

# COMPLIANCE WEEK

THE LEADING INFORMATION SERVICE ON CORPORATE GOVERNANCE, RISK AND COMPLIANCE

## **Transfer Pricing Rules Take Aim at Tax Avoidance**

By Tammy Whitehouse — January 20, 2009

The Internal Revenue Service has issued new rules taking aim at the transfer pricing arrangements corporations often use to develop new technologies—a move that piles on more concern about valuing intangible assets and disclosing tax uncertainties.

Issued in the last days of 2008, the rules went into effect with the start of this year. Their final language largely follows the plan first proposed by the IRS in 2005, which has been razzed by corporate tax advocates ever since. Still, the long-simmering battle is not necessarily over. The IRS remains open to comment through April 6 and has scheduled a hearing on the measure for April 21.

The battle focuses on cross-border cost-sharing arrangements, says Rocco Femia, a tax lawyer with the law firm Miller & Chevalier. Multinational corporations with business units in various countries develop and share technologies, and tax authorities such as the IRS are keen to assure that income generated from those developments is properly taxed at home.

In essence, U.S. authorities “are trying to combat the ability of multinational corporations to game the taxing system,” says Rich Walton, a tax lawyer at the firm Buchalter Nemer.

When the IRS first proposed a new tax policy for cross-border technology developments in 2005, it suspected U.S. companies were shifting ownership of new technologies outside the United States to avoid paying income taxes, says Kash Mansori, senior economist for transfer pricing at consulting firm Jefferson Wells. The IRS then decided to adopt an “investor model” to determine how income derived from technology developed in the United States, but shared with related business units outside the United States, should be taxed.

By following an investor model, Mansori says, the IRS presumes that technology developed in the United States can be taxed here except to the extent an entity from outside the United States has invested in the development and is expecting a normal, 10 percent rate of return. The IRS views the investor-return approach as an appropriate way to determine the reward from the development of technology that should be allowed to leave the United States untaxed.

The objection companies raise: following a normal rate of return doesn't allow for any "blockbuster development," where the profit margin might be far greater than the standard 10 percent, Mansori says. An overseas affiliate of a U.S. company that strikes such a technology goldmine "could not have cost allocated to that," he says. "It would have to stay in the U.S., so it could be taxed in the U.S."

The new rules also place more emphasis on the valuation, says Daniel Falk, senior manager with tax advisory firm True Partners Consulting. "The IRS prefers an income approach, which means you have to do some kind of discounted cash-flow analysis that comes up with a value for the intangibles," he says. "It would be based on what an outside investor would be willing to pay for those intangibles."

Femia says cost-sharing arrangements sprang up as a way to escape difficult valuation questions. The original premise was that related entities from different countries would share equally in the cost of developing intellectual property, and would share equally in the rewards as well, then pay their respective taxes in their home countries.

Alas, the world is never that simple according to the IRS. "The IRS says you would never have projects with new intangible property without building on old intangible property, so how do you compensate the original owner?" Femia says. That's really the issue being addressed by the regulation."

The final regulations represent a somewhat less drastic approach than the IRS originally proposed, Walton says. The original plan would have required companies to establish a geographic allocation that would have been permanent, but the final regulations at least provide a little more flexibility.

"The old rules were viewed as inflexible and unfair to taxpayers, so Treasury tried to address that without going too far the other way, without giving loopholes sufficient to allocate in a way that Treasury would not be getting a fair share," Walton says. "We didn't get everything we asked for, but there will be further comment and criticisms of these rules."

### **Future Arrangements**

While that flexibility may be viewed as a good thing for those establishing the cost-sharing agreements, it creates new uncertainty about how future arrangements will be viewed by the IRS. That, in turn, complicates a company's compliance on the financial reporting side. Putting a value on intangible assets developed under cost-sharing arrangements is never easy; Walton compares the chore to assessing the fair value of assets according to Financial Accounting Standard No. 157, *Fair Value Measurement*.

FAS 157 is just taking effect this year for non-financial assets, including intangible ones—so accounting executives have two new, complex rules to follow (one for financial reporting and one for tax reporting) that require a lot of judgment calls. All that makes it hard to forecast how well regulators will accept companies' value estimates.

It gets worse: Financial Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, requires companies to specify where they may have uncertainty about their ultimate tax liabilities. Cost-sharing arrangements are a frequent point of disagreement between taxpayers and the IRS, so they were already difficult to describe under FIN 48, Walton says. The IRS's new valuation rules make agreement that much more elusive.

“To the extent these new rules increase flexibility, it makes it harder to predict how things will be viewed by Treasury,” Walton says. “Anytime you back away from a simple, unpopular rule, you introduce more opportunities for planning, and therefore more uncertainty.”

Falk says FIN 48 and cost-sharing agreements are among the most controversial between taxpayers and authorities. “If you put them both together, there’s a lot of uncertainty to begin with,” he says. And if things weren’t already complicated enough, the grandfathering provisions of the new regulations may also lead to some further uncertainty.

Existing arrangements may be subject to the old tax rules, he says, but companies will have to study the fine points of the rules and their agreements—especially if the agreements change in any way—to ensure that grandfathering will apply. Companies may want to study existing arrangements to see if they’ll fare better under the old rules or the new ones, he says.

“There’s a lot of minutiae here,” Walton says.

#### DETERMINING PCT

**The following excerpt is from Section 482: “Methods to Determine Taxable Income in Connection With a Cost Sharing Arrangement.”**

Arm's length range—(A) In general. The guidance in Sec. 1.482-1(e) regarding determination of an arm's length range, as modified by this section, applies in evaluating the arm's length amount charged in a PCT under a transfer pricing method provided in this section (applicable method). Section 1.482-1(e)(2)(i) provides that the arm's length range is ordinarily determined by applying a single pricing method selected under the best method rule to two or more uncontrolled transactions of similar comparability and reliability although use of more than one method may be appropriate for the purposes described in Sec. 1.482-1(c)(2)(iii).

The rules provided in Sec. 1.482-1(e) and this section for determining an arm's length range shall not override the rules provided in paragraph (i)(6) of this section for periodic adjustments by the Commissioner. The provisions in paragraphs (g)(2)(ix)(C) and (D) of this section apply only to applicable methods that are based on two or more input parameters as described in paragraph (g)(2)(ix)(B) of this section. For an example of how

the rules of this section for determining an arm's length range of PCT Payments are applied, see paragraph (g)(4)(vii) of this section.

(B) Methods based on two or more input parameters. An applicable method may determine PCT Payments based on calculations involving two or more parameters whose values depend on the facts and circumstances of the case (input parameters). For some input parameters (market-based input parameters), the value is most reliably determined by reference to data that derives from uncontrolled transactions (market data). For example, the value of the return to a controlled participant's routine contributions, as such term is defined in paragraph (j)(1)(i) of this section, to the CSA Activity (which value is used as an input parameter in the income method described in paragraph (g)(4) of this section) may in some cases be most reliably determined by reference to the profit level of a company with rights, resources, and capabilities comparable to those routine contributions. See Sec. 1.482-5. As another example, the value for the discount rate that reflects the riskiness of a controlled participant's role in the CSA (which value is used as an input parameter in the income method described in paragraph (g)(4) of this section) may in some cases be most reliably determined by reference to the stock beta of a company whose overall risk is comparable to the riskiness of the controlled participant's role in the CSA.

#### **Source**

Methods to Determine Taxable Income in Connection With a CSA (Jan. 5, 2009).

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