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Sean M. King

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U.S. Developments Update

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Limits on Check-the-Box Planning

Proposal would allow a foreign eligible entity with a single owner to be treated as disregarded for US tax purposes only if:

(i) its owner is created or organized in the same country in which the foreign eligible entity is organized, or

(ii) (except in the case of tax avoidance) a first-tier foreign eligible entity is wholly owned by a US person.

- There would be section 367 consequences
- There would be section 987 branch loss recapture
- Effective for taxable years beginning after 12/31/2010

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Foreign Tax Credits

- Pooling concept applied across foreign subsidiaries:
  - Deemed paid foreign tax credits based on the average rate of the "qualified group"
  - Effectively creates a § 902 "super pool"
  - Pooling averaging would not apply to the direct foreign tax expenses of a U.S. taxpayer
    - § 904 limitation applies to the combined § 901 and § 902 credits
- Effective for tax years beginning after 12/31/2010

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Treaty Shopping

Proposal would disallow the treaty reduction of withholding tax on deductible payments by U.S. payors to foreign related parties unless a reduced rate of withholding would apply if the payment were made directly to the common foreign parent.

- *Proposed to be effective for payments made after the date of enactment of America's Affordable Health Choices Act of 2009 (H.R. 3200).*

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Economic Substance In International Tax

- Proposal would clarify that a transaction satisfies the economic substance doctrine only if:
  - *it changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position, and*
  - *the taxpayer has a substantial non-federal tax purpose for entering into the transaction.*
- The present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the net federal tax benefits.
- Foreign tax savings and U.S. state tax savings may cease to be a valid business purpose.
- Practitioners believe that economic substance doctrine should not apply to choices to:
  - *Capitalize a business with debt or equity,*
  - *Choice to use a foreign or domestic sub to make a foreign investment,*
  - *Choice to engage in a reorganizations,*
  - *Choice to use a related or unrelated entity in a transaction.*

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Transfer Pricing

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Controlled Services Transactions

July 2009 Final Transfer Pricing Regs

Services Cost Method ("SCM") - Examines the amount charged for certain "covered services" by reference to the total cost of the service with no markup. Applies if:

- *–The taxpayer concludes that the services do not contribute significantly to the competitive advantages, core capabilities, or fundamental risks of business success or failure.*
- *–The taxpayer must keep adequate books and records related to the service.*
- *–The taxpayer's books and records must contain a statement stating that the taxpayer intends to apply the service cost method, and*
- *–The services must be "covered services."*

Covered services are:

- *–"Specified covered services" - a service identified by the IRS in an IRS Revenue Procedure. The IRS promulgated Rev. Proc. 2007-13 identifying 101 specified covered services.*
- *–"Low margin covered services" - a controlled service for which the "median comparable markup" on total services costs is 7% or less. The median comparable markup is determined by examining uncontrolled comparable uncontrolled service transactions.*

The following transactions are not covered services: (i) manufacturing, (ii) production, (iii) extraction, exploration or processing of natural resources, (iv) construction, (v) reselling, distributing, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement, (vi) R&D or experimentation, (vii) engineering or scientific, (viii) financial transactions including guarantees, and (ix) insurance or reinsurance.

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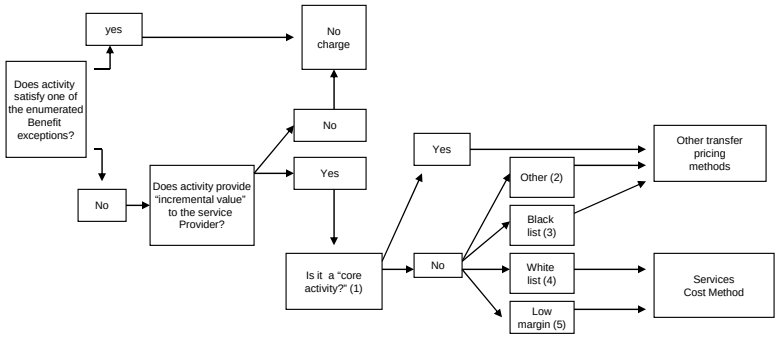
Services Decision Tree



(1) Determined by applying the "business judgment rule" as set forth in Treas. Reg. 1.482-9(b)(5)/
(2) Non-core chargeable services that do not fall within any of the following categories: (i) black list, (ii) white list, and low margin.
(3) Services that are not eligible for the Services Cost Method and which are defined as "excluded activities" in Reg. 1.482-9(b)(4).
(4) Services that are eligible for the services Cost Method and that the Commissioner specifies by Rev. Proc. See Rev. Proc. 2007-13
(5) Services for which the median comparable markup on total services costs is less than or equal to 7%.

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Controlled Services Transactions

July 2009 Final Transfer Pricing Regs

Comparable Controlled Services Price Method - Evaluates whether the amount charged in a controlled services transaction is arm's length by reference to amounts charged in comparable uncontrolled services transactions. Comparable controlled services price method is used where the controlled services are ether identical to or have a high degree of similarity to services in uncontrolled transactions.

Factors relevant to the application of comparable controlled services price method are:

- *Quality of services rendered,*
- *Contractual terms (for example, scope, warranties, guarantees, volume, credit and payment terms, allocation of risks including contingent payment terms and whether costs were incurred without provision for reimbursement),*
- *Intangible assets used in rendering the service,*
- *Geographic market,*
- *Risks born (for example, costs incurred to render the services without provision for reimbursement),*
- *Duration or quantitative measure of the services,*
- *Collateral transactions or ongoing business relationships between the provider and consumer of the services, and*
- *Alternatives realistically available to the provider and the consumer of the services.*

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Controlled Services Transactions

July 2009 Final Transfer Pricing Regs

Gross Services Margin Method - Evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. Regulations state that the gross services margin method is ordinarily applied where the controlled taxpayer performs services in connection with an uncontrolled transaction between a member of the controlled group and a party outside of the controlled group. The relevant applicable uncontrolled price is the price paid by the uncontrolled taxpayer to the member of the controlled group.

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Controlled Services Transactions

July 2009 Final Transfer Pricing Regs

Cost of Services Plus Method - Evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross services profit markup realized in comparable uncontrolled transactions. The cost of services plus method is ordinarily used where the controlled service provider provides the same or similar services to both controlled and uncontrolled (*i.e.*, unrelated) parties.

The costs if service plus method seeks to add the "appropriate gross services profit" to the service provider's "comparable transaction costs." Comparable transaction costs are the costs of providing the service subject to examination, which typically include compensation of employees directly providing the service and cost of supplies used in providing the service.

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Evaluating Transfer Pricing in a Recession

Issues that may arise as a result of a slow down:

- Profits turn to losses
- Longer startups
- Excess inventory
- Cash flow and debt service constraints
- Decline in capacity utilization
- Extraordinary costs:
  - *Layoffs*
  - *Plant closures*
  - *Bad debts*

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Evaluating Transfer Pricing in a Recession

Transfer Pricing Disequilibrium:

- Profits for routine activities, while all other affiliates suffer losses
- Supply chain structures – paying a manufacturer a fixed markup or return on assets, but principal company has losses
- US parent selling to foreign distributors – pricing to retain margin at distributors, but US now has significant losses and needs cash
- Royalty structure where payor now experiencing losses
- Cost plus service company charging entity that needs cash
- Significant group losses but paying cash tax
- Transfer pricing system conflicts with where cash is needed

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Comparables Selection in a Downturn

Industry comparability:

- Comparables from different industries are most likely to differ in terms of susceptibility to recessions
- Not all companies in the same industry are similarly affected by the recession (e.g., business outsourcing companies)
- When selecting comparables, consider economic measures that may be relevant for the industry under analysis

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Comparables Selection in a Downturn

Ensure potential comparable data reflect economic reality:

- Update comparables to capture changed economic circumstances
- Subset of previous comparables that reflects tested party sensitivity to down economy
- Eliminate companies that have not been affected by the economic downturn in the same way or to the same degree
- Identify companies with similar sales declines
- Re-consider loss companies
- Use of 10Q data (esp. for judging prices going forward)
- Extend comparables' data to previous economic downturns

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Adjustment to Comparables' Financial Data

Comparability adjustments:

- Unforeseen economic event
- Market adjustments
- Plant capacity
- Negative growth
- Differences in asset levels (A/R, inventory levels will be up)
- Differences in the ratio of fixed costs to total costs
- Differences in cost structure
- Decline in sales level
- High operating leverage
- FX movements

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Statistical Measures

Modification to range:

- Using longer time period to capture both up and down economic environment
- Utilizing historical data for past recessionary periods
- Consider different PLIs (Profit Level Indicators)

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Additional Considerations

Might rationally accept reduced profit or losses if:

- *Expected economic profit is greater than that which can be obtained under the next most attractive option (factoring in exit costs and potential compensation payments), and*
- *Expected economic profit is positive over the medium term. A temporary price reduction is then an investment in order to reap increased future profits.*

Keep records of recession impact

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Cost Sharing – Reg. § 1.482-7

Reg. § 1.482-7 Cost Sharing Regs – related parties share costs of developing intangibles in proportion to reasonably anticipated benefits.

- Controversy: "Buy-in" at § 1.482-7(g).
- 1995 Regulations
- 2009 Temp Regs (2005 Prop. Regs)

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What is a Cost Sharing Arrangement?

1995 and 2009 Regulations:

- An arrangement by which controlled participants share the costs and risks of developing intangibles in proportion to their "reasonably anticipated benefit" (RAB) shares
- Controlled Participant must make arm's length payment to other controlled participant(s) that makes relevant pre-existing assets available to the Cost Sharing Arrangement (Buy-in/ Platform Contribution Transaction (PCT))

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1995 Regs – Cost Sharing Arrangements

Key issue is valuation of buy-in under § 1.482-7(g)

Reg §1.482-4 for Transfer Pricing Methods:

- *Ramp down – royalty form of payment – Residual Profit Split Method (RPSM)*
- *Valuation research rights vs. make-sell rights*
- *Intangibles not "used" (transferred, useful, valuable)*
- *Limitations of license (term, exclusivity)*
- *"Goodwill" etc. § 936(h)(3)(B) & Reg §1.482-4(b)*

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2009 Temp Regs

- Effective on or after January 5, 2009
- Same force & effect as Final Regs
- Some differences from 1995 Regs
  - *Limitations on Division of Interest*
  - *New Specified Methods*
    - Income
    - New Residual Profit Split Method (New RPSM)
    - Acquisition Price Method
    - Market Capitalization Method
- New application of "Commensurate with Income" standard

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TRANSITION RULES – APPLICABLE REGULATIONS

	Pre-existing CSA Without A Material Change In Scope		Pre-existing CSA With A Material Change In Scope		New CSA (Entered Post 1/5/09)
	PCTs occurring prior to 1/5/09	PCTs occurring after 1/5/09	PCTs occurring after 1/5/09 prior to material change	PCTs (1) occurring after 1/5/09 on/after the material change	
Periodic Adjustment	Prior	Prior	Prior	New	New
Methods (3)	Prior (2)	New	New	New	New
Definition of contribution	Prior (2)	New	New	New	New
Divisional interests	Prior	Prior	Prior	Prior	New
Administrative requirements	New (4)	New	New	New	New

(1) Including PCTs relating to the change in scope or PCTs relating to the original scope.
(2) Arguably, pursuant to the Coordinated Issue Paper (CIP), this may be the same as New.
(3) Best method rule always applies.
(4) Some exemptions.

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Xilinx, Inc. v. Commissioner

- May 2009 opinion, the Ninth Circuit Court of Appeals (jurisdiction over AK, AZ, CA, HI, ID, MT, OR, WA) reversed the U.S. Tax Court.
- The Tax Court held (in 2005) that the arm's length standard applied to R&D "cost sharing arrangements", and found as a fact that parties at arm's length wouldn't agree to share costs associated with employee stock options ("***ESOs***")
- The Ninth Circuit admitted that uncontrolled parties would not share stock option costs, but held that the arm's length standard was not controlling and that "all costs" relating to intangible development had to be shared.

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Facts of Xilinx

- In 1995, Xilinx and it's Irish subsidiary, XI, entered into a cost sharing agreement ("*CSA*") permitted under Treas. Reg. § 1.482- 7 (the "***Cost Sharing Regulations***").
- Under the CSA, Xilinx and XI agreed to share ongoing R&D Costs based on their respective anticipated benefits from exploiting co-developed technology.
- Xilinx offered employee stock options ("***ESOs***") to its employees.

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Xilinx - IRS Adjustment

- **IRS adjustment. —** The IRS asserted that ESO amounts Xilinx deducted in 1997-1999 should have been included in the CSA pool of shared costs.
- **Effect on Xilinx of IRS adjustment. —** By including ESO costs in the CSA pool, those ESO costs would be reimbursed by XI thus reducing Xilinx's ESO deductions, thereby increasing Xilinx's taxable income for 1997-1999.

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Xilinx – Tax Court Ruling

Arm's length standard. — The Tax Court held that the Cost Sharing Regulations were subject to the arm's length standard in Treasury regulations § 1.482-1(b)(1):

- ***(b) Arm's length standard—(1)*** *In general. In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result).*

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Xilinx – Tax Court Ruling

Cost Sharing Regulations. — The Cost Sharing Regulations held by the Tax Court to be subject to the arm's length standard defined the pool of costs to be shared:

- ***(d)* Costs—(1) Intangible development costs.** *For purposes of this section, a controlled participant's costs of developing intangibles for a taxable year mean* all of the costs *incurred by that participant related to the intangible development area,. . . .*

The Cost Sharing Regulations required the parties to the CSA to share intangible development costs "in proportion to their shares of *reasonably anticipated benefits*" from exploiting technology assigned to them under the CSA.

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Xilinx – Tax Court Ruling

Factual finding. — The Tax Court found that Xilinx's "uncontradicted evidence established that in determining cost allocations unrelated parties would not include any cost related to the issuance of ESOs."

Tax Court holding. — Xilinx's allocations met the arm's length standard.

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Xilinx – Ninth Circuit Appeal

IRS Appealed to 9th Circuit

Xilinx and the IRS agreed that the arm's length standard applied to cost sharing arrangements. They differed on how the arm's length standard was determined:

- *Xilinx argued it was the traditional arm's length standard — i.e., what parties at arm's length would do based on evidence of uncontrolled transactions.*

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Xilinx – Ninth Circuit Appeal

The IRS argued that an arm's length result could be achieved by use of an economic assumption rather than by a comparability analysis. Specifically, the IRS contended that:

- *"a qualified cost-sharing arrangement (the controlled transaction) meets the arm's length standard if the results of the transaction (i.e. the allocation of costs thereunder) are consistent with the results that would have been realized (allocation of costs in proportion to reasonably anticipated benefits) if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)."*

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Xilinx – Ninth Circuit Decision

The Ninth Circuit majority's reversal rejected the use of an arm's length standard in determining costs to be shared.

The majority opinion refused to apply the U.S.-Ireland Income Tax Treaty by concluding that the regulation controlled as opposed to the Treaty, notwithstanding the Technical Explanation under the Treaty, which specifically mentioned cost sharing as a transaction to which the arm's length standard was to be applied.

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Xilinx – Ninth Circuit Decision

Majority held the regulation language of the arm's length standard in § 1.482-1(b)(1) (standard to be applied "in every case") and the costs to be shared in § 1.482-7(d)(1) ("all of the costs") to be unambiguous yet "*distinct and irreconcilable*."

Majority analyzed the "all costs" language: "'All' means the "entire number, amount of quantity" ….[This term] describe[s] a fixed set of costs that must be shared in their totality and that will not vary based on the type of intangible property being developed."

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Xilinx – Ninth Circuit Decision

The majority interpreted the regulations: "Transporting an arm's length standard into section -7(d)(1) would transform this apparently all encompassing and self contained description of the costs to be shared into a methodology under which the costs to be shared would not be fixed by these defined terms but would rather ultimately be defined by the conduct of unrelated parties. Significantly, achieving an arm's length result is not itself the regulatory regime's goal; rather, its purpose is to prevent tax evasion by ensuring taxpayers accurately reflect taxable income attributable to controlled transactions."

The majority then used the canon of statutory interpretation that specific provisions control general provisions-the "all of the costs" language trumped the arm's length standard and required that Xilinx had to share ESO costs.

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Xilinx – Ninth Circuit Decision

The majority held the U.S.-Irish Treaty did not apply.

The majority acknowledged that: "the Technical Explanation, which was issued while the tax regulations at issue in this case were in effect, states that the treaty incorporates the arms' length principle from United States tax law.

The majority stated that: "As we have explained, we do no believe the Secretary accidentally promulgated a highly specific regulation that plainly requires related parties in cost sharing agreements to share all costs. The treaty documents do not alter our view."

The majority observed that the saving clause of the Treaty "expressly allows a contracting state to apply its domestic laws to its own citizens, even if those laws conflict with the treaty."

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Xilinx – Ninth Circuit Dissent

The dissent argued that the majority's opinion frustrates the purpose of the regulations by preventing parity between taxpayers in controlled transactions and taxpayers in uncontrolled transactions

The dissent argued that the U.S. – Irish tax treaty should be a guide in the analysis of the ESO issue:

- *"Similarly, the facts that associated enterprises may have concluded arrangements, such as* cost sharing arrangements *or general services agreement, is not in itself an indication that the two enterprises have entered into a non-arm's length transaction. . . . As with any other kind of transaction, when related parties enter into an arrangement, the specific arrangement must be examined to see* whether or not it met the arm's length standard*."*

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Xilinx – continuing to unfold

Xilinx submitted a petition for rehearing

The Ninth Circuit has accepted four amicus briefs and ordered the Justice Department to respond to Xilinx's petition for rehearing by 10/6/2009.

Sean M. King
Partner & Chair
International Tax Practice Group

Williams Mullen
sking@williamsmullen.com
+ 1 804 644 9812

www.williamsmullen.com