Caplin & Drysdale

taxAlert

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In this edition of Tax Alert, Caplin & Drysdale lawyers summarize a number of recent Government actions that may have significance for your own work on current tax issues. We think these short pieces reflect both the scope of the IRS's activities and the breadth of our own tax practice, and we hope you will find them useful. If you need additional information, please contact the attorneys mentioned at the bottom of each item.

Transfer Pricing: New Rules for Services and Intangibles

In September, the IRS proposed important changes to the cross-border transfer pricing rules. The proposal not only tailors existing transfer pricing methods to fit the particular shape of 'service' transactions better, but also shifts analytical emphasis away from a transaction's label and onto its economic characteristics. Greater harmony with OECD rules is intended. Under the new rules, contractual documentation of the respective rights and responsibilities for all kinds of transactions will be critical.

The proposal should also change the way multinational businesses allocate income from intangible property. Although the true dimensions of this conceptual shift remain to be seen, it would require multinationals to identify, isolate and value contributions made by group members to centrally owned intangibles as to well as various rights in the intangibles.

The potential implications of the proposals relating to intercompany services are clearer and pervasive. Multinationals should begin reviewing their intercompany relationships to assess the impact.

Several general changes merit attention. The proposal suggests a more prominent role for the residual profit split method, which has complex contours and implications. In addition, the proposal replaces the familiar 'general benefit' approach for allocating centralized service costs among group members with the OECD's 'specific benefit' approach. Multinationals will need to think less about which services can be charged out than about to which group members, and in what relative amounts, to allocate (and possibly mark up) such costs.

On another front, while ancillary services in a property transfer need not be separately allocated under the current rules, the proposed rules manifest particular sensitivity to multi-element transactions in a hunt for disguised valuable intangibles transfers. In many cases the rules require integrated transactions to be broken apart for separate arm's length evaluations. Deciding which cases require such separation could present a considerable challenge; conducting evaluations of integrated transactions, whether or not separated, could present another. A special corroboration rule applies to certain integrated transactions with intangible components (sweepingly defined as transactions that "result in or have an effect similar to a transfer of intangible property"). If the intangible element is "material", it must be evaluated or corroborated under the rules for intangibles.

The proposal's most striking specific change is replacing the familiar 'cost-only' safe harbor with a much narrower "simplified cost-based method" (SCBM) for low-margin services. SCBM requires identifying comparables data for non-core services and significantly compresses the ability to charge no or low markups on such services. Multinationals will need to consider a new set of definitional issues to determine which, if any, services qualify, and with the reduced benefits may ultimately end up pricing most intercompany services at arm's length rates.

The treatment of loan guarantees has also been changed. Whether they remain "services" (as previously indicated by the IRS) is unclear, but they are categorically excluded from SCBM and thus may not be effectively provided free as under the current cost safe harbor. Given the potential difficulty of valuing guarantees under the arm's length benefit-based standard, multinationals may wish to voice their views on this topic, as well as the implicitly sharper focus on other "benefits" derived from group membership.

The IRS proposal explicitly recognizes that contingent payment arrange-

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ments can be an appropriate arm's length way to pay a related party for services. Taxpayers performing independent or contract R&D services (which might otherwise necessitate a high current markup) may find such an arrangement useful, but must be sure to reflect the arrangement in a written contract beforehand.

While the above changes are certainly newsworthy, the expansion of the imputed agreement provision may ultimately have the most impact. The IRS seems to have given itself hindsight carte blanche to recharacterize transactions on the basis of the IRS's view of their underlying economic substance. Such a change could particularly trouble related parties who change ongoing relationships (by shifting risks, for example), and it could also effectively circumvent the statute of limitations on assessments.

We follow the progress of this and other transfer pricing developments closely. If we can help your business better understand the implications of these proposed regulations, please contact Patricia G. Lewis (202-862-5017 or pgl@capdale.com).

"Hot Interest" for Large Corporate Underpayments

"Large corporate under-payments" exceeding $100,000 are subject to a "hot interest" rate that is 2 percent higher than the normal rate for underpayments. The higher rate may take effect after the taxpayer is notified of an underpayment exceeding the threshold and fails to pay. There must, however, actually be a "large corporate underpayment" at the end of the day for the additional interest to be due. Thus, the regulations provide that "hot interest" is provisionally collected once total tax assessments exceed $100,000, but the extra interest will be refunded if a court later determines the underpayment to fall below the threshold.

On September 9, 2003, the Tax Court held in *Med James, Inc. v. Commissioner* that the "hot interest" rate does not apply when an underpayment is reduced below the $100,000 threshold by a carryback. The taxpayer had reduced its potential $225,753 underpayment for 1994 to $63,573 by carrying back a loss from 1995. The Service contended that the carryback from 1995 should be ignored in determining whether the $100,000 threshold was exceeded for 1994. However, the Tax Court held that the regulatory language squarely covered the case. Thus, "hot interest" did not run on the 1994 underpayment at all because the final liability was less than $100,000.

Language in the opinion creates some confusion about its scope. For example, the preamble to the regulations expressly states that carrybacks should be disregarded in determining whether the $100,000 threshold is exceeded. The court held this language refers only to refunds of previously paid deficiencies and does not apply when the carryback is taken into account in computing the initial assessment, as it was in *Med James*. This distinction is debatable. The overriding issue seems to be whether the Tax Court is right that carrybacks should be considered, or whether the preamble is right that they should not. If the Tax Court's reasoning is accepted, it could extend to any case in which "hot interest" may apply.

Taxpayers potentially affected by the holding should be conscious of potential statute of limitations issues. As long as a related carryback claim remains pending, taxpayers may be able to raise an argument based on *Med James*. After a carryback is allowed, however, a request for refund of further interest may be treated as an independent claim for limitations purposes. Taxpayers therefore should consider taking appropriate steps to protect their position while the issues raised by *Med James* are being litigated.

If you are interested in the implications of the "hot interest" rules or other matters relating to settlements and audit calculations, please contact James E. Salles (202-862-5012 or jes@capdale.com).

Exempt Organizations—Current Developments

A number of legislative actions and IRS pronouncements over the last six months may be of interest to charitable organizations and other organizations that are exempt from tax under the provisions of Internal Revenue Code section 501.

Charitable Giving Bills Stall. The House has passed the Charitable Giving Act of 2003 (H.R. 7), and the Senate has passed the CARE Act of 2003 (S. 476. Both bills contain a number of incentives for charitable giving, the most significant of which are a non-itemizer charitable contribution deduction of up to $250 ($500 for joint filers) for cash contributions above $250 ($500 for joint filers) and an IRA rollover provision that would permit IRA beneficiaries over a certain age to contribute their IRA proceeds to charities or split-interest trusts without having to take the IRA proceeds into income. The non-itemizer provision would sunset after two years; the IRA rollover provision would be permanent. The House bill also contains significant changes to the private foundation rules, including

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denying section 4942 qualifying distribution treatment for certain administrative expenses and reducing the section 4940 investment income tax to a flat 1 percent. Further progress on these bills is unlikely this year, as Senate Democrats are refusing to send the Senate bill to conference as a way of protesting the fact that Democrats have been shut out of conference negotiations on other bills.

IRS Scores a Victory in Joint Venture Case. The U.S. Court of Appeals for the Fifth Circuit reversed the grant of summary judgment in St. David's Health Care System v. United States. The District Court had ruled St. David's Health Care System was tax-exempt under section 501(c)(3) even though it had transferred its health care activities to a partnership formed with a for-profit company and had ceded control over those activities to a for-profit entity. The Court of Appeals concluded that the control analysis articulated by the IRS in Revenue Ruling 98-15 was the correct analysis to apply, and then found that genuine issues of material fact existed regarding whether St. David's had ceded control over the partnership to its for-profit partner. The Court of Appeals therefore remanded the case back to the District Court for trial.

IRS to Increase Focus on Political Activities. The IRS has announced that during the upcoming federal election year it will be focused on ensuring that exempt organizations are aware of their responsibilities with regard to political activities. The IRS is particularly concerned about the possible shift of money away from political parties and toward section 501(c)(4) and section 501(c)(3) organizations because of the restrictions imposed by the Bipartisan Campaign Reform Act, which may put pressure on these organizations to "push the envelope" with respect to their election-related activities. The IRS is also planning to review compliance with the tax form filing requirements for section 527 political organizations.

Treasury and the IRS Announce Guidance Plans for FY2004. Treasury and the IRS have announced that they plan to issue guidance by June 30, 2004 on: (1) joint ventures between exempt organizations and for-profit companies; (2) activities of section 501(c)(4) organizations; (3) the Internet and the unrelated business income tax; (4) low-income housing partnerships and section 501(c)(3) organizations; (5) down payment assistance organizations; (6) split-interest trusts; (7) qualified tuition programs under section 529; and (8) reporting requirement applicable to Coverdell education savings accounts. Treasury and the IRS are also working on new guidance for international activities under section 501(m), but have not set a timetable for issuing that guidance.

IRS Continues Market Segment Audits. The IRS plans to undertake in the near future "market segment studies," audits of a statistically valid sample of organizations of a particular type, for section 501(c)(3) organizations that raise funds for other organizations, private schools, and non-exempt charitable trusts. The IRS is continuing such studies for eleven other types of organizations, including private foundations, community foundations, colleges and universities, and hospitals. The IRS expects to publish reports of its studies for section 501(c)(5) labor unions, section 501(c)(6) trade associations, and section 507(c)(7) social clubs in early 2004.

We closely track developments pertaining to tax exempt organizations. If you or your organization have questions or would like further information about the implications of these developments, please contact Lloyd H. Mayer (202-862-5056 or lhm@capdale.com).

Recent Developments in the Tax Shelter Area

The ongoing enforcement effort against abusive tax shelters has taken several turns in the past few months. Taxpayers and practitioners who have shelter issues need to be aware of a number of recent developments.

Legislative Developments. First, as of this date (mid-November) anti-tax shelter legislation appears to have stalled in Congress. The Senate has passed a comprehensive set of disclosure and penalty provisions, including a codification of the economic substance doctrine that is estimated to raise nearly $14 billion of revenue alone. But the economic substance provision continues to be controversial, and the shelter bill appears to be caught up in House-side wrangling over other tax legislation. To focus more attention on the shelter issue, several days' worth of hearings were held on Capitol Hill this fall. The Senate Finance Committee held a hearing in October at which Government, private sector, and so-called "whistleblower" witnesses testified about both systemic enforcement concerns and specific shelter transactions (such as "Son of BOSS" and cross-border leasing variants). And earlier this month, the Senate Permanent Subcommittee on Investigations held hearings focusing on the promoters and marketers of shelters and their professional and fiduciary obligations. Despite these efforts to bring attention to the issue, however, prospects for the passage of legislation continue to be uncertain.

Administrative Developments. The IRS has nevertheless continued its anti-shelter enforcement efforts using existing administrative tools. For instance,

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just recently the IRS updated its roster of so-called "listed" transactions for tax shelter reporting purposes under Code sections 6011 and 6112, and in July the IRS added certain compensatory stock option plans to that "list." The IRS also issued a Coordinated Issue Paper on lease-in, lease-out (or "LILO") transactions in October, and a new notice regarding so-called "lease stripping" transactions in November (at the same time withdrawing regulations first proposed in 1995).

In addition, the IRS is pursuing information from taxpayers and third parties using its existing summons power and other investigative tools. As of this writing, so-called "John Doe" summonses (under IRC section 7609(f)) have been sought from the law firm of Jenkins and Gilchrest, the Grant Thornton accounting firm, and the investment group Presidio Advisors. Several recent opinions in the *BDO Seidman, Arthur Anderson, Wachovia Bank*, and *KPMG* cases, as well as in the (non-shelter) *G-I Holdings* bankruptcy proceeding, have addressed the scope of privileges in the tax practice area, including the attorney-client privilege, so-called "Kovel" arrangements, and the statutory (IRC section 7525) tax advisor-client privilege. And although the opinions are somewhat confusing, they share one theme: privileges are endangered when tax shelters are involved. Likewise, tax accrual workpapers regarding shelter transactions may be sought more frequently, under the policy shift the IRS revised earlier this year

In sum, the anti-tax shelter enforcement field is quite busy these days. If you need assistance with tax shelter issues or have further questions about developments in this area, please call Christopher S. Rizek (202-862-8852 or csr@capdale.com).

UPCOMING TAX LAW EVENTS

The following is a partial list of upcoming events at which Caplin & Drysdale attorneys will be speaking. If you would like additional information on any of these events or the topics covered, please contact any of the attorneys listed below.

December 4, 2003
Pennsylvania Bar Institute – Philadelphia Bar Tax Section Annual Meeting
Speaker: ***Richard E. Timbie***
Topic: "Sarbanes-Oxley Act of 2002: Tax Services and the Auditor Independence Rules"

December 4-5, 2003
ALI-ABA's Tax Exempt Charitable Organizations Conference
Location: Hilton Embassy Row, Washington, DC
Co-Planning Chairs: ***Marcus S. Owens*** *and* ***Douglas N. Varley***
Speakers: ***Diara M. Holmes, Kirk L. Jowers, Lloyd H. Mayer,*** *and* ***Richard W. Skillman***
Topics: "Lobbying and Politicking;" "Deferred Compensation in the Charitable Sector;" and "Significant Developments Affecting Tax Exempt Organizations"

December 5, 2003
Tennessee Society of CPA's Federal Tax Conference
Speaker: ***Christopher S. Rizek***
Topic: "Evolving Privilege and Confidentiality Rules"

December 11-12, 2003
George Washington University's 16th Annual Institute on Current Issues in International Taxation
Speakers: ***Patricia Gimbel Lewis, H. David Rosenbloom***
Topics: "Latest IRS Transfer Pricing Guidance" and "The Changing World of Permanent Establishment Taxation"

January 30, 2004
American Bar Association Section on Taxation's Mid-Year Meeting
Speaker: ***Rebecca I. Rosenberg***
Topic: "Current Issues Surrounding Tax Credits"

February 20, 2004
First Annual NYU Gerald L. Wallace-Charles S. Lyon National Tax Workshop
Speaker: ***H. David Rosenbloom***
Topic: "International Taxation"

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 39 years ago.

The articles appearing in this **taxAlert** do not constitute legal advice or opinions. Such advice and opinion are provided only upon engagement with respect to specific factual situations.

For more information on the issues discussed in this **taxAlert** or on Caplin & Drysdale, please contact the authors or visit our website (www.caplindrysdale.com).

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