will discourage participation in cost-sharing arrangements, poten-

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tially causing companies to move their research and development activities offshore.

Investor Model

The IRS takes an investor model approach in the proposed cost-sharing regulations. By this, the IRS means that whether a party's investment in a cost-sharing arrangement - that is, its share of ongoing costs plus its external contributions - is arm's length is a function of its expected risk-adjusted return from the cost-sharing arrangement. In applying the investor model to value external contributions, the proposed rules add a requirement that an arm's-length charge for a preliminary or contemporaneous transaction consider "realistic alternatives." To determine whether this "realistic alternative" principle is met, the net present value to a participant from entering into the cost-sharing arrangement as of the date of the preliminary or contemporaneous transaction is compared to the net present value of realistic alternatives. Additionally, the investor model carries over to the proposed periodic adjustment provisions, where the threshold inquiry for determining whether an adjustment is necessary is the ratio of the present value of a participant's total profits from the cost-sharing arrangement to the present value of its total investment - that is, its actual investment return.

"Cost-Sharing Arrangement" Defined

A "cost-sharing arrangement" is a contractual agreement through which related parties (controlled participants) agree to share the costs and risks of developing intangibles in proportion to the benefits that each reasonably expects to derive from exploitation of the intangibles. Under the proposed regulations, the agreement must satisfy three substantive and four formal requirements.

The most significant change from the definition in the existing regulations is that participants must carve the world into non-overlapping geographic territories. (Prop. Reg. Section 1.482-7(b)(4).) Each participant must receive at least one territory; in the aggregate all territories must be allocated to participants; and each participant must be entitled to the perpetual and exclusive right to all profits earned within its territory from intangibles developed under the cost-sharing arrangement. Thus, if any member of the controlled group of which a participant is a member engages in a transaction with an uncontrolled taxpayer that involves property or services for use, consumption or disposition within the participant's territory, any profit from the transaction attributable to intangibles from the cost-sharing arrangement must be paid over to the participant. For this purpose, use, consumption or disposition of property or services is considered to occur at the location where the uncontrolled taxpayer receives notices or other communications under the contractual terms of the transaction.

As in the existing regulations, the IRS may apply the cost-sharing rules to any agreement that meets the substantive requirements, notwithstanding a failure to comply with any of the formal requirements. The IRS also may apply the rules to an arrangement that meets the formal requirements, and must apply the rules if the participants both meet the formal requirements and reasonably conclude that the arrangement is a cost sharing arrangement.

The controlled participants must continuously monitor results under the cost-sharing arrangement, timely updating and maintaining sufficient documentation. The IRS will use this documentation in audits of the cost-sharing transaction to determine whether the cost-sharing transaction and preliminary or contemporaneous transactions produce arm's-length results.

Valuing External Contributions

The proposed rules identify six methods that may be used to value preliminary or contemporaneous transactions: five specified methods, plus unspecified methods. Three methods are new and specific to cost sharing, and the proposed rules substantially modify another method for use in cost-sharing. The "best method" rule of the Section 482 regulations applies to the choice of method. (Prop. Reg. Section 1.482-7(g).)

Periodic Adjustment

The proposed regulations incorporate a new periodic adjustment provision that permits the IRS to impute an arm's-length arrangement when the IRS believes that the taxpayer's arrangement does not appropriately reflect the profit potential of transferred intangibles. This provision enables the IRS to address concerns raised by *ex post* outcomes that are significantly different from *ex ante* expectations, in effect substituting a mechanical rule

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for an evaluation of whether the *ex ante* expectations were realistic. However, taxpayers are not permitted to make periodic adjustments because the IRS believes that taxpayers are in the best position to evaluate the risks and profit potential and can adopt an arrangement that appropriately reflects those risks and benefits.

Effective Date

The proposed rules are effective on the date they are published as final regulations. A qualified cost-sharing arrangement under the existing regulations will be grandfathered and subject to the existing regulations for cost-sharing transactions and preliminary or contemporaneous transactions occurring prior to the effective date. However, grandfather status will be terminated under certain events, and even grandfathered cost-sharing arrangements will be subject to the new rules for preliminary or contemporaneous transactions if there is a periodic trigger on account of a subsequent preliminary or contemporaneous transaction occurring on or after the effective date. (Prop. Reg. Section 1.482-7(m)(3)(i).)

For further information on this topic please contact Neal Kochman at 202-862-5000 or nmk@capdale.com.

Supreme Court Set to Hear Major Case on Grass-Roots Lobbying

Tax exempt organizations engaged in advocacy of public policy issues via television and radio advertisements should be closely following a case the Supreme Court is scheduled to hear on January 17th. In *Wisconsin Right to Life v. Federal Election Commission*, the 501(c)(4) plaintiffs are seeking an exemption for grass-roots lobbying advertisements from the restrictions of the Bipartisan Campaign Reform Act ("BCRA" or "McCain-Feingold").

Among a variety of other changes, McCain-Feingold introduced a new legal category of advertising about candidates and public affairs – the "electioneering communication." BCRA prohibits labor unions and corporations (including non-profit and tax-exempt corporations) from funding any communication transmitted over television or radio within 60 days of a general election, or within 30 days of a primary election or nominating convention, which makes any reference to a clearly-identified federal candidate. This provision is aimed at restricting the funding of so-called "sham issue advocacy" – the kind of advertisements which typically berated one candidate or another but avoided using words that overtly advocated anyone's election or defeat. By carefully stepping around the use of any language that would constitute such "express advocacy," the makers of these ads could previously take the position that they did not constitute "expenditures" as that term is defined by campaign finance law, and therefore concluded that they could use corporate or labor union money to pay for them.

BCRA changed that, and in *McConnell v. FEC* the Supreme Court upheld the electioneering communications provisions (along with virtually all the rest of BCRA) against a facial challenge to its constitutionality.

Availability of As Applied Challenges

Consequently, the first issue presented by *WRtL* is whether a plaintiff may bring an "as applied" challenge to BCRA at all. In the *McConnell* opinion, the Court indicated they were upholding BCRA's constitutionality under "all applications" – arguably preventing any future plaintiffs from presenting a specific case which, while not invalidating the law as a general matter, would support the conclusion that the law can't be applied to a specific party under specific circumstances and still be consistent with the Constitution. The lower court in this case followed that language from *McConnell* and found that "as applied" challenges such as this were not available. However, given the Supreme Court's traditional reluctance to categorically foreclose relief on First Amendment issues of such constitutional moment, most observers expect this part of the appellant's argument to succeed.

BCRA's Constitutionality With Respect to Grass-Roots Lobbying

The other issue presented in the case is more complicated – namely, whether WRtL and other similarly situated non-profit organizations can in fact sustain such an "as applied" challenge. WRtL has very prominently built its case around communications that were designed to constitute grass-roots lobbying under the Internal Revenue Code. In their brief, they overtly take the position that the Supreme Court should preclude the government from enforc-

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ing BCRA's "electioneering communications" provisions against any such grass-roots oriented radio and television issue advertisements. In fact, as a measure of the significance WRtL places on this argument, consider that the words "grassroots lobbying" appear in their brief no fewer than one hundred and four times!

The outcome of this issue holds special importance for non-profit organizations that are active in grass-roots lobbying. In the *McConnell* opinion, the Court noted that organizations could avoid the funding restrictions and disclosure obligations imposed on "electioneering communications" by avoiding reference to any clearly identified federal candidates.

One alternative the Court may open in deciding *WRtL* would follow its approach in *Taxation With Representation*. Specifically, the Court may allow non-profits, even though incorporated, to establish and raise money for special accounts into which no money from corporations, labor unions, or foreign nationals could be deposited, and allow these entities to use these separate accounts to fund legitimate grass-roots lobbying which would otherwise be restricted as "electioneering communications." Another possibility is that the Court could deny relief to WRtL on the grounds that as a 501(c)(4), they could have created a federal PAC to pay for such advertising. WRtL rejects this as a false choice, on the basis that the speech it could afford through a PAC would be diminished since individual contributions to federal PACs are limited to $5,000 per year, whereas no limit otherwise applies to individual funding of electioneering communications. Certain 501(c)(4)s that accept no corporate or labor funds are already exempt from BCRA's electioneering communication provisions, but WRtL cannot claim this exemption because it accepts corporate funding.

This case does not directly raise the issue of whether and how any 501(c)(3) charities should be entitled to the same exemption WRtL is seeking. Nevertheless, a variety of organizations have filed *amicus* briefs arguing that the same justifications cited by WRtL for allowing 501(c)(4) organizations a limited exemption from BCRA's electioneering communications rules should apply with equal force to the "insubstantial" grass-roots lobbying occasionally undertaken by 501(c)(3)s.

Supreme Court Nomination Considerations

This case will certainly present the first opportunity for newly-installed Chief Justice Roberts to wade into the campaign finance debate. Since the case has been set for argument prior to any expected conclusion to the confirmation hearings for Judge Alito, it remains to be seen whether Justice O'Connor will ultimately carry the balance in *WRtL* as she did in *McConnell*. In fact, if Judge Alito becomes Justice Alito after the oral argument, but before the decision, and Chief Justice Roberts votes as Chief Justice Rehnquist did, the votes of the Court could very possibly split 4-4, requiring a re-argument of the case after which Justice Alito could be expected to determine the outcome single-handedly.

The issues presented by this case, both procedural and substantive, are complicated but enormously meaningful for any exempt organization which engages in grass-roots lobbying during an election season.

For more information, please contact Joe Birkenstock at 202-862-7836 or jmb@capdale.com.

Caplin & Drysdale helps clients plan and evaluate tax-related transactions. The firm's 35 tax lawyers have been designing and reviewing tax strategies for companies, organizations, and individuals throughout the United States and around the world since the firm was founded in Washington, D.C., by former IRS Commissioner Mortimer Caplin 40 years ago.

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