transfer pricing perspectives*

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A note from Garry Stone

In this journal we have developed a survey of several of the leading-edge topics in the transfer pricing area. We not only attempt to lay out an overview of the key issues impacting transfer pricing in North America, but also to provide unique analytical insights into these issues.

We have compiled these essays from a number of the leading transfer pricing professionals in North America. The topics include:

- An overview of the current state of transfer pricing in North America;
- An analysis of how to manage the most controversial sections of the new Temporary and Proposed Services Regulations;
- A critical analysis of potential negative U.S. macroeconomic impacts which may result from the U.S.'s Proposed Cost Sharing Regulations for intellectual property;
- A discussion of best practices for managing a transfer pricing controversy in Mexico;
- An evaluation of the key elements needed to effectively utilize the profit split method in the financial services industry;
- An evaluation of the ability to effectively use transfer pricing structures using limited-risk manufacturers and distributors; and
- Effective management of functions, risks, and intangibles to optimize Interstate Transfer Pricing and minimize U.S. state tax controversies.

Each of these topics addresses an area of either immediate or future critical concern to tax departments that are trying to effectively manage their North American transfer pricing. We provide both a deep technical underpinning for each of these topics and practical advice on how to manage—and avoid—the associated transfer pricing pitfalls resulting from each. Abstracts from many of the essays in this volume will eventually also be published in external journals, and we hope you enjoy this fresh, in-depth look at the selected issues.

Sincerely Yours,

Garry Stone
North American Transfer Pricing Leader
PricewaterhouseCoopers LLP

"Each of these topics addresses an area of either immediate or future critical concern to tax departments that are trying to effectively manage their North American transfer pricing."

A survey of key transfer pricing issues impacting North America

by Garry Stone, Saul Plener and Mauricio Hurtado

Introduction

The transfer pricing situation in North America is relatively mature as compared to many other regions. The U.S., Canada and Mexico have all had transfer pricing regulations and audit activity in their territories for some time. The major change affecting all three countries is the intensity of the audit activity over the past several years. As the countries are major trading partners, this is leading many companies eventually into either Advance Pricing Agreement (APA) or Competent Authority (CA) negotiations. We are seeing a greater percentage of CA negotiations between the governments that are not correcting double tax situations which are inevitably created by transfer pricing audit adjustments made by one of the trading partners. We see penalties being assessed more frequently, and the complexity of the issues/arguments has also generally increased across the region. To further complicate matters, the Internal Revenue Service (IRS) has recently published new Temporary and Proposed Regulations which will significantly impact the determination of appropriate intercompany charges for services into and out of the U.S.

Below we provide a brief summary of the current transfer pricing environment in each of these North American countries. We also discuss some key transfer pricing initiatives likely to significantly impact multinationals operating in these countries in the future.

U.S. transfer pricing overview

At the federal level, the transfer pricing environment in the U.S. had been fairly stable for about 10 years after taxpayers adjusted to the new documentation requirements and associated transfer pricing penalties along with new technical regulations the IRS issued in the mid-1990s. Then, in 2003, things started to change. An IRS directive was issued early in 2003 that required agents to request contemporaneous transfer pricing documentation from multinationals and perform more than a cursory review of these reports. This has led to both an increase in the number and intensity of transfer pricing audits in the U.S. and has resulted in a substantial increase in the number of disputes between taxpayers and the IRS. Some of these disputes are finding their way into the courts, where the cases currently focus on a wide range of issues from appropriate inclusion of option values in cost sharing arrangements, the determination of buy-in compensation and appropriate marketing intangible considerations for U.S. distributors. The IRS has also addressed more standard intercompany pricing issues, including transfer pricing of services (including financial services), tangible goods pricing and intellectual property royalties.

It should be noted that the IRS recently adopted or proposed new regulations which may have far reaching impacts on several key issues, including intercompany services and intellectual property development cost sharing arrangements. The Proposed and Temporary Services Regulations will be effective for tax years beginning after December 31, 2006, and, therefore, immediately require significant compliance activities by multinational taxpayers. The key issues of concern for taxpayers which are raised by these new regulations are appropriate documentation of business/transaction structures, determination of appropriate cost plus markups on the services rendered, and determination and documentation of stewardship and high value services under the new definitions provided by these regulations. In addition, the proposed Cost Sharing regulations have been through a significant comment period and it is expected that the IRS will also finalize these regulations in the near future. The regulatory changes have set the stage for another significant round of transfer pricing adjustments for taxpayers with U.S.-connected transactions.

It is interesting that during the 10 year period when things were relatively stable on the Federal level, the state tax authorities significantly increased transfer pricing pressure on companies with operations which cross state boundaries within the U.S. Most of the states that focus on transfer pricing also utilize the Federal Section 482 Regulations when evaluating transfer pricing issues. The states have primarily focused on interstate intellectual property issues and have increased their audit sophistication substantially during the past decade. There are now as many (or more) transfer pricing disputes being resolved in court in the various states as there are at the federal level. Documentation is now as much of a key to a successful audit defense in the state arena as it is at the federal level, although so far documentation is generally not required by the states.

Canadian transfer pricing overview

The transfer pricing environment has intensified in Canada since the introduction of new transfer pricing legislation in 1997. The Canada Revenue Agency (CRA) kept to its word and increased transfer pricing audit activity through a substantial increase in both auditors and economists, as well as through the introduction of a form letter requesting taxpayers to submit their contemporaneous documentation within 90 days of the beginning of every audit. This has resulted in taxpayers' having to devote additional time and resources to transfer pricing audits. Auditors appear to be taking aggressive positions on their interpretation of the arm's length principle, and there has been a lack of consistency in audits across the country. Intellectual property (IP) migrations, interest rate determinations, location savings, consignment manufacturing and restructuring costs are some of the issues that are receiving the greatest amount of attention from the CRA.

The legislative changes in 1997 included the introduction of a transfer pricing penalty. When transfer pricing adjustments exceed a pre-established threshold, a mandatory referral is made by the auditor to the Transfer Pricing Review Committee in Ottawa. The Committee determines whether the taxpayer has made reasonable efforts to prepare contemporaneous documentation and followed its transfer pricing policies. Whereas a penalty was levied in 25% of the referrals in 2004, this has increased to more than 50% in 2006. Over this time, the number of referrals increased more than tenfold.

The CRA has also provided guidance to both taxpayers and auditors in the form of Transfer Pricing Memoranda, which are a series of position papers on specific transfer pricing issues such as repatriation of funds by non-residents, downward adjustments, referrals to the penalty committee and bundled transactions.

As a result of the level of current audit activity, coupled with the aggressive positions being taken by the auditors, more taxpayers are turning to the Advance Pricing Arrangement (APA) program as an alternative dispute resolution mechanism. The CRA is actively promoting the program and recently conducted an information session with advisors to solicit input on how to improve the program in the future.

While the landscape has been harsh, there is hope for the taxpayers that the objectivity witnessed through the APA program spills over to the auditors in the field.

Mexican transfer pricing overview

Transfer pricing legislation is relatively new in Mexico, with the first specific regulations being enacted in 1997. The Mexican legislation is OECD based, thus there is relative consistency with global transfer pricing principles. Prior to 2004, the transfer pricing tax authorities focused primarily on regulating the "maquiladoras," companies operating under a special toll and contract manufacturing customs regime for Mexican subsidiaries of foreign companies.

The maquiladora transfer pricing environment is now relatively stable, and the tax authorities have moved on to other areas. Reviews in the past couple of years have focused mainly on companies that have requested letter rulings on transactions such as reorganizations, debt and equity restructurings, and the transfer of operations outside of Mexico. In addition, the tax authorities have focused on companies reporting unusual data obtained in the annual statutory tax audit reports issued by independent accountants.

The tax authorities' primary concern in debt restructurings is that excessive debt should be classified as equity. Moreover, they are questioning values used in establishing the initial debt. As for operational shifts to offshore principal companies, the tax authorities seek to ascertain that real economic and substantive change in local operations has occurred and that a buyout has been paid for any Mexican-financed or Mexican-owned intangibles. In addition, the tax authorities are focusing on taxpayers they perceive have improperly analyzed their intercompany transactions and may have improperly used transfer pricing methods and economic assumptions.

For the first time, several transfer pricing audits in Mexico are approaching the level of litigation. Although there have been no final court decisions as of the current date, we expect to see a significant increase in transfer pricing litigation over the next few years. The authorities are seeking substantial audit adjustments and appear to have been able to obtain significant results through out-of-court settlements reached in certain recent audits.

Garry Stone, Mauricio Hurtado and Saul Plener are PwC's North American, Mexican and Canadian Transfer Pricing practice leaders, respectively.

Editorial: An indecent proposal

by Garry Stone, Marios Karayannis, and Chris Dunn

Suddenly, it seems like *legacy* is a bad word. Though the term conjures up a connection with the past, and all of the positive connotations associated with longevity and continuity, in modern business, that's not always a good thing.

In information technology (IT), the omnipresent challenge for many chief technology officers is helping the business remain competitive by overcoming the many difficulties posed by its legacy systems. Securities regulation, too, has legacy issues, as watchdogs grapple with the bending of depression era laws around an industry in the full bloom of innovation.

Therefore it should come as little surprise that legacy issues would ultimately exert their influence on tax policy. And in this context, it's not surprising that cost sharing arrangements (CSAs) between U.S. companies and their foreign affiliates have become sources of concern. Of course, it didn't used to be this way. After all, a transaction echoing arm's length results and occurring between controlled entities within the same tax jurisdiction—the United States—could not result in the wholesale loss of U.S. tax revenue.

But cost sharing arrangements between a domestic parent and a foreign subsidiary might result in significant income (and tax revenue) being migrated offshore, presumably at a lower tax rate. Such migration of tax revenue could come about when the foreign subsidiary bears the R&D risks and the domestic parent does not get an R&D deduction.

Were it that the tax revenue implications of CSAs were incidental, a mere by-product, perhaps concerns regarding compliance may not have reached current levels. But from the perspective of the Internal Revenue Service, it's the degree of *intention* that appears to have stirred real concern. Speaking before the Senate Committee on Finance in June 2006, IRS Commissioner Mark Everson said, "large businesses increasingly engage in sophisticated transactions for both non-tax purposes and tax purposes, resulting in complex relationships with multiple filing requirements. Tax administration continues to be challenged by the increasing number of high-value, sometimes cross-border, mergers, acquisitions and other multifaceted international and domestic tiered transactions."

Thus, like other institutions, we must now confront the legacy of our tax policy in a world gone global. And admittedly, some revisions to the existing regulations governing CSAs may be necessary. However, the current proposal embodied in Proposed Treasury Regulation §1.482-7, particularly as it relates to the intended application of the Investor Model in measuring an arm's length compensation for U.S.-owned intangible assets, may not be the best approach. This is because compensation to the U.S. parent under the proposed application of the investor model is inconsistent with what a third party would be willing to pay for the right to participate in a CSA.

While it may be true that companies entering into a cost sharing arrangement forgo the opportunity to develop and exploit future intangibles on their own, few would claim the right to be compensated fully for giving up the requirement to make future R&D expenditures and, hence, reappoint future profits from those intangibles, especially when the development of those intangibles is funded by another party. Under the proposed regulations, however, all future profits for IP with a legacy would be returned to the original developer U.S. parent, and the foreign CSA participants that funded the research would be restricted to a risk-adjusted routine return based on their weighted average cost of capital, a figure based on an average return to all of an entity's investments.

There are also some very cogent macroeconomic arguments to bolster the contention that the proposed use of the investor model is an inappropriate tool to defend the overall U.S. tax base: the migration of employment, the migration of a national research and development enterprise and the reduced competitiveness of U.S. businesses in increasingly global capital markets are just some of the results which could flow from the proposed changes.

Home court advantage

The proposed revisions to the cost sharing rules provoke one of the central issues of tax policy: is the revision an instrument of social (economic) policy, or simply an instrument to generate revenue? Oftentimes it's difficult to measure social policy success, or success, when achieved, can be controversial.

Yet quite the opposite is true regarding a frame of reference focused solely on raising revenue. The central merit of any particular tax policy or regulation is whether or not it increases or decreases tax revenues with the least possible distortion to economic activity, as designed. With respect to the proposed CSA rules, the basic premise of increasing tax revenue must be challenged. Specifically, will more tax revenue be generated in the long run if the R&D functions of U.S. corporations, particularly on new technological developments, migrate overseas?

That question presumes economically rational behavior on the part of U.S. corporations if they are forced to apply the investor model in their CSAs. Specifically, by stipulating the return foreign subsidiaries can earn in a CSA, and as a consequence shifting income from the resulting intellectual property developed by overseas investment back to the United States, U.S. multinational corporations (MNCs) are strongly encouraged to conduct their research and development in other countries. By doing so, MNCs realize the opportunity to enjoy the benefits of lower tax rates in markets where such rates exist and to pay marginal rates in the U.S. of approximately 35%, only on income generated within U.S. borders. In the long run, U.S. parents may even need to pay royalties to their foreign affiliates for the IP generated by overseas R&D centers.

This contention is not simply armchair speculation. Rigorous academic research has confirmed the positive correlation between tax changes and the level of research and development. In their landmark 2000 study, *"Do R&D Tax Credits Work?"*[1], British economists Bloom, Griffith and Van Reenen study tax changes and R&D investments over a 19 year period in Australia, Canada, France, Germany, Italy, Japan, Spain, the United Kingdom and the United States. The results were unequivocal: "Fiscal provisions matter. The econometric analysis suggests that tax changes significantly affect the level of R&D." The economists estimated that a 10% fall in the cost of R&D stimulates a short-term increase of 1% in total R&D spending and a 10% increase long term.

While a full scale econometric analysis is beyond the scope of this article, a "scenario check" using available facts is not, and what it shows is illuminating. Take, for instance, the U.S. pharmaceutical industry, which makes use of cost sharing arrangements with foreign subsidiaries to develop and distribute products for discrete markets. According to the Pharmaceutical Research and Manufacturers of America (PhRMA), the net R&D investment of its members during 2005 was $39.4 billion, which was part of an industry-wide investment of $51.3 billion.[2] Of the PhRMA members' commitment to R&D in 2004, 79% was spent in the United States.

So what could happen if $5 billion of U.S. pharmaceutical R&D spending, or about 12%, were to migrate overseas? Applying economic multipliers to this figure does not provide a precise answer, but nonetheless offers insight into the magnitude of the loss. The Bureau of Economic Analysis estimates multipliers for output and employment. The output multipliers typically indicate that each $1 in production leaving an area will result in the eventual reduction of around $2 in that area's total output. A $5 billion reduction in U.S. pharmaceutical spending could therefore translate into a $10 billion reduction in total U.S. output. Similarly, a typical relationship between spending reduction and job loss of 20 jobs lost per $1 million in spending reduction would indicate that a $5 billion reduction in U.S. pharmaceutical spending could result in the loss of 100,000 jobs in the U.S. That loss of 100,000 jobs would also correspond to a loss of approximately $5 billion in personal incomes (and therefore the loss of the U.S. personal income tax revenue associated with these earnings).

It's important to note that pharmaceuticals represent just one industry. The energy, electronics, information technology and aerospace industries, to name a few, rely heavily on innovation and have, in aggregate, equally massive research and development budgets.

How likely is this scenario? Given economically rational behavior on the part of American MNCs, it's possible. For surely if U.S. MNCs are forced to pay U.S. marginal tax rates even on income earned in foreign markets, with some of these markets offering low corporate tax rates, it's reasonable to speculate that the American portion of these research and development budgets will atrophy.

Competitiveness issues

As the foregoing scenario check suggests, the tax revenue and economic output losses may be quite substantial under an investor model for CSAs. However, it may also be that tax revenues will not be as large as anticipated either. In the words of commissioner Everson, "LMSB [Large and Mid-Size Business Division] taxpayers are sophisticated, well-capitalized, well-organized, and adept at planning … [with] the resources and willingness to aggressively defend and contest tax positions."

Were it perhaps just a question of revenue, the new regulations, as proposed, might be worth the gamble. That is, perhaps MNCs would relent in the drive to optimize their tax footprint, substantial new revenue would materialize, and the loss of R&D employment with associated benefits would be *de minimis*. Under this scenario, concern about the proposed regulations is little more than distaste for change.

But the case is not that simple. The prospect of revenue gains must be considered in light of competitiveness issues. There are a number of emerging economies with well-educated workforces that have shown their mettle for conducting highly technical research and development. These countries include India, China, Indonesia, Brazil, Russia and Croatia. As the following exhibit indicates, the wage disparities between the United States and these countries, as measured by per capita gross domestic product (GDP), are stark.

Exhibit 1: 2005 per capita GDP—United States vs. selected emerging economies

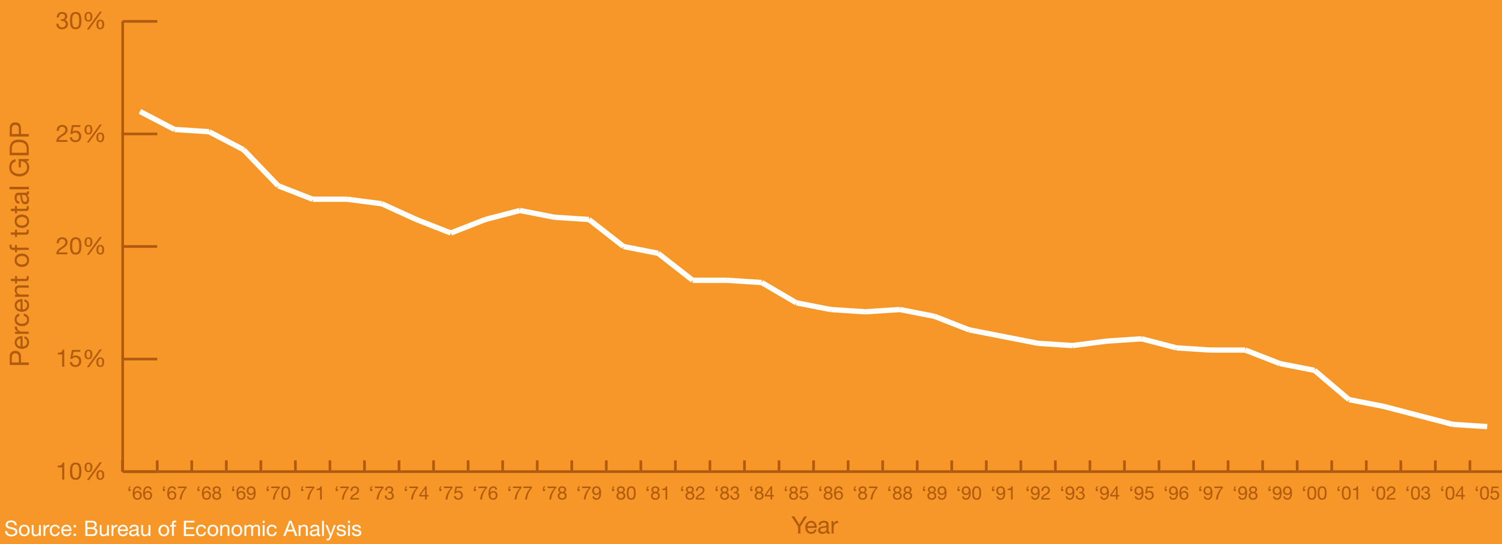
United States	$41,800
Croatia	$11,600
Russia	$11,000
Brazil	$ 8,400
China	$ 6,800
Philippines	$ 5,100
Indonesia	$ 3,600
India	$ 3,300

Source: *Central Intelligence Agency World Fact Book*

Thus the question we must ask is whether we want to provide MNCs tax incentives on top of already compelling salary differentials to move some or all of their research and development offshore. The per capita GDP figures are jarring, but in real life it means that an engineer in India might command a salary of $19,000 a year, versus $25,000 in eastern Europe, versus $75,000 or more in the United States. Support personnel that would cost $3 an hour in the Philippines cost more than $12 per hour in the U.S.

And it's not that the United States hasn't been here before. We witnessed a dramatic decline in manufacturing brought about almost exclusively by wage differentials. Therefore, how quickly might the U.S. research and development enterprise wither under the twin burdens of highly skilled, inexpensive foreign workers and tax incentives to conduct research outside of the United States?

Exhibit 2: U.S. manufacturing as percent of GDP, 1966–2005

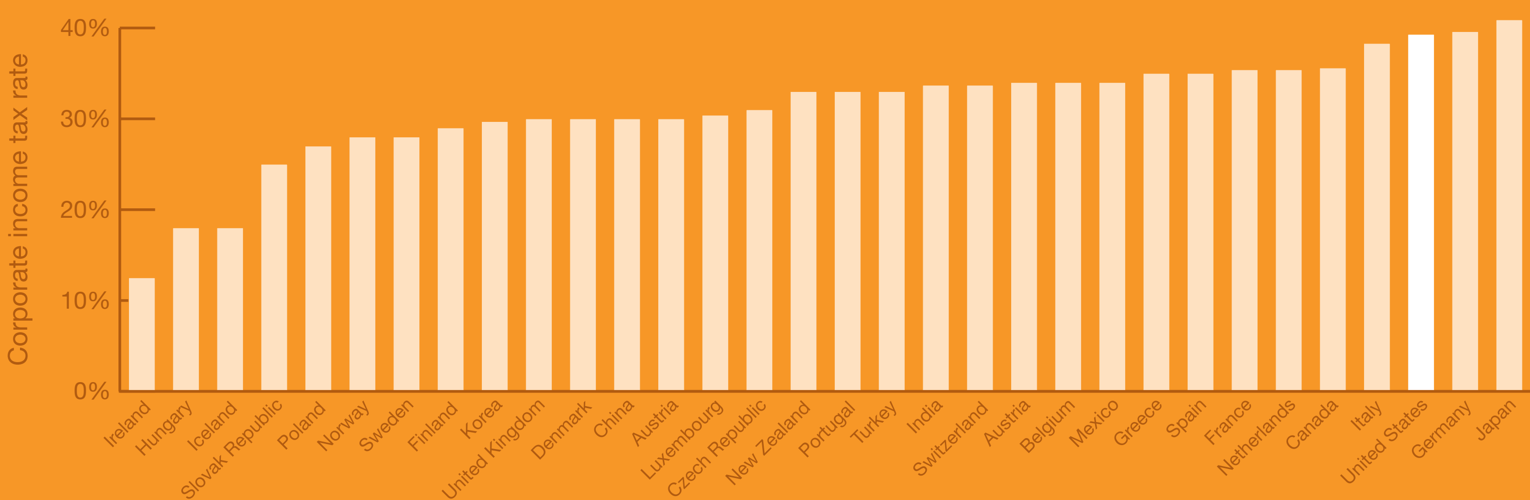


Source: Bureau of Economic Analysis

But the concept of competitiveness is multifaceted. It occurs within industries, and between workforces and countries. But it also occurs in the capital markets. Corporations are competing for the capital of investors. Those which are capable of generating the highest return on invested capital are the ones most likely to be attractive to investors.

Once again, it's important to understand the implications of applying the investor model and the economic consequences which flow from it. Specifically, the stipulation that foreign cost sharing participants are relegated to earning only a risk-adjusted routine return on their investments in CSAs has the effect of shifting income that results from the exploitation of intellectual property developed through cost sharing arrangements back to the United States. Therefore, while both the U.S. parent and the foreign subsidiary make equivalent investments in developing future intangibles, the intangible profit earned by the enterprise in perpetuity belongs solely to the U.S. parent as the owner of historical intangibles that at some point have no economic value. (Parenthetically, it's worth noting the absurdity of such a position by analogy. As Irving H. Plotkin, a Managing Director in PricewaterhouseCoopers' Transfer Pricing practice, pointed out in testimony before the IRS/Treasury Hearing on Proposed Cost-Sharing Regulations on December 16, 2005, were the investor model applied to the aerospace industry, then Boeing would still be making payments to the estate of the Wright Brothers for Boeing's use of basic aviation technology.)

Exhibit 3: Comparative international corporate income tax rates



Sources: Congressional Budget Office, Corporate Income Tax Rates: International Comparisons; PricewaterhouseCoopers.

Under these terms, a rational investor would not enter into a CSA and bear the risk of innovation and new technology creation only to earn an average return on assets. From the perspective of U.S. corporations, future profits will be recognized as taxable income in the U.S. This shifting of income back to the United States has the potential to put American MNCs at a disadvantage to their competitors around the globe because the United States maintains one of the highest corporate income tax rates in the world. All other things being equal, the application of the investor model means that an American corporation will likely deliver a lower after tax return on its R&D investments than almost every one of its foreign competitors will.

With respect to competitiveness in the capital markets, it's important to understand what this really means in the context of truly global markets. It's not as if the emerging companies inside of emerging economies cannot be accessed by institutional investors any longer. Today, investors in Dubai can access companies in Durban as easily as those in Dubuque. Thus, because capital can flow freely, capital will flow freely.

An indecent proposal

To all of the foregoing, a contrarian might reasonably ask, "So what?" The U.S. economy has been through several incarnations, and will continue to evolve. After all, what was once an agrarian economy now derives just 1% of its gross domestic product from agriculture. In the latter half of the 20th century, the United States witnessed the decline of its manufacturing sector as services rose to the fore. And still, despite these changes, gut-wrenching as they may have been for large segments of the workforce, the U.S. economy remains the envy of the world.

While this is true, there is a fundamental difference in shifts that cause changes in the composition of the workforce versus those that change the ways we develop and store intellectual property. The American economy was able to weather, and in fact prosper from, its transition to a service economy precisely because it was able to develop and maintain technological leadership in the industries which constituted its foundations.

Yet the adoption of the proposed IRS rules in an increasingly global economy provides, as noted earlier, strong incentives for the very pearl of American technological leadership—the basic research and development enterprise—to migrate overseas. And what then? The U.S. becomes an economy and a nation based on stewardship. There are any number of nations rich beyond all measure in natural resources that must rely exclusively on foreign technology to develop and exploit those resources. The experience of these nations provides ample evidence that an economy based on stewardship is not in the interest of its businesses or its citizens. And for that reason, the proposed cost sharing regulations, while well-intentioned, may represent an indecent proposal.

Garry Stone is the North American Transfer Pricing Leader, Marios Karayannis is a Partner, and Chris Dunn a Manager in PricewaterhouseCoopers' Transfer Pricing practice.

1 "Do R&D Tax Credits Work? Evidence from a Panel of Countries 1979-1997," Nick Bloom, Rachel Griffith, and John Van Reenen, *Journal of Public Economics*, July 2002.

2 "Industry Profile 2006," Pharmaceutical Research and Manufacturers of America (PhRMA), http://www.phrma.org.

Temporary and proposed Transfer Pricing Service Regulations: A survey of key issues and considerations

by PwC U.S. Transfer Pricing Group

On July 31, 2006, the Treasury Department and the Internal Revenue Service issued temporary and proposed regulations (Temporary Regulations) providing guidance on the treatment of controlled services transactions under Section 482 and the allocation of income with respect to intangibles contributed by a controlled party. The Temporary Regulations also significantly modify the regulations under Section 861 regarding stewardship expenses to be consistent with the changes made to the Section 482 regulations.

The IRS issued the services regulations in temporary form in order to allow for further public input in refining the final rules. The Temporary Regulations are effective for taxable years beginning after December 31, 2006.

Introduction

The Temporary Regulations make several important changes in the rules published in proposed form in September 2003 (2003 Proposed Regulations), including the introduction of a new pricing method, explicit guidance on shared services arrangements, and the mandatory inclusion of stock-based compensation in total services costs. Additionally, certain important changes have been made to sections relating to the relationship between intangible property and services and the definition of stewardship.

Uncertainty remains with respect to several sections of the Temporary Regulations, including which types of transactions are covered and the flexibility available to taxpayers with respect to the application of certain rules. There also appears to be some disparity between the stated aims in the preamble versus the language and examples of the actual Temporary Regulations. The following sections take a closer look at several of the key areas of these new regulations.

Services cost method (SCM)

This new version of the "cost safe harbor" evaluates whether the price for covered services is arm's length by reference to the total costs incurred in providing these services (without a markup). For purposes of the SCM, there are two categories of covered services:

(a) Specified covered services

The Treasury Department and the IRS will specifically identify, in a Revenue Procedure to be published prior to the effective date of the Temporary Regulations, a list of services that will generally qualify for the SCM. The aim of this "good list" approach is to reduce the administrative burden on taxpayers by permitting some classes of services to qualify for cost based reimbursement without the need for an independent comparables analysis.

An initial listing of covered services, along with descriptions, has been issued concurrently with these Temporary Regulations in Announcement 2006-50, and includes (among others) payroll, accounts receivable and payable, general and administrative, public relations, accounting and auditing, tax, staffing, recruiting, and legal services. The IRS is seeking public input on this listing's completeness as well as the contained descriptions and intends to update the list from time to time.

"Uncertainty remains with respect to several sections of the Temporary Regulations, including which types of transactions are covered and the flexibility available to taxpayers with respect to the application of certain rules."

(b) Low margin covered services (LMCSs)

Recognizing that the specific covered services identified via revenue procedure may not encompass the entire universe of low margin services, taxpayers are provided an alternative avenue to demonstrate that other services qualify for the SCM. This can be established via an economic analysis that demonstrates that comparable services are performed by unrelated parties at prices yielding a median markup on total costs that is less than or equal to seven (7) percent.

Applicability

Under Treas. Reg. §1.482-9T(b)(2), specific covered services or LMCSs will qualify for the SCM only if the taxpayer, using its business judgment, reasonably concludes that "the services do not contribute significantly to key competitive advantages, core capabilities, or fundamental chances of success or failure in one or more trades or businesses of the renderer, the recipient, or both." In evaluating whether the taxpayer's business judgment is reasonable, the Commissioner will consider all relevant facts and circumstances. In general, this provision allows cost based remuneration for a broad range of services that are generally low margin for a majority of industry sectors, but also allows the IRS to challenge cost based payments in particular cases where the same type of service may represent a high margin or critical service in the context of a particular business.

Included examples illustrate the impact of this condition. Examples 3 and 4 of Treas. Reg. §1.482-9T(b)(6) contrast cases where recruiting services may be eligible (or ineligible) for the SCM. In the former, the human resources department of one affiliate recruits mid-level employees for itself as well as for affiliated members of a controlled group engaged in manufacturing. In the latter, the human resources department of one affiliate hires highly compensated agents for itself as well as for affiliated members of a controlled group engaged in representing celebrities in the entertainment industry. While the services in both cases are assumed to represent specified covered services under (b)(4)(i), in the latter case the taxpayer cannot reasonably conclude that these services do not contribute significantly to the controlled group's competitive advantages or core capabilities. As such, the services under Example 4 cannot be charged under the SCM.

Procedural requirement

Under Treas. Reg. §1.482-9T(b)(3)(i), the taxpayer must maintain documentation of the covered services costs and their allocation. This must include a statement evidencing the taxpayer's intention to apply the SCM.

Specific exclusions

In keeping with the 2003 Proposed Regulations, Treas. Reg. §1.482-9T(b)(3)(ii) retains the same list of transactions that are considered by the IRS to be high margin services, whereby underlying services costs are not considered representative of an arm's length price and thus ineligible for the SCM. These include (a) manufacturing, (b) production, (c) extraction, exploration or processing of natural resources, (d) construction, (e) reselling, distribution, acting as an agent, acting under a commission arrangement, (f) research, development, or experimentation, (g) engineering or scientific, (h) financial transactions, including guarantees (see below), and (i) insurance or reinsurance services.

Shared Services Arrangements

Treas. Reg. §1.482-9T(b)(5) of the Temporary Regulations provides explicit guidance on the treatment of shared services arrangements. Shared services arrangement rules apply to specified covered services or LMCSs. Such arrangements must include two or more controlled taxpayers (participants) that reasonably anticipate benefit from at least one covered service in the arrangement. In addition, each covered service in an arrangement must confer benefit on at least one participant.

The general concept of the shared service arrangement is similar to Chapter VIII of the OECD Guidelines, which covers cost contribution arrangements (CCAs). Although the OECD rules governing CCAs have broader application than just shared services, there are many parallel concepts and definitions with the Temporary Regulations. Costs are allocated on the basis of each participant's respective share of the reasonably anticipated benefits from the services. Actual realization of anticipated benefit bears no influence on the allocation.

In addition to the general books and record maintenance requirements under the SCM rules, taxpayers should maintain documentation that evidences the intent to apply the SCM for covered services in a shared services arrangement. Documentation should also include (i) a list of the participants and the renderer or renderers; (ii) a description of the basis of allocation to all participants according to reasonably anticipated benefits; and (iii) a description of any aggregation of covered services.

In the event a shared services arrangement participant is also a participant in a cost sharing arrangement, subject to Treas. Reg. §1.482-7 rules, an allocation will first be made pursuant to the shared services arrangement. Further allocations may be made according to the cost sharing arrangement rules.

Intangible property

The Temporary Regulations have amended certain clauses and examples included in the 2003 Proposed Regulations relating to the treatment of "high value" services, the use of the profit split method, and the relationship between economic substance and legal ownership of intangibles, all with a view toward addressing commentators' concerns about the ambiguity raised by such clauses and examples. As noted in greater detail below, the Temporary Regulations express a strong intention on the part of the IRS to respect taxpayer agreements and the characterization given transactions by taxpayers, provided such agreements are followed in practice and are consistent with the substance of the underlying transaction.

Certain amendments included in the Temporary Regulations, however, raise new questions about the scope of this economic substance carve-out that may concern taxpayers. It is not clear whether the IRS may still, in effect, seek to reverse a Westreco-like arrangement for say, R&D services, based on economic substance grounds (even when taxpayers can point to similar uncontrolled arrangements).

Profit split method and "high-value" services

The 2003 Proposed Regulations placed a great deal of emphasis on the use of the profit split method in a controlled services setting. While the IRS and Treasury Department state in the preamble to the Temporary Regulations that they have responded to commentators' concerns about overemphasizing the use of the profit split method, questions remain about the method's applicability and scope despite the amendments made to the Temporary Regulations. Specifically, the changes made to the language describing the application of the profit split method as well as the new Example 2 under Treas. Reg. §1.482-9T(g)(1) leave taxpayers with new questions and uncertainties as to how to address certain controlled service transactions.

The Temporary Regulations have eliminated certain language with a view toward clarifying the instances in which a profit split method analysis is warranted. Specifically, Treas. Reg. §1.482-9T(g)(1) now states that the profit split method is "ordinarily used in controlled services transactions involving a combination of non-routine contributions by multiple controlled taxpayers." References to "high value" and "highly integrated transactions" have been eliminated; however, the preamble emphasizes that "routine" transactions do not necessarily signify transactions with a low value.

“Certain amendments included in the Temporary Regulations, however, raise new questions about the scope of this economic substance carve-out that may concern taxpayers.”

The comments in the preamble as well as the amendments made in the Temporary Regulations suggest that the IRS is clarifying its position that the profit split method is applicable to fact patterns in which multiple parties contribute non-routine services (i.e, services that "cannot be determined by reference to market benchmarks"), rather than simply in cases in which "high value" services are provided.[1] The new Example 2 under Treas. Reg. §1.482-9T(g)(1) presents a fact pattern in which a combination of such non-routine services is provided. Both the language in the preamble and the description of non-routine services in Example 2 (i.e., government contacts, reputation, etc.) suggest that applicability of the profit split method may not necessarily be as narrow under the Temporary Regulations as taxpayers had hoped or as suggested by the IRS in the preamble.

Contractual arrangements and embedded intangibles

The Temporary Regulations have not changed the emphasis on the importance of legal ownership in an analysis of transactions involving intangible property. This issue is particularly critical in situations where intangible property development is bundled or "embedded" in a controlled services transaction. In such situations the economic substance of the transaction must follow the contractual terms. In addition, such economic substance must adhere to the arm's length standard, such that the terms of the contract are consistent with those that would be negotiated in similar circumstances by unrelated parties. In the sections pertaining to the ownership of intangible property, the Temporary Regulations seek to clarify the use of the profit split method in controlled services transactions in situations involving embedded intangibles. Examples 2, 3, 5, and 6 in Treas. Reg. §1.482-4T(f)(4)(ii), which present fact patterns that involve embedded intangibles, have removed references to the use of the profit split method in determining whether such transactions are consistent with the arm's length standard. In addition, such examples cross-reference new examples in Treas. Reg. §1.482-8T that provide additional guidance on the application of the best method rule.

It appears from various provisions and examples that the IRS is likely to continue to argue in many instances that an entity contributing to the development of intangibles by virtue of its special capabilities should be entitled to some share in the income attributable to the developed intangible, either as a high service fee or as part of a contingent payment arrangement.

Stock-based compensation

In response to commentators' questions, the IRS also has clarified their intent that total services costs should include stock-based compensation. (See Treas. Reg. §1.482-9T(j).) The IRS ties this issue into the question of comparability, with examples illustrating how total services costs and operating income of the tested party and comparables should be adjusted to take account of stock-based compensation.

Grant date vs. spread-at-exercise valuation

Unlike the regulations covering cost sharing arrangements, the Temporary Regulations do not explicitly state whether taxpayers are given a choice of using a grant date or the spread-at-exercise valuation methodology for computing stock-based compensation. The examples provided by the IRS seem to indicate a preference for including stock-based compensation in total services costs under a grant date valuation method. By referring in the examples to "fair value," the IRS has ignored the potential use of spread-at-exercise valuation methods. In contrast, the Temporary Regulations also state that "making reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point" in order to calculate total services costs. (See Treas. Reg. §1.482-9T(j).) The IRS seems inclined to use grant date valuation amounts as a result of the availability of such information for publicly traded companies (as opposed to the amounts deducted for U.S. tax return purposes). Nonetheless, the language of the Temporary Regulations leaves this question open for debate.

Comparables adjustments

The Temporary Regulations provide guidance on when it may be appropriate to adjust the financial data of comparables in order to account for stock-based compensation. (See Treas. Reg. §1.482-9T(f)(3) Examples 3–6.) The examples illustrate that, if there is a "material difference in accounting for stock-based compensation, as defined in §1.482-7(d)(2)(i)", and this difference would materially affect the arm's length result, then adjustments to improve comparability should be made in accordance with Treas. Regs. §1.482-1(d)(2) and §1.482-5(c)(2)(iv). Such adjustments could affect the total services costs of the tested party, the comparables, or both.

Some examples refer to years in which stock-based compensation was not included as an expense for financial reporting purposes (i.e. pre-FAS 123R). It is unclear whether this implies a requirement to adjust the cost of services for stock-based compensation in years prior to 2007, or whether instead it is intended merely to establish methods for taxpayers electing to apply the Temporary Regulations on a retroactive basis.

Financial guarantees

The preamble to the Temporary Regulations states that the Treasury Department and the IRS believe that the provision of financial guarantees requires compensation at arm's length and therefore the Temporary Regulations exclude guarantees from eligibility under the SCM. One can infer from this statement that it is the IRS's view that an arm's length profit element should be earned on guarantee transactions. The language in the preamble also suggests that financial transactions, including guarantees, do not necessarily fall under the Temporary Regulations. However, a strict interpretation of the Temporary Regulations' definition of a "Controlled Services Transaction" appears to include financial guarantees and other financial services transactions except for a financial transaction entered into in connection with a global dealing operation, which is specifically excluded pursuant to Prop. Reg. §1.482-9T(m)(6). The Treasury Department and the IRS intend to issue further guidance on the subject along with guidance on the treatment of global dealing operations.

Contractual relationships

In response to comments from practitioners and taxpayers, the IRS attempted to clarify when the Commissioner may impute contractual relationships based on economic substance. The IRS added an example whereby the economic substance of contractual terms between related parties would be respected even though the cost plus remuneration percentage was deemed by the Commissioner to be outside the arm's length range. (See Treas. Reg. §1.482-1T(d)(3)(ii)(C) Example 5.) The IRS, however, indicated that if the cost plus percentage were "significantly outside the arm's length range", the Commissioner may further pursue the possibility of an imputed contractual relationship. The regulations do not provide a basis for determining what qualifies as a significant divergence from the arm's length range. Furthermore, the IRS reiterated its authority to impute contingent-payment contractual terms, in spite of numerous objections from commentators.

The preamble to the regulations concludes this rather confusing discussion with the quite remarkable statement that “whether a particular arrangement entered into by controlled parties has economic substance is not determined by reference to whether it corresponds to arrangements adopted by uncontrolled parties.” While it is not entirely clear whether the IRS intends by this language to persist in asserting its authority to read the arm’s length standard out of the transfer pricing rules when it suits the government’s objectives, it is quite evident that the Temporary Regulations strongly underscore the importance of both adopting and following written agreements covering the provision of services among related entities.

Contingent payments

The IRS has eliminated the requirement that in order for contingent-payment terms to be respected, it must be shown that an uncontrolled taxpayer would have paid a contingent fee in a similar transaction under comparable circumstances. (See Treas. Reg. §1.482-9T(i).) In addition, the IRS has retained language to the effect that contingent-payment arrangements must be consistent with economic substance, while eliminating duplicative or unnecessary references to the economic substance rules. There is a concern that this language may give the IRS too much latitude in imputing contingent payments in situations where unrelated parties would not do so.

Pass-through costs

The Temporary Regulations indicate that, in certain situations, a tested party may be analyzed on a disaggregated basis. As a result, it may be appropriate that the tested party receive a markup only on its internal costs, excluding charges from unrelated parties (“pass-through costs”). (See Treas. Reg. §1.482-9T(l)(5) Examples 20 and 21.) What is less clear is whether third party costs related to high value activities such as R&D or advertising agency fees and media costs can be passed on at cost.

Passive association benefits

Treas. Reg. §1.482-9T(l)(3)(v) discusses instances in which a controlled taxpayer is deemed not to receive a benefit due to its status as a member of a controlled group. Examples 15 – 19 in Treas. Reg. §1.482-9T(l)(5) provide fact patterns describing the threshold between passive association and services that constitute a benefit. Taxpayers should note that performance guarantees, as described in Example 17 of this section, constitute services that result in benefits obtained by the recipient.

Stewardship

The Temporary Regulations also revise the rules relating to computation of U.S. source income, providing a definition of stewardship expenses that cross-references the duplicative activities and shareholder activities outlined in the Temporary Regulations. (See Treas. Reg. §1.861-8T(e)(4)(ii).) The IRS has also revised the definition of “shareholder activities” to potentially include a narrower scope of services, including only such services whose “sole” rather than “primary” effect benefits the shareholder. This is a significant change of dubious economic validity that could impact taxpayers significantly and is likely to attract comment.

Conclusion

Key takeaways from the Temporary Regulations include the following:

- The SCM should reduce the compliance burden for qualifying “covered services.” The provision on the use of business judgment provides added flexibility for the taxpayer and allows the consideration of a wide variety of services under this method.
- There is continued uncertainty regarding the determination of an arm’s length return for “non-routine” services. While the imposition of the profit split has been de-emphasized in certain instances, there still appears to be a broad potential for application of the profit split method. This issue can be mitigated somewhat, however, through carefully developed and adhered to legal contracts and agreements.

"While the imposition of the profit split has been de-emphasized in certain instances, there still appears to be a broad potential for application of the profit split method."

- While the imposition of the profit split has been de-emphasized (at least in the preamble of the Temporary Regulations), the issue of where the provision of high-value services ends and intangible development begins remains.
- In a shared services arrangement, the arm's length charge for covered services will be a portion of the total costs of the services that reasonably reflects the participant's anticipated benefit from the respective services. The costs would require no markup.
- Taxpayers may wish to consider whether to apply the Temporary Regulations on a retroactive basis.
- It is unclear whether taxpayers have a choice in calculating stock-based compensation to be included as total services costs under a grant date or spread-at-exercise valuation.
- There is uncertainty as to whether stock-based compensation granted before the effective date of the Temporary Regulations should be included in total services costs if the taxpayer does not elect to apply these Temporary Regulations retroactively.
- Further scrutiny may be placed on the comparables used by taxpayers for services transactions in light of the possibility of imputed contingent payment for results "significantly" outside the arm's length range.
- Adjustments to total services costs and operating income for comparables to account for stock-based compensation may cause services otherwise requiring a markup under the SCM method to now be considered low margin covered services, therefore requiring no markup. (See Treas. Reg. §1.482-9T(b).)
- There is considerable uncertainty regarding remuneration for financial guarantees, including the value of such remuneration and the correct transfer pricing method to apply.

1 See p. 20 of preamble to Temporary Regulations.

Coping with changing state transfer pricing legislation: An alternative to the intangible holding company structure

by Brett House, Terri Ziacik, and Irving Plotkin

When it comes to auditing and regulating intercompany transactions between related domestic entities, state tax authorities have become increasingly sophisticated. In recent years, several states have enacted legislation disallowing expenses for various intercompany intangible property transactions, including technology royalties, trademarks, trade secrets, and other expenses relating to intangible property. In addition, in many states, management service fees payable to a related party have become disallowed expenses to the extent that they involve any embedded intangible assets or non-routine[1] services where it is difficult to benchmark the market value.

The changing legislative environment requires a transfer pricing approach that provides for appropriate arm's-length compensation for non-routine services while supporting the economic substance of the transaction; for example, simply using a royalty to price these transactions is no longer the optimal solution as this approach is likely to be scrutinized and disallowed. Although most states allow for exceptions to the add-back rule as long as a sufficient business purpose and supporting documentation exist, responding to challenges from state tax authorities can be a costly and time-consuming process. In addition, any state transfer pricing work must carefully conform to the individual requirements of the states in which the taxpayer has operations.

The intangible holding company (IHC) concept has been applied since the 1980s as a means of consolidating all intangible property ownership within a single location. This concept is frequently challenged by states as a structure that lacks economic substance and that is established purely for tax avoidance purposes.[2] Even though companies usually establish IHCs or otherwise centralize the ownership of intangible assets for a variety of reasons—including easier management of the assets—states persist in viewing this approach as a way to move related income to a more tax-advantageous location.

When the intangible assets also include business models, trade secrets, or other know-how used in the day-to-day operations of the company, an alternative to the IHC is to price those intercompany transactions by using a service model that accounts for non-routine contributions by allowing for the sharing of certain profit between entities that perform non-routine services (the profit sharing services model). When compared with the IHC, this approach provides a more analytical method of calculating arm's-length compensation based specifically on the taxpayer's facts and circumstances. However, taxpayers need to be aware of state-specific concerns that they should consider when documenting these transactions.

Determining when to use the profit sharing services model

Generally, non-routine services create some type of unique process or synergy that improves the efficiency of the operating entities and that allows a company to generate residual profit. What constitutes a non-routine service may vary widely among companies, but the common theme is that such services encompass skills and knowledge that are unique to the company and that typically cannot be outsourced to a third party, even to a management consulting company. Examples of non-routine services may include services related to crafting a central business model that is used throughout the company's global operations, to key management personnel, to strategic planning, to logistics, or to developing proprietary software or other intangible property that is particular to the company's operations and not comparable to mainstream products.

“Additionally, royalties may have adverse tax consequences for a corporation: withholding tax at the federal level and add-back provisions at the state level.”

Appropriate compensation for non-routine services has been the core issue of certain court cases and has become one of the key focuses of the Treasury and IRS' Proposed and Temporary Services Regulations (Temporary Regulations). Companies that use an affiliate to render intercompany non-routine services may have difficulty determining the appropriate compensation for these activities because readily available similar uncontrolled transactions to use as benchmarks do not exist.

In 2004, Bankruptcy Court Examiner for the WorldCom case, Dick Thornburgh, called WorldCom's royalty program, which generated over $20 billion in income that was mostly nontaxable at the state level over a four-year period, "highly aggressive and … seriously vulnerable to state challenge."[3] It can be argued that the decline in state corporate income tax revenues is largely due to the use of tax-avoidance strategies in intangible property companies or in passive investment entities. This is evidence as a result of several state court cases investigating such companies.[4]

The IHC structure has been upheld in state tax court when it can be demonstrated that a clear business purpose exists.[5] In some cases, however, the treatment of the IHC differs from one state to the next. The Sherwin Williams case is a good example; in Massachusetts, the structure was found to be legitimate and the royalty payments were deductible, while in New York, the payments were disallowed and the structure was found to have no business purpose.[6] Likewise, in *Syms Corp. v. Commissioner of Revenue*, the Massachusetts court found that Syms' IHC had no legitimate business purpose.

The payment of royalties is one method that companies use to remunerate an affiliate that performs non-routine services such as intangible-generating services where there is no clear market comparable to benchmark the value. However, tax authorities are increasingly examining such royalties, since they are oftentimes very high, and it is difficult to find direct comparables. Additionally, royalties may have adverse tax consequences for a corporation: withholding tax at the federal level and add-back provisions at the state level.

Typically, when companies determine the consideration for a non-routine service provider, one of three situations tends to occur. One situation is that the compensation for the non-routine service provider is the total cost of the service plus an "industry standard" markup of, for example, five percent. However, this consideration may be too low especially when the non-routine service is high-value in nature and there are no market benchmarks. The second situation is when a royalty is put in place for the purpose of capturing a larger share of the profit, but that may be disallowed or questioned if considered by the tax authority to be too high. Or lastly, both situations exist, which may lead to double compensation for the same services if the royalty base is not clearly defined by the analyst or the tax authority or the agreements among the related parties.

An alternative to using these approaches is to compensate the non-routine service provider with a share of the profits earned by the related-party recipient of these services—profits resulting from the non-routine services provided.

The most common transfer pricing method used for benchmarking a return to management services is the comparable profits method (CPM), which uses profit level indicators (PLIs) from uncontrolled public management services companies. Because of the unique nature of non-routine services, public companies that engage in the specific service(s) considered are not likely to exist. Therefore, the intangible value that these non-routine services create cannot be generalized by using comparable public company data to benchmark compensation. Every situation is unique as it pertains to the value that is created for a specific company in a particular industry.

Another method that is used by some taxpayers, especially when these services involve strategic management or key personnel know-how or "foresight," is the royalty approach in which related parties pay a royalty to the parent company for these services. Recently, this practice has come under scrutiny by state tax authorities, most notably in the WorldCom bankruptcy case, where the Bankruptcy Court Examiner found that the royalty program in place for various intangible assets including "management foresight" was without economic substance.[7] As a result, several states pursued legal action against WorldCom and were awarded $315 million in damages.[8]

The Temporary Regulations provide specific guidance for the treatment of intercompany services, and in particular for when the services are non-routine in nature. The Temporary Regulations identify the use of the profit split method (PSM) for testing services where there is no direct market comparable related to the value of the service, such as services that are unique, require special know-how, or cannot be easily outsourced to a third party. The PSM allows for the renderer of the non-routine services to be compensated with a share of the profits earned by the recipient of the services.

Applying the profit sharing services model

The application of the PSM in compensating for non-routine services is achieved in three phases. In the first phase, services are categorized and allocated by the taxpayer into three general areas at the service-providing affiliate or business units: routine, non-routine, or non-allocable (such as shareholder activities), which is based on functional analysis interviews and client-specific information. In some cases, complete cost centers are classified in a single service category, while in other cases, cost centers are divided among multiple categories.

In the second phase, the taxpayer or analyst determines the arm's length charge for the routine activities. Typically, profit margins associated with routine activities are determined by benchmarking third party comparables, or in the case of applying the Services Cost Method[9], the cost of the routine activities without a profit margin can be used. With respect to shareholder activities, in most incidences, the costs associated with these activities cannot be allocated. The charge for the routine activities is then allocated to each affiliate either directly (in the case of the service being performed solely on behalf of a particular entity) or indirectly (in the case of the activities benefiting a group of entities). For activities that benefit a group of entities, the allocation key that should be used is one that provides the best estimate of the anticipated benefits of the activities, for example, sales or units sold.

In the third phase, the taxpayer or analyst calculates the residual profit and determines the allocation of this residual profit to the entities that contribute to it (the non-routine contributors) based on the value of their relative contribution. The residual profit is the operating profit that remains after accounting for the routine contributions from the entity (or group of entities) that benefit[10] from the non-routine services. Allocating the residual profit is case specific and is determined by estimating the value of the non-routine service in generating the residual profit. For instance, in many cases, non-routine contributions may be contributions of intangible property. In the case of intangible property, one alternative for estimating the value of the non-routine service may be the capitalized development cost and all related improvements, less an appropriate amount of amortization (based on the useful life of the intangible).

The Temporary Regulations introduce new methods for capturing the arm's-length value of intercompany services and give guidance regarding the ownership of intangibles. The proposed rules also place renewed focus on the contractual terms surrounding particular controlled transactions and revisit the concept of economic substance.

“The proposed rules also place a renewed focus on the contractual terms surrounding particular controlled transactions and revisit the concept of economic substance.”

The Temporary Regulations clarify the existing regulations by emphasizing that residual profits be divided between participants based on the relative value of each taxpayer's "non-routine contributions," which may include contributions of intangible property. Non-routine contributions are defined as contributions that cannot be fully accounted for by reference to market returns or that are so interrelated with other transactions that they cannot be reliably evaluated on a separate basis. Certain examples in the Temporary Regulations imply that non-routine contributions may include unique services or business opportunities, as well as traditional intangibles.

Under the Temporary Regulations, the application of the profit split method in the case of non-routine services is consistent with the U.S. government's perception that many services performed in the U.S. on behalf of multinational groups have not resulted in appropriate arm's-length reimbursement.

Understanding state legislative developments related to transfer pricing

Many states that do not require combined filing for state income tax purposes have modified legislation to include requirements that taxpayers add back certain expenses or deductions (add-backs) related to intangible property transactions.[11] In general, these add-back provisions are directly limited to royalty expenses, but Kentucky also includes intercompany management fees in its add-back legislation. While other states may not explicitly include management fees, states with add-back provisions have begun to examine these payments to the extent that they relate to services involving any intangible property.

On June 16, 2006, the Massachusetts Department of Revenue adopted a regulation that includes expenses related to any "embedded royalty" among items subject to add-back. The add-back is the "portion of a cost or expense paid, accrued, or incurred by a taxpayer for property received from or services rendered by a related member that relates to intangible property owned by such related member or to an intangible expense paid, accrued or incurred by said related member in a direct or indirect transaction with one or more other related members."[12] The Massachusetts regulation provides for exceptions similar to other add-back regulations, but the use of the embedded royalty concept opens more transactions to scrutiny by the tax authorities.

In addition to add-back provisions, some states are taking actions that result in attributing additional income to the taxpayer from operations in other states. In cases where a significant amount of intercompany transactions exists, some states have required the taxpayer to combine its business in one state with its business in another. For example, in *Sherwin-Williams v. Tax Appeals Tribunal of the Department of Taxation and Finance* (New York, October 2004), the court found that the taxpayer must file its tax return on a combined basis with its Delaware IHCs. Similarly, recent actions in North Carolina, New Jersey, and Louisiana have begun to subject out-of-state IHCs deriving all income from use of intangible property to state income tax even if they have no physical presence in that state.[13]

The key advantages of using a profit sharing services model for domestic transfer pricing instead of an IHC structure are as follows:

- There is clear economic substance in all entities involved in the transaction, which may prevent disallowance of the expense deduction.
- Compensation is a payment for services rather than a royalty, which should prevent disallowance for royalty payments.[14]
- The high-value service provider does not receive compensation purely from the use of intangible property, which should prevent states from attributing nexus to the entity if there is no physical presence in the state.

“The identification of a company’s routine and non-routine activities is important in most types of organizational structures including centralized and decentralized intangible structures.”

Economic transparency of intercompany services

Given the recent court cases and enacted state legislation relating to intercompany transactions that oftentimes involve intangible-generating activities, taxpayers should carefully consider the exercise of explicitly determining the costs related to their routine and non-routine activities. The identification of a company's routine and non-routine activities is important in most types of organizational structures including centralized and decentralized intangible structures. Not only can this identification help a company in determining the economic value of the non-routine activities for the business, it can help a company to provide the first step toward building an economically more transparent and defensible model for the compensation of intercompany services.

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1 "Do R&D Tax Credits Work? Evidence from a Panel of Countries 1979-1997," Nick Bloom, Rachel Griffith, and John Van Reenen, *Journal of Public Economics*, July 2002.

2 Christopher Desmond and Westly Cornwell, "The Intangible Holding Company: How to Better Manage Property and Reduce Corporate Tax Liability," *State Tax Notes*, February 2, 2004, pp. 393-394.

3 Kirkpatrick & Lockhart LLP, *Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner*, January 26, 2004, p. 11.

4 Glen R. Simpson, "Diminishing Returns: A Tax Maneuver in Delaware Puts Squeeze on States," *Wall Street Journal*, August 9, 2002, A1. Discusses the effect that trademark holding companies are having on state tax revenues, noting a number of large companies that are involved in state tax proceedings on their trademark holding companies—Limited Brands, Toys "R" Us, ConAgra Foods, Home Depot, Kmart, Gap, Sherwin-Williams, Circuit City, Stanley Works, Staples, and Burger King.

5 See, for example, *Sherwin-Williams Co. v. Commissioner of Revenue* (Massachusetts) and *Cambridge Brands, Inc. v. Commissioner of Revenue.* In *Sherwin-Williams* (Massachusetts), the judge held that the transfer of intellectual property from the parent to its subsidiary and subsequent royalty payments did constitute a legitimate transaction for tax purposes and that the royalty payments were reasonable ordinary business expenses. Likewise, in *Cambridge Brands*, the Board of Appeals found that the creation of the intangible holding company had economic substance and associated royalty payments did not exceed fair market value and qualified as a deductible business expense.

6 *In the Matter of Sherwin-Williams Company, Petitioner v. Tax Appeals Tribunal of the Department of Taxation and Finance of the State of New York et al., Respondents*, Supreme Court, Appellate Division, Third Department, New York (October 28, 2004).

7 Kirkpatrick & Lockhart LLP.

8 Barney Tumey et. al., "MCI Transfer Pricing Royalty Case Resolved; States to Receive $315 Million in Settlement," *BNA Transfer Pricing Report*, 14(2), October 12, 2005, pp. 470-471.

9 Referenced in the Temporary Services Regulations for circumstances where the median profit margin of the benchmarked comparables is less than or equal to seven percent.

10 The beneficial entities in this case are those entities that generate revenue through selling products or services to third parties.

11 Karen Nakamura, "Intercompany Expense Addbacks: The States Tinker with a Tax Base," *State and Local Tax Trends Affecting Businesses in 2006: Looking Back, Looking Ahead*, PricewaterhouseCoopers, 2006, pp. 32-39.

12 Mass. Dept. of Rev., Reg. 830 CMR 63.31.1, June 16, 2006, obtained from http://www.dor.state.ma.us/rul_reg/reg/830_CMR_63_31_1.htm

13 Nakamura.

14 A state may still disallow all or part of the payment to the extent it relates to embedded intangibles. This must be considered on a state-by-state basis as there is not yet a strong history of judicial precedent.

Mexican transfer pricing dispute resolutions: A case study

by Fred Barrett and Claudia Margarita Lopez

Background

Transfer pricing rules were introduced into Mexican Income Tax Law in December 1996 in order to be consistent with the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). Moreover, in 2002, the Mexican income tax law was modified to state explicitly that the OECD Guidelines apply for the purpose of interpreting the law.[1]

The arm's length principle applies to transactions between related parties,[2] and Mexican income tax law requires the contemporaneous documentation of intercompany transactions.[3] Under Mexican law, companies with less than $1,182,000 in revenues are not required to prepare contemporaneous documentation.[4]

Mexican transfer pricing regulations specifically recognize the traditional transactional methods and the OECD Guidelines' profit based transactional methods.

According to the 2006 Mexican income tax law (the law), the taxpayer should apply the transfer pricing methodology and consider the Comparable Uncontrolled Price (CUP) method as the first option. If the CUP method is not applicable, the taxpayer should then be able to demonstrate that the CUP method does not apply and that the applied method produces more accurate results than any other method. The law considers the traditional transactional methods to be more appropriate than the profit based methods. As previously mentioned, OECD Guidelines are applicable if and only if they are consistent with any of the dispositions stated in the law or in the international tax treaties to which Mexico subscribes. According to the law and to the OECD Guidelines, the taxpayer should select a transfer pricing methodology based on a comparability analysis. This determination should be supported with the functional, risk, contractual, and asset analyses of the transaction being studied.

There are special transfer pricing options for the maquiladora industry[5] that include the calculation of safe harbors based on the level of profits as a proportion of total operating costs and expenses and of the value of assets.[6] In addition, there are a number of other specific advantages, including tax and customs benefits for this sector.

Mexican taxpayers have four main transfer pricing related obligations:

1. To determine income and deductions on an arm's length basis.
2. To maintain at the tax domicile of the taxpayer the annual contemporaneous documentation[7] that demonstrates the arm's length nature of all intercompany transactions (domestic or foreign).
3. To file an information return for all intercompany transactions with related parties abroad.[8]
4. To instruct an independent accountant to file a tax audit report (*Dictamen Fiscal*) regarding compliance with transfer pricing (and all other tax) obligations in the *Dictamen Fiscal*.[9] This document also contains the audited financial statements.

"Mexican transfer pricing regulations specifically recognize the traditional transactional methods and the OECD Guidelines' profit based transactional methods and establish a 'best method' rule."

Failure to comply with the arm's length principle, documentation and/or filing of the information return typically results in fines and/or disallowance of the deduction of payments made to non-resident related parties.

In the reminder of this article we provide a simplified example of a hypothetical taxpayer facing a transfer pricing audit, and provide for the reader an appreciation of real issues faced and procedural aspects in resolving disputes.

Case study: Possible scenarios for a Mexican transfer pricing audit

Consider the following example:

The headquarters of a multinational group are outside of Mexico and global manufacturing operations are being re-aligned and streamlined in strategic locations. Consequently, manufacturing operations for the Mexican market were moved out of Mexico in 2005. In addition, drastic marketing efforts are under way to re-establish market positioning in Mexico eroded by tough competition over the past 10 years, and by negative publicity due to the loss of manufacturing job positions in Mexico.

The facts in this case study point to actual situations where manufacturing operations are being outsourced to other developing countries. However, Mexico is also experiencing a trend to receive significant manufacturing operations transferred from the U.S.

Our case study involves a full fledged manufacturer with residence outside of Mexico (Company X) which is now selling finished goods to a related party Mexican distributor (Company Y) for distribution in the Mexican market. The amount of Company Y sales was $2,688,000 for 2006, which is the year under analysis.

In order to evaluate whether the related transactions carried out by the Mexican distributor comply with the arm's length principle, Company Y selected a transactional net margin method as a transfer pricing methodology, with a Return on Sales (ROS) as a profit level indicator. The ROS obtained by Company Y during the year under analysis was –3.2 percent.

During 2006 Company Y is operating as a full-risk distributor and due to its new functions, the company invested approximately USD $200,000 in its market expansion strategy.

During the market expansion strategy (2006 and 2007), Company Y incurred a net loss which is justified given the fact that Company Y expects to improve its position in the Mexican market and increase its profits in the future.

A company seeking to expand its market share might temporarily incur higher costs (e.g., additional marketing efforts) and therefore achieve lower profit levels than other companies operating in the same market.[10] Intensive marketing and advertising efforts often accompany a market penetration or expansion strategy.

It is important to determine whether there is a plausible expectation that executing a market penetration strategy will produce a return sufficient to justify its costs within a period of time that would be acceptable in an arm's length arrangement.[11] In the case study, multiple year projections clearly demonstrated a plausible increased return to justify these expenses, although the tax authorities were not impressed with the details behind the projections.

Exhibit 1 shows the financial statements of Company Y for fiscal years 2002–2005. The data shows a very slow increment (4%) in net sales with a steady rate of return on manufacturing sales equal to 12%. Nevertheless, Exhibit 1 shows that there were significant profits attributed to the manufacturing activity which were no longer present in Mexico beginning in 2006, as shown in Exhibit 2.

Exhibit 1: Return on sales (ROS) of Company Y (Full fledged manufacturer), 2002-2005 with annual net sales increase of 4%

			2002	Gross/ROS	2003	Gross/ROS	2004	Gross/ROS	2005	Gross/ROS
	Income statement									
(1)		Net sales	1,830		1,906		1,985		2,068	
(2)		Cost of sales	1,424		1,484		1,546		1,610	
(3)	=(1)−(2)	Gross income	405	22%	422	22%	440	22%	458	22%
(4)		Operating expenses	195		203		211		220	
(5)	=(3)−(4)	Operating income	211	12%	219	12%	228	12%	238	12%

Critical assumption is that there are no cost efficiencies with volume increases. Also, an ROS profit level indicator is used to provide more comparability to operations before and after reorganization, even though other profit level indicators might be more appropriate for manufacturing operations.

Beginning in 2006, Company Y ceased manufacturing operations and began to implement its market expansion strategy. The company estimates that with this strategy Company Y will be able to grow at an annual rate of 30 percent during 2007, 2008 and 2009, maintaining a constant return (equal to 6 percent) in Company Y as of 2008, as shown in Exhibit 2:

Exhibit 2: Return on sales (ROS) of Company Y (full distributor), 2006-2009 with annual net sales increase of 30%

			2006	Gross/ROS	2007[E]	Gross/ROS	2008[E]	Gross/ROS	2009[E]	Gross/ROS
	Income statement									
(1)		Net sales	2,688		3,495		4,543		5,906	
(2)		Cost of sales	2,254		2,930		3,809		4,952	
(3)	=(1)−(2)	Gross income	434	16%	565	16%	734	16%	954	16%
(4)		Operating expenses	321		389		447		581	
(5)		Market expansion strategy	200		200					
(6)	=(3)−(4)−(5)	Operating income	87	−3.2%	24	−0.7%	2878	6%	3738	6%

[E] *Estimate*

"Tax authorities do not easily accept multiple year analyses, even when applied to a market penetration strategy."

Transfer pricing implications

Company X can be classified as a "full-fledged" distributor beginning in 2006. Company X is the owner of all of the manufacturing intangibles, assumes the product related risks, and assumes complete manufacturing functions at all stages of the product line cycle. Company Y is a "distributor with full risks" in Mexico as concerns

- currency exchange losses (since it purchases in U.S. dollars and sells in Mexican pesos),
- product damage/loss after it becomes the owner,
- credit risks,
- marketing burdens and risks, and
- financing of the development of marketing intangibles in Mexico over many years.

This characterization is necessary in order to perform the transfer pricing analysis, i.e., to choose the entity to be studied and to find the set of comparable uncontrolled companies under the Transactional Net Margin Method.[12]

Given this characterization, Company Y is chosen as the entity to be studied (tested party) and a sample of distributors with risks under similar circumstances is performed. Exhibit 3 illustrates the unadjusted results.

Exhibit 3: Adjusted ROS: Company Y and sample of uncontrolled distributors

	Unadjusted ROS
Upper quartile	7.0%
Median	3.9%
Lower quartile	3.7%
Max	13.5%
Min	2.7%
Company Y	–3.2%

In arriving at the aforementioned sample documented by Company Y, we are assuming there were no samples engaging conclusively in special market penetration strategies. Therefore, certain adjustments were required to enhance comparability. The adjusted ROS of uncontrolled distributors showed that the –3.2 percent return was within the range of comparable independent companies after making the market expansion adjustment. Since Company Y is a complex distributor, it bears all risks regarding the market expansion strategy and absorbs full risks and responsibility for the market. Company Y has full documentation and projections regarding its business strategy and the reasonableness to believe its market share will increase in the future as an integral part of the transfer pricing documentation, although the tax authorities have rejected these positions.

An example of dispute resolution in Mexico[13]

Mexico has relatively little experience in transfer pricing audits. Mexico's tax authorities have concentrated their tax efforts in the maquiladora industry, with special focus on the automotive industry; however, in the past year, they have focused on corporate restructurings, frequently involving debt obligations, or migration of business activities and assets as part of global business restructurings. Consequently, many taxpayers will need to become familiar with potential audit dispute events in Mexico.

The following is a possible chronology of audit dispute events:

- Audit examination commences with formal notification of a summons to the Registered Public Accountant (RPA) who signed the *Dictamen Fiscal* of the taxpayer under examination.
- If the tax authorities need more information than can be provided by the RPA, they will request the necessary information or documentation directly from the taxpayer though a formal request of information. (This is technically the initiation of the actual audit process).
- If the tax authorities consider the information provided by the taxpayer insufficient to determine the tax situation of the company, they will initiate an on-site examination.
- During the on-site examination, the tax authorities issue partial written records throughout the audit process, observing tentative conclusions and requesting more evidence.

- Taxpayer formally responds to the partial written records and provides information to support the response.
- Tax authorities issue the last partial written record (*Ultima Acta Parcial*).
- Taxpayer formally responds to the last partial written record.
- Tax authorities issue the "Final Record" (*Acta Final*).
- Tax authorities issue the "Tax Assessment" (*Liquidación*).
- Taxpayer may file an Administrative Appeal for Reversal of the Liquidación within Hacienda (*Recurso de Revocación*)
- Tax authority formally concludes the administrative appeal.
- Taxpayer may file a Lawsuit with the tax court (*Tribunal Federal de Justicia Fiscal y Administrativa*) named a "Nullity Petition" (*Juicio de Nulidad*).
- Taxpayer or tax authority may appeal the tax court decision to the Appeals and Constitutional Court (*Tribunal Colegiado de Circuito*).
- Taxpayer or tax authority may appeal the tax court decision to the Supreme Court (*Suprema Corte de Justicia de la Nación*).
- Taxpayer may request involvement of the competent authority (mutual agreement procedure—MAP) at any point in the proceedings.

In our hypothetical case, the transfer of manufacturing operations abroad has drawn the attention of the Mexican tax authorities due to the loss of manufacturing profits in Mexico. On January 1st, 2007, Company Y received an on-site examination request signed by the Mexican Tax Authorities to initiate an audit procedure regarding the transfer pricing obligations for fiscal year 2006.[14] During the on-site examination the taxpayer must generally: i) allow tax authorities full access to the company's operations; ii) make available all accounting information (paper and electronic); and iii) deliver the transfer pricing documentation, the transfer pricing information return and any other information related to compliance (upon request).[15]

The regular statute of limitations is five years from the income tax return submission date. However, a formal audit suspends the statute of limitations. In the event of a transfer pricing audit, Mexican law requires the audit inspection to be concluded within two years.

It is recommended that Company Y obtain multi-task assistance, including legal, tax and transfer pricing counseling, from the beginning of the examination. Accurate and complete information may save time and money and provide more options.

Suppose that in our case, Company Y is asked to provide all related information regarding its distribution activities in Mexico. After the audit process, Company Y received the last partial written record.[16] According to this statement, the purchase of finished goods from related parties abroad for its distribution in Mexico did not meet the arm's length principle. Tax authorities maintain that Company Y should not absorb all market expansion expenses. The authorities claim that the taxpayer is a limited distributor, and other aspects of the reorganization are being reviewed in 2005 notwithstanding the fact that the 2006 audit inspection is currently being finalized.

Company Y underestimated the level of sophistication of the transfer pricing authorities and did not take the audit very seriously. As a result, the company neither developed a comprehensive defense nor presented all relevant information in order to formally refute the alleged facts stated by the tax authorities in the last partial written record.[17]

“Accurate and complete information may save time and money and provide more options.”

“Fines range from 75 percent to 100 percent of total tax omissions and from 30 percent to 40 percent of incorrectly stated tax losses, if those losses were used to reduce part or all of the taxable profits in future years.”

Finally, after issuing the final record (say December 31, 2008), the tax authority has a maximum of six months (June 30, 2009)[18] to issue the tax assessment *(Liquidación).* The *Liquidación* includes the calculation of the transfer pricing adjustment, tax omissions, fines, surcharges and inflation adjustment. Fines range from 75 percent to 100 percent of total tax omissions and from 30 percent to 40 percent of incorrectly stated tax losses, if those losses were used to reduce part or all of the taxable profits in future years. In the case of transfer pricing adjustments, fines may be reduced by 50 percent if the taxpayer adequately documents transfer prices on a contemporaneous basis.[19] The surcharge rate is published on an annual basis and represents an interest charge. The inflation adjustment is calculated from the month the taxes should have been paid until the date payment is received.[20]

Exhibit 4: Transfer pricing adjustment, penalties, surcharges and inflation adjustment for Company Y

			2006	ROS
	Income statement			
(1)		Net sales	2,688	
(2)		Transfer pricing adjustment	192	
(3)		Cost of sales	2,254	
(4)	=(1)+(2)−(3)	Gross income	628	
(5)		Operating expenses	321	
(6)		Market expansion strategy	200	
(7)	=(4)−(5)−(6)	Operating income	105	3.9%
(8)		Tax omission (Tax rate† Tax omission) (29† 105)	30.45	
(9)		Penalties (75%† 30.45† 50%)	11.42	
(10)		Surcharges†	1.22	
(11)		Inflation adjustment†	1.22	
(12)	=(8)+(9)+(10)+(11)	Tax assessment	44.30	

†The calculation assumes a 75 percent penalty rate applied to the tax omission, reduced by 50 percent since the documentation was timely and adequately documented. In addition, the calculation assumes a penalty and surcharge and inflation adjustment of 4 percent.

Note that according to the law, if the profitability obtained by a taxpayer is below the range, the transfer pricing adjustment will be calculated considering the median of the comparable set.

After receiving the tax assessment the taxpayer has three alternatives of defense: (i) File a Competent Authority procedure;[21] (ii) Administrative Appeal for Reversal before the tax administration *(Recurso de Revocación)*; and, (iii) file a law suit formally called *"Nullity Petition"* with the Tax Court *(Tribunal Federal de Justicia Fiscal y Administrativa).*

i) During the Competent Authority procedure, the taxpayer has a maximum of four and a half years starting from the date the income tax return was filed for the applicable year[22] in order to file the request for a mutual agreement procedure. In general, this procedure consists of a request by the affected foreign taxpayer that the foreign tax authority review and possibly accept the adjustment proposed by the Mexican tax authority. At some point the tax authorities try to arrive at a negotiated adjustment.

Should the taxpayer decide to initiate its defense with the Competent Authority, the time requirement to file the other two alternatives of defense mentioned below is suspended[23] for the duration of the competent authority review.

If the Competent Authority rules against the taxpayer, the taxpayer will be permitted to apply any of the two remaining options.

However, it is important to point out that if the taxpayer appeals to its local tax authorities or the court system before pursuing the competent authority procedure, the taxpayer may lose the right to initiate the Competent Authority procedure because the four year time limit is not suspended while the taxpayer pursues local defense alternatives.

ii) The Administrative Appeal for Reversal before the tax administration can be applied before filing the Nullity Petition. The taxpayer has 45 business days to file for this appeal before the Mexican Tax Authorities, starting from the date the authority issues the tax assessment (*liquidación*).[24]

In this phase, the taxpayer attempts to establish the technical basis for not making an adjustment or develops a case to establish that the assessment does not apply due to the improper application of procedures.

If this administrative appeal option is chosen, the taxpayer gains additional time to negotiate a settlement and delays the time required to deposit or guarantee the applicable tax assessment for an additional five months. However, the filing of an administrative appeal does not suspend the time limit for competent authority review.

iii) In the third case, the law suit in the tax court formally called "Nullity Petition", the taxpayer has 45 business days from the date the authority issues the tax assessment (*liquidación*), in order to appeal before the tax court. This period is postponed if the taxpayer files an administrative appeal for reversal to the tax administration (*Recurso de Revocación*) by the same date as stated earlier. In this case the 45-day period begins after the administrative appeal if finally concluded. Also, as mentioned, the competent authority option also potentially extends the time period for filing the nullity petition with the tax court.

“Poor documentation will normally lead to time-consuming and costly explanations to tax authorities and the shifting of the burden of proof to the taxpayer.”

In this phase, the taxpayer attempts to establish the technical basis for not making an adjustment or develops a case to establish that the assessment does not apply due to the improper application of procedures.

The taxpayer or the tax authority may appeal the tax court decision in the Appeals and Constitutional court (*Tribunal Colegiado de Circuito*). In addition, the taxpayer can also litigate constitutional issues in this court. In general, constitutional issues in the case of tax disputes usually involve the violation of constitutional rights as concerns the determination of the tax.

It should be noted that the taxpayer or the tax authority may appeal the Appeals and Constitutional Court decision to the Supreme Court although in this instance the Supreme Court will only evaluate constitutional issues.

Finally, the aforementioned litigation alternatives do not suspend the time limit for competent authority review.

Conclusions

Restructurings will be targeted, methods and methodology will be scrutinized, and multiple year analysis will probably result in a battle.

In our example we are assuming that tax authorities do not accept the full risk distribution characterization of Company Y. In practice, tax audits tend to question and review in a very detailed way the functional, risk and asset analysis of the entity under study in order to determine whether the characterization of the entities involved in the intercompany transaction is correct. This will be used as the basis for the tax authority to accept or reject the transfer pricing methodology, the profit level indicator and the set of comparable companies. The law and related procedures are not clear with regard to special business circumstances, including market penetration strategies. In addition, there are a number of other areas in which clear guidance does not exist; therefore, solid economic analyses are essential. This is particularly important in light of Mexico's penalty system.

Especially complex transactions or business structures will draw the attention of the tax authorities, with particular scrutiny placed on intangibles, non-routine profits, or creation of value added in the distribution channel or in know-how transfers.

Regarding the set of comparable companies, the tax authorities will review properties such as the relative structure of total operating costs and expenses with respect to the sample of comparable independent companies, intangible property, business risks, service provision, outflows of capital; and financial operations, among many others. In addition, the review of internal comparables will be certain in audit processes.

As mentioned before, transfer pricing audits have become more important in the past few years. As a consequence, competition for the provision of transfer pricing services has increased significantly. However, there are special considerations a company must take into account in selecting a transfer pricing advisor, such as professional experience in transfer pricing defense, professional relationships with the tax authorities, a multitask team and a global network in order to obtain a favorable decision during an audit procedure or litigation. It is important to mention that correct and timely documentation could save money and time. Poor documentation will normally lead to time-consuming and costly explanations to tax authorities and the shifting of the burden of proof to the taxpayer.

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1 Article 215, last paragraph, Mexican Income Tax Law.

2 Article 215, first paragraph, Mexican Income Tax Law.

3 Article 86, paragraph XV, Mexican Income Tax Law.

4 Article 86, paragraph XII, Mexican Income Tax Law.

5 Maquiladoras are typically Mexican companies that assemble or manufacture on a contract basis for a foreign related party principal using temporarily imported raw materials and components, machinery and equipment under the consignment regime.

6 Article 216-BIS, Mexican Income Tax Law.

7 Usually, Transfer Pricing Documentation is considered contemporaneous if it exists or is created at the time arrangements that may give rise to transfer pricing issues are entered into or at the time of preparation of income tax returns which record information relevant to transfer pricing decisions, but it is generally interpreted that the documentation must be obtained by the due date of the tax return (generally March 31).

8 This document is required to be filed at March 31 of each year except as otherwise stated by the "Resolución Miscelánea" published annually. The data required in the Information Return includes: i) the name of the entities involved in the intercompany transactions; ii) ID of the entities involved; iii) The countries of residence of each entity; iv) The amount of the transactions; v) Operating margin (gross/net) if applicable; vi) The transfer pricing methods used in order to establish the transfer price.

9 Large taxpayers (among others) are required to file a "Dictamen Fiscal". Large taxpayers are separate entities with previous year taxable income of USD$2,452,420 and controlled groups of entities with previous year taxable income of USD$4,904,840. The Dictamen is generally due in May or June after the year end. The accountant will note an exception in the report if a reasonable transfer pricing study is not received and reviewed by this date.

10 OECD Guidelines , Chapter 1, paragraph 1.32.

11 OECD Guidelines, Chapter 1, paragraph 1.35.

12 For purposes of this case study we are assuming that there are no internal or external Comparable Uncontrolled Transactions. In the example, we are also assuming that the best method for the transfer pricing analysis is the Transactional Net Margin Method (TNMM).

13 This section is based on the International Tax Treaties Signed by Mexico; Federal Tax Code; Mexican Income Tax Law; and Federal Law of Administrative Appeals in force.

14 Article 42, Federal Tax Code.

15 Article 86, paragraph XII and XIII, Mexican Income Tax Law.

16 During the audit procedure the taxpayer may receive as many partial written records as tax authorities consider appropriate. Article 46, Federal Tax Code.

17 According to Article 46 of the Federal Tax Code, paragraph IV, the taxpayer has an initial period of two months in order to refute the facts stated by the tax authorities. This period could be extended for only one time to a maximum of one additional month.

18 Article 50, Federal Tax Code.

19 Article 76, Federal Tax Code. Additional fines apply if the taxpayer does not meet the requirement to present the Information Return regarding transactions with foreign related parties. These fines range from U.S.$3,774 to USD$7,548. Fines may be increased or reduced under very specific circumstances. Articles 81, Paragraph XVII and 82, Paragraph XVII Federal Tax Code.

20 Article 21, Federal Tax Code.

21 The international Tax Treaties subscribed by Mexico have specific requirements in order to apply them.

22 Article 25, Model Tax Convention.

23 Article 121, Federal Tax Code and Article 13, Ley Federal de Procedimiento Contencioso Administrativo.

24 Article 121, Federal Tax Code.

Transfer Pricing for financial institutions: The new frontier for applying Profit Split Methods

by Lucia Fedina, Stan Hales and Adam M. Katz

In the current global tax environment, the pricing of transactions between related parties under common control, also named intercompany transfer pricing, is a top, if not the top, concern of executive management at multinational companies.[1] As a result, tax authorities are increasing the domestic revenue base by more rigorously enforcing existing transfer pricing rules and interpreting those rules in a manner that often focuses on the operating revenue or profit earned by multinational companies.

In some cases, tax authorities recalculate the profit earned by each affiliate of a multinational as a percentage of the combined cross-border operating profit, and compare this percentage against certain "arm's length" benchmarks. This approach is known as the Profit Split Method, or PSM. Tax authorities often believe that the PSM approach will produce better results than approaches based on either a share of revenues (i.e., a fee split or revenue split) that may not cover costs, or a costs plus a markup method, which may under-remunerate higher value services.

In the past, the PSM used to be out in the frontier of complex and costly advance pricing agreements with tax authorities and employed mainly for global dealing operations of money center banking institutions operating in branch form. Tax authorities are gradually pushing the PSM into the mainstream. Although the implementation of the PSM as a company's transfer pricing policy may seem difficult, the financial consequences from a tax audit may be of far greater cost if the results under an existing transfer pricing method, versus those under a PSM imposed by a tax authority, differ significantly. It is prudent from a tax risk perspective that a company's transfer pricing policies produce a result that is consistent with methodologies used to test the arm's-length nature of transactions between affiliates. For some companies, such as multinational integrated financial services businesses, market comparables often do not exist, which leaves the PSM as the most likely method to test whether controlled transactions are arm's length.

From a practical perspective, multinational companies may reduce transfer pricing risk and the size of potential adjustments to operating income by a tax authority through consideration of the PSM as either the primary method for certain non-routine integrated services transactions or as a secondary confirming method that produces reasonably similar results to a revenue split or cost plus return.

When is a PSM appropriate?

Due to increasing globalization in the financial services industry and to expansion of operations into multiple countries, many multinational financial services companies are changing the way they operate, leading to changes in controlled transactions. For example, certain locations, such as "centers of excellence," may become more specialized in specific services or products and may supply this service or product to all of the organization's locations worldwide.

In other cases, certain sales and marketing offices of a global financial services company may become more involved with the production of products like investment management, and may begin sharing responsibilities with other locations. Shared responsibility for a product or service offering, joint contributions to a combined profit and loss account, global employee bonus pools, shared development expenses for IT infrastructure and software applications, and other joint activities between employees located in different taxing jurisdictions lead to increasing global integration of financial services businesses.

"In the past, the PSM used to be out in the frontier of complex and costly advance pricing agreements with tax authorities and employed mainly for global dealing operations of money center banking institutions operating in branch form."

Two areas that come to mind are global investment management and global investment banking. For example, in the past, many investment management firms managed global assets from a single location, say New York, while other offices, say Toronto, London, Frankfurt, Hong Kong, Tokyo, and Sydney may have employed a few people whose major responsibility was to source clients for new capital commitments, coordinate with third party sub-advisors, and collect certain research information. The resulting cross-border transactions (monitoring of third party sub-advisors and performing of basic research) were often evaluated against available market benchmarks under a "cost plus" policy and tested for local country transfer pricing purposes under a "Transactional Net Margin Method" of the OECD Transfer Pricing Guidelines (also referred to a the Comparable Profits Method under the U.S. Transfer Pricing Regulations).

Recently, increased competition, the search for more diversified non-U.S. portfolios and increased investment capital raising activities outside the U.S. led many investment management firms to move people to the geographic locations relevant to their everyday responsibilities. Globalization also made such a move easier by speeding electronic communications and reducing the differences in living conditions among certain geographic locations. More companies now employ portfolio managers in different geographic locations. These managers may share responsibilities—for example, accepting portions of a global mandate or managing a shared amount of risk, or participating in the global investment committee decisions or performing certain activities in a way that are generally proprietary for the organization. Globalization thus decreases the chances that third party comparables for these activities may be found. The PSM may likely be one transfer pricing method employed in this situation to assess the financial results of this integrated business in performing a transfer pricing study.

As a second example, specialization may lead to further integration. For example, some investment banks used to operate primarily on a regional basis, with two or three offices occasionally working together and sharing fees in relation to certain deals. As some regions favored specific approaches and/or deals, the offices have become specialized in certain areas. With increasing globalization and companies acquiring each other in different regions, certain specialized expertise now may be required in almost every region, thus leading investment bankers to travel across the globe and to participate in the deals worldwide. As a result, the PSM may become the best method to assess the results for tax purposes of such globally integrated non-routine operations.

Transfer pricing rules that govern the PSM

U.S. Treas. Reg. §1.482-6 provides two profit split methods: the comparable profit split and the residual profit split. Under a comparable profit split, each party is allocated a certain percentage of the combined operating profit or loss of the relevant business activity. The percentage allocated to each party is based on internal or external comparables. Under a residual profit split, first, each party is allocated a routine return based on internal or external comparables. The remaining profit or loss (the residual) is then attributed to intangibles and allocated in proportion to the parties' respective *contributions of the intangible property.* Proxies for value correlated to the functions performed and the efforts involved in generating the profits might be employee compensation, transaction volume, changing asset values, or other factors.

"Although the PSM is also cited as an applicable method in the OECD Transfer Pricing Guidelines, in practice, the profit split method was not welcomed by the tax authorities in some countries or may only be applied in restricted circumstances (e.g., Germany)."

The OECD Guidelines offer two profit split approaches, a contribution analysis approach and a residual analysis approach.[2] Under a contribution analysis approach, the combined profit is divided based upon the relative value of the functions performed by each entity, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances. The residual profit split analysis is similar to that in the U.S. regulations. In the first stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises.

Although the PSM is also cited as an applicable method in the OECD Transfer Pricing Guidelines, in practice the profit split method was not welcomed by the tax authorities in some countries or may only be applied in restricted circumstances (e.g., Germany).[3] This attitude has been changing as more countries accept and become more sophisticated in the application of the PSM.

The U.S. proposed regulations for global dealing that would apply to participants in a global dealing operation if promulgated in final form also offer two profit split approaches: a total profit split and a residual profit split. The total profit split method of the proposed regulations is the same as the comparable profit split of the current regulations if comparable transactions between unrelated parties are identified. In the absence of comparables, which is typically the majority of cases, the total profit split method allows an allocation that takes into account the economic value of the contribution of each participant. The residual profit split analysis applies in two steps as in the U.S. regulations: after compensating the routine functions, the residual profit is allocated among the participants based upon their *respective non-routine contributions.*[4] Non-routine contributions are contributions so integral to the global dealing operation that it is impossible to segregate them from the operation and find a separate market return for the contribution.

Additionally, the recently published temporary regulations, Temp. Reg. §§1.482-2T and -9T extend the use of the comparable profit split and residual profit split methods to controlled services transactions. The language of the new temporary regulations has changed compared with the language of the 2003 proposed services regulations, which referred to *high-value* or *highly-integrated* transactions to be likely candidates for profit split.[5] The Preamble to the 2006 temporary services regulations states:

> Under these temporary regulations, all references to "interrelated" transactions in §1.482-6(c)(3)(i)(B)(1), as well as references to "high-value services" and "highly integrated transactions" in §1.482-9(g)(1) have been eliminated. Section 1.482-9T(g)(1) now states that the profit split method is "ordinarily used in controlled services transactions involving a combination of non-routine contributions by multiple controlled taxpayers.

This concept is similar to the proposed U.S. global dealing regulations under Prop. Reg. §1.482 and as such the two sections are now more consistent.

U.S. Temp. Reg. § 1.482-6T(c)(3)(i)(B)(1) also defines a non-routine contribution as "a contribution that is not accounted for as a routine contribution." The Preamble to the temporary regulations states:

> … a nonroutine contribution is one for which the return cannot be determined by reference to market benchmarks. Importantly, in this context, the term "routine" does not necessarily signify that a contribution is low value. In fact, comparable uncontrolled transactions may indicate that the returns to a routine contribution are very significant.

Based on this guidance in the U.S. as well as other countries and the OECD, the PSM is becoming a more accepted transfer pricing method by tax authorities and practitioners for many more circumstances, including general financial services (apart from global dealing of securities) and other high value services.

Implementation of the PSM

If the PSM is found to be the "best" or "most appropriate" method under local transfer pricing rules, it does not mean that a company must implement the PSM as its transfer pricing policy. A company's policy may be based on transactional methods (e.g., a comparable uncontrolled price) or on some form of a fee or revenue sharing arrangement. The results of this policy would then be tested under the PSM as part of the company's transfer pricing documentation study. Practically, many companies prefer to coordinate the company's policy with the best method to increase the probability of year-end compliance with transfer pricing requirements by taxing authorities.

There may be certain constraints to implement the profit split as a company's transfer pricing policy. For example, certain entities may have regulatory restrictions on how much of a loss they can book, and/or require a certain amount of capital to be allocated to support the profit split results.

Below are the questions one needs to ask, and the important collateral issues that should be considered, when determining if the company policy should be based on the PSM:

1. Are there separate legal entities involved, especially regulated legal entities, or does the organization operate in branch form?
2. Is the PSM likely to be deemed the best method by the tax authorities in each relevant jurisdiction (evaluate the level of globalization, local transfer pricing legislation, etc.)?
3. How easy would it be to build and implement the PSM model taking into account routine vs. non-routine contribution analyses, profit split drivers, financial reporting based on a combined P&L, and the ability to segment legal entity P&Ls relevant to the business line subject to the PSM?
4. What would be the transfer pricing results for the past several years if the PSM had been implemented as the policy? Are the results consistent from year to year? Which locations seem to have most of the profit?
5. What are the regulatory, tax and legal constraints in each jurisdiction?
6. What is the exposure for the location where a method different from the PSM is likely to be employed by the tax authorities?
7. What are the existing intercompany service level agreements, and is there a need to modify such agreements if the PSM were to be adopted as formal policy?

In general, leading industry practices may dictate the formation of a steering committee composed of individuals responsible for the PSM model development, implementation, and regulatory issues. Together with the company's outside transfer pricing advisors, this committee would oversee the development and implementation of the profit split method. An implementation manual that ties the profit split inputs to either the legal entity financials or to the results in the tax return and lists each step may also be helpful as a tool within the company's financial control operation. Other considerations regarding the implementation of the PSM include:

- The level of integration;
- Routine versus non-routine functions;
- Profit split drivers; and
- A combined profit and loss statement.

Each of these considerations is described below.

Level of integration

The PSM is often the best method when the business is highly integrated. In some cases, however, the level of integration between different locations may differ, making it more difficult to implement the PSM.

For example, consider a portfolio of assets that may be managed from four locations: New York, London, Tokyo, and Hong Kong. New York is the head office, with portfolio managers in New York and London working together 80 percent of the time and Hong Kong and Tokyo working together 80 percent of the time. In addition, New York works closely with Tokyo, and London works closely with Hong Kong about 20 percent of the time via investment committees. One could apply several different profit split models: between New York and London, New York and Tokyo, London and Hong Kong, and Hong Kong and Tokyo. All expenses and revenues would have to be allocated accordingly into segmented affiliate profit and loss statements. Although this may be a sound theoretical approach, implementing multiple profit split models for each set of interactions may not be a practical approach because of the administrative costs. To deal with this issue, one should assess the thinking of tax authorities in each jurisdiction and develop an optimal approach that is designed to meet the requirements of tax authorities with a minimum implementation burden.

Routine versus non-routine contributions

Circumstances determine whether certain contributions should be treated as routine or non-routine in the context of the routine PSM. Certain contributions, such as back-office services or straightforward research that may be outsourced, often have third-party comparables and, therefore, may be deemed routine under the rules cited earlier. Other functions such as product development, asset selection, pricing, and risk management of financial products are often unique to specific transactions, do not have comparables, and, therefore, would be deemed non-routine.

Certain contributions, such as sales, marketing, and IT development, may be routine or non-routine. These contributions are most likely to be non-routine if the marketer or sales people *substantially* participate in generating new incremental assets under management, in developing products, or in tailoring the products to the unique requirements of customers.

A situation may arise where a contribution differs in each location, and some locations may occasionally participate in non-routine activities. Certain functional analysis questionnaires may be appropriate to evaluate how important and complex these contributions are and to determine whether these contributions should be treated as routine or non-routine in each location.

“Certain contributions, such as sales, marketing, and IT development, may be routine or non-routine.”

Profit split drivers

The analyst should carefully select and define the profit split drivers. Salaries (including bonuses) of key people who provide non-routine contributions are often used as such drivers. This profit split driver is convenient because it forms a base to compare different types of contributions by employees, who are typically unrelated parties. As such, because compensation is generally a deductible expense in all jurisdictions, this factor is less fungible for the taxpayer. As a practical matter, it may not be a very convenient driver because bonuses and therefore the amount of profit allocated to each location are hard to predict. In addition, in a year of loss, most of this loss will be allocated to the location that employs the highest-paid people. Additionally, higher paid people may imply cost of living differentials and not increased productivity or increased contributions to the shared profits.[6]

For example, an integrated hedge fund asset management team may have non-routine contributions provided by asset managers, risk managers and programmers. It is not easy to find factors other than salaries that help to bring the contributions provided by these three groups to the same basis.

Other profit split value drivers include some form of level of activity by location, such as transactions booked, and in many instances may also include a factor for capital.[7]

Profit and loss (P&L) statement

Often, identifying revenues attributable to the integrated operations is a straightforward procedure. For example, for a global investment management firm, this revenue may be the revenue paid by third parties in relation to the globally managed accounts and funds. If, however, the global team manages only certain portfolios of the funds, while other portfolios are managed locally, the profit split revenue needs to be allocated as the clients pay fees in relation to a fund that encompasses both local and global portfolios. This revenue may be allocated based on the assets under management if the contributions in relation to local and global portfolios are similar, or based on some ratio of advisory to sub-advisory fees. While it often may not be the case, revenue may need to be allocated based on market comparables. Lipper and other databases may be used to allocate fund revenue to global portfolios.[8]

On the expense side, both direct (i.e., salaries and bonuses) and indirect (i.e., overhead) expenses incurred for both routine and non-routine contributions need to be estimated and entered into the model.

Summary: The PSM in the mainstream

In the past, the PSM used to be out in the frontier of complex advance pricing agreements with tax authorities and employed mainly for global dealing operations of money center banking institutions. As noted earlier, tax authorities are gradually pushing the PSM into the mainstream by applying the PSM more frequently with the expectation that a share of combined cross-border operating profit is better than either (1) a share of revenues, which may not cover costs; or (2) policies that reimburse costs plus a defined markup, which may under-remunerate higher value non-routine services. In a multinational, integrated financial services business it may be beneficial to look into the possibility that the tax authorities may apply the PSM to test the results of the controlled services transactions. Notwithstanding perceived difficulties in performing a PSM sensitivity analysis in an integrated business, the financial consequences from an income tax audit may be significant if the results under the company's existing transfer pricing method differ significantly from the results under a PSM.

As such, multinational companies may reduce transfer pricing risk and the size of potential adjustments to operating income by a tax authority by considering the PSM as either the primary method for certain non-routine integrated services transactions or as a secondary confirming method that compares reasonably similar results to those from a revenue split method or cost plus return.

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1 This is evidenced by two recent surveys and mainstream business press articles: "Managing and Planning for Tax in Asia Pacific—2006 Survey report on tax challenges in the region," *PricewaterhouseCoopers* and Lighthouse Global Survey on the UK tax market. Vanessa Houlder, "U.S. revenue service gets tougher on multinational manoeuvres to avoid tax: Companies fear moves to curb the lucrative tactic of transfer pricing," *Financial Times*, February 3, 2005.

2 In July of 1995, the OECD published in final form the OECD Transfer Pricing Guidelines for Multinational Enterprises. These OECD Guidelines describe considerations to be taken into account and the accepted methodologies for determining transfer prices for multinational entities. ¶3.15.

3 The OECD Guidelines ¶3.5 to ¶3.25. German transfer pricing rules did not formally accept the use of the PSM until the issuance of the Administrative Principles—Procedures *(Verwaltungsgrundsätze—Verfahren)* by the German Ministry of Finance on April 12, 2005. While in Germany profit split methods can only be applied with the standard transaction methods and cannot be applied to produce unreliable results, the use of profit split methods is increasingly gaining acceptance in Germany.

4 U.S. Prop. Reg. §1.482-8(e)(6)(iii).

5 Proposed Regulations: Treatment of Services Under Section 482 (September 5, 2003), as corrected on December 16, 2003, and on January 23, 2004.

6 "For example, if trader compensation is used as a factor to measure the value added by the participants' trading expertise, adjustments must be made for variances in compensation paid to traders due solely to differences in the cost of living." U.S. Prop. Reg. §1.482-8(e)(2)(ii).

7 The use of capital as a driver of profit within a profit split method may be challenged by many tax authorities if the result is to reward the capital provider with more than a routine return (i.e., time value of money measure) for the use of its capital. This has been addressed by the IRS in connection with the 1998 Proposed Regulations on Global Dealing and by the OECD in the draft papers on Attribution of Profits to Permanent Establishments.

8 Lipper Analytical News Application (LANA) database distributed by Lipper, Inc.

Standing on "principal": Transfer pricing structures using limited-risk manufacturers and distributors

by Joseph Andrus and Michael Durst

In recent years, the apparently increased centralization of management within multinational groups, coupled with many groups' desires to obtain reasonable simplicity and certainty in their tax transfer pricing regimes, has led to widespread adoption of what often are called "principal company" structures. In such structures, the entities within the group typically are divided between (a) one or more "principal" companies (which generally include the parent company and might also include one or more regional "hub" companies) and (b) a typically larger group of "limited risk" distributors and manufacturing entities. The limited-risk distributors might be structured either as commission-sellers ("commissionaires") or as buy-sell distributors operating under contracts that essentially assure the distributors a return on each item sold. The manufacturers typically operate either under tolling arrangements or under simple cost-plus contracts similar to those employed by contract manufacturers. The principal company or companies typically remain financially responsible for the development of valuable intangibles (e.g., through research & development and the design of global advertising campaigns). The intended result is that the taxable incomes of the limited-risk components of the group will be both relatively limited and relatively predictable; the income of the principal company or companies, however, will fluctuate significantly with the fortunes of the global business (and is expected on average to be somewhat higher than the incomes of the limited-risk companies, as it is the principals that bear the significant financial risks of the business and therefore would on average expect higher returns).

Generally, companies that have adopted principal structures have done so while relying on what they perceive to be straightforward readings of the U.S. transfer pricing regulations and the OECD Transfer Pricing Guidelines. Both the regulations and the Guidelines make clear that related entities can, as a general matter, arrange their respective risks and functions by contract, provided that the contracts are consistent with arrangements into which unrelated parties might have entered at arm's length. It is not unusual for unrelated co-venturers to enter into arrangements in which, in return for differing expected levels of return, they share risks asymmetrically. Accordingly, taxpayers generally have expected, provided they established the proper returns to the limited-risk entities based on analyses of comparable companies and transactions, that the governments involved would respect principal structures for tax purposes.

Indeed, it can be argued as a practical matter that the use of a principal structure, or of a similar structure based largely on the use of limited-risk entities, is in many instances the only means by which a complex multinational can gain reasonable confidence that its transfer pricing arrangements will be respected. The alternative to a principal structure under currently applicable transfer pricing rules is some form of global profit split. Available rules governing profit splits, however, are notoriously vague, and in many instances the "swings" possible based on different countries' likely interpretations as to the reasonableness of the profit splits employed would render their use prohibitively uncertain. The principal structure, however, rests upon what might be considered the only truly "rock hard" principle in transfer pricing law as it is understood internationally: namely, the principle that an entity that, by contract, is largely insulated from business risks is entitled at arm's length to a relatively low but steady return, based on the results of comparable independent businesses facing similar risk profiles. Based on this perspective, the principal structure should be among the least controversial structures available in transfer pricing.

“…provided they established the proper returns to the limited-risk entities based on analyses of comparable companies and transactions, that the governments involved would respect principal structures for tax purposes.”

In practice, however, principal structures have given rise to substantial controversy between taxpayers and the tax authorities of particular countries, and the magnitude and persistence of the controversies have led to intensive study by the OECD's Committee on Fiscal Affairs. The controversies appear to fall into several different categories; by examining each, it is possible to gain a better understanding of both how companies might structure principal arrangements so as to minimize the prospect of conflict with tax authorities, and how governments and the OECD might respond to current controversies by offering useful policy guidance.

Controversies based on "transitions"

Many controversies related to the establishment of principal structures arise when a tax examiner believes that adoption of the structure has "stripped" income from an entity that is newly designated under the structure as a limited-risk entity. Historically, the entity may, as is typical of an entity that faces significant business risks, have experienced periodic fluctuations in income but have on average earned higher returns than the entity is assigned under the new "limited risk" structure. Typically, the tax examiner may view the prior record of downward fluctuations in income as representing a period of investment by the entity in the development of some form of intangible, and the higher-income periods as periods of return on those investments.

Under this view, the transition of the entity to a limited-risk model, in which its income will be stable but low, represents a taxable transfer ("migration," in the currently fashionable phrase) of an intangible asset. Outside the United States, the tax examiner is likely to refer to the perceived transfer of an intangible as a transfer of "goodwill"; in the United States, the perceived transfer is more likely to be described as the transfer of a "marketing intangible." Whether inside or outside the United States, the tax examiner is more likely to find a transfer to have taken place if the move to a limited-risk structure occurs when the local entity is in the "trough" of its income cycle, so that it can be argued most persuasively that some of the entity's investment in intangibles remains, for tax purposes, unrecovered. In some instances, tax examiners may also interpret consistently high returns over a number of years as evidence of this type of "goodwill" intangible.

The question of whether a move to a limited risk structure results in the transfer of an intangible is a legitimate question of fact. In some circumstances the facts may suggest that a move to a limited risk structure involves the effective transfer of such intangibles, and their effective movement could legitimately give rise to tax consequences. However, in many cases such claims by tax authorities are either unwarranted or are substantially overstated. In some instances, the notion of long-lived "goodwill" or "marketing intangibles" appears vague and inconsistent with the realities of the business concerned; in most businesses, if marketing expenditures were suddenly to be curtailed, the income-producing potential of any "goodwill" or "marketing intangibles" would erode very quickly. In such circumstances, it is hard for a government to argue that a shift of the financial burden of marketing and other expenditures to a principal results in the transfer of a highly valuable asset to the principal. A government's argument might be relatively more persuasive if, as mentioned previously, the shift to a limited risk structure occurs when an entity is at a trough of its business cycle. Even then, however, claims that a taxable transfer of highly valuable intangibles has occurred are often exaggerated.

Of course, despite the authors' views, the claim that a taxable transfer of an intangible has taken place is a possibility whenever an entity enters into a risk-limiting contract, and in some instances—especially where the transition occurs at the trough of the entity's business cycle—the claim might have particular merit. Groups entering into risk-limiting arrangements always should assess the possibility of such a claim; they should document transactions in such a manner as to minimize the likelihood that such claims might be made to an excessive extent; and they should make appropriate allowances to the extent the companies believe that valid claims to taxable migrations of intangibles might properly be made.

From the governmental perspective, it would be very helpful if, possibly through the OECD, governments could articulate with greater specificity the criteria by which they will evaluate whether they believe taxable intangibles migrations have occurred. The limited risk structure appears well ensconced in international practice and appears to be here to stay for at least the foreseeable future. Therefore, by providing criteria by which taxpayers could better assess the tax consequences of such transactions, governments would be helping to remove significant business uncertainties. In addition, because shifts to limited risk structures tend to be one-time events that involve significant prior planning, and since potential claims to intangibles migration can involve significant tax exposures, such shifts

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would appear to be good candidates for treatment by advance pricing agreement procedures.

Transfers of discrete intangibles in the context of a principal structure

Another kind of tax controversy associated with moves to principal-based structures involves issues that differ from the issues arising from the principal structure *per se*; nevertheless, these issues are important enough to warrant specific mention in this discussion. In some circumstances, the establishment of a global principal structure coincides with the movement of interests in discrete intangibles such as patents or copyrights. For example, a parent company might want to establish regional hubs (that are intended to operate as principals) in tax-favored locations in Europe and Asia and provide those newly established principals licenses to core intangibles of the group such as patents or copyrights to high-margin products. Such a transfer might or might not coincide with the establishment of a cost-sharing arrangement for further development of the intangibles. Generally, the parent company enters into an agreement under which the newly established regional hub companies pay royalties for use of the licensed intangibles.

Of course, such explicit transfers of interests in high-value intangibles represent the paradigmatic source of high-stakes conflict between taxpayers and revenue authorities. The conflict is likely to arise independently of any considerations specific to the establishment of "principal" structures. The fact, however, that explicit transfers of interests in high-value intangibles are likely to occur in conjunction with the establishment of global principal structures is addressed here primarily for two reasons.

First, companies should recognize that the incorporation of an explicit transfer of a high-value intangible into the establishment of a principal structure does not change the nature, or the potential for tax controversy, of the explicit intangibles transfer. In assessing exposures, taxpayers should not make the mistake of focusing so much on the forest of the global principal structure that they fail to give adequate attention to the tall and potentially perilous tree represented by the embedded transfer of a high-value intangible.

Second, it seems possible that the frequent inclusion of explicit transfers of high-value intangibles in the establishment of global principal structures has tended to transfer to the discussion of principal structures some of the rhetorical heat that, over the years, has become associated with tax controversies over explicit transfers of intangibles. The result may have been to inject an unnecessary degree of intensity into current policy debates over principal structures. The establishment of principal structures in itself generally raises less cause for concern among tax policy-makers than the kinds of explicit intangibles transfers that, from time to time, have made headlines. It would be helpful to all if those involved in debates regarding principal structures could insulate the debate as far as possible from revenue authorities' ongoing efforts to come to grips with large scale "intangibles migrations."

Controversies related to concerns regarding sufficient "substance"

Sometimes, tax authorities appear concerned that principal companies, especially in low-tax countries, have insufficient employees and active business activities to serve the functions and fulfill the risk-bearing role attributed to the principals under applicable contracts. To the extent tax authorities believe such views are warranted in a particular case, they should couch their challenge in the form of a challenge to the recognition of the entity, or as a challenge to the actuality of the company's compliance with the contracts establishing the structure. Challenges of both these kinds can be evaluated by reference to established principles of tax law, including the OECD Guidelines. Tax authorities should, however, take care to avoid permitting such challenges to spill over into broadly stated denials of the validity of intragroup contracts *per se.*

Controversies over the validity of risk-limiting structures *per se*

Some recent assertions by tax authorities have done more than simply try to identify and tax implicit or explicit transfers of intangibles that might arise in connection with the establishment of principal structures. In some instances, tax authorities are challenging the legitimacy *per se* of the use of intragroup agreements to apportion risks among group members so as to render some entities as "risk limited" and others as "principals."

The challenges generally have taken two forms. In one, tax authorities claim that unrelated parties at arm's length never would have agreed to enter into relationships in which risk is assigned almost entirely to one party and that, therefore, the contracts should not be respected as being commercially reasonable. Such claims ignore the fact that commercially reasonable behavior

"In some instances, tax authorities are challenging the legitimacy *per se* of the use of intragroup agreements to apportion risks among group members so as to render some entities as 'risk limited' and others as 'principals'."

extends over a broad spectrum, from complete risk sharing to risk-limited participations such as limited partnerships. Indeed, arrangements very similar to the risk limited agreements used in principal structures—namely, commission sales arrangements and toll manufacturing arrangements—do in fact exist among unrelated parties in the marketplace. There appears to be little or no intellectually sound basis on which to argue that risk-limited contracts are inherently unreasonable when measured against the arm's length standard. Courts are unlikely to accept such arguments when raised by tax authorities; indeed, such arguments are essentially attacks on the arm's length standard itself. Such attacks may or may not be valid as a matter of policy, but they would appear to have little strength under transfer pricing law as it is now understood around the world.

A second kind of challenge by tax authorities is a bit more complex, and has received a great deal of attention over the past few years, especially in the deliberations of the OECD. This challenge, based on the terminology of a pending OECD working draft that articulates its rationale, might be called the "deemed branch/KERTs" challenge. Such a challenge is apparently based on the view of the tax authority that a risk-limiting contract may be effective in reducing the financial risk to which the entity is subject, but that even after that risk is extracted from the entity, the personnel who previously managed the risk remain present in the entity's tax jurisdiction. Because these personnel—who, in the language of the OECD draft, are considered to perform "key entrepreneurial risk-taking functions (KERTs)"—no longer support the activities of the local entity (since that entity no longer bears the risks that the KERTs personnel manage), those personnel must instead be performing a service on behalf of the "principal" company to which the risk has been shifted. Some of the income of the principal company then is considered taxable in the country in which the deemed branch is located, either under principles governing the attribution of income to permanent establishments (PEs) under income tax treaties or, in the absence of an applicable tax treaty, under local law governing the taxation of branches. The extent of this taxation is likely to be somewhat uncertain because the rules governing the attribution of income to PEs (or, in the absence of treaty, to branches under local tax laws) are notoriously indeterminate.

More recent comments by individuals involved in the OECD deliberations suggest a likely forthcoming change in the KERTs terminology. It remains to be seen whether such a change in terminology also portends a change in the underlying premise that taxpayers should have limited ability to segregate contractually the business risk and the returns that accrue to such risk from the people who decide to assume those risks and from the people who manage the risks once they are assumed.

A generalized practice of "deeming" branches under KERTs or similar approaches represents an undesirable step away from law-based tax administration. The practice, at least as presently understood, is not based on an argument within the framework of the OECD Guidelines that the underlying risk-limiting contracts are commercially unreasonable; instead, the contracts are deemed, on apparently subjective grounds, undesirable, so the effects of the contracts are simply ignored. As a result, the "deemed branch" approach nullifies the only basis—namely, intragroup contracts—on which multinational groups can achieve anything approaching predictability in the international allocation of their tax base.

In many cases, the approach also cannot be seen as being based fairly on a view that the individuals performing services—whether KERT or non-KERT services—are somehow not being compensated or not being adequately compensated. The individuals providing services are presumably compensated the same as they were before the change in statutory regimes, so that the individual tax base of the country concerned is not compromised; moreover, even under a risk-limiting contract, the entity performing the services is in economic effect reimbursed by the principal company for the entity's personnel costs, as well as with a profit element (typically consisting of some kind of markup on costs).

The "deemed branch" argument, where it is made, appears to rest instead on a perception by some revenue officials that there is a "natural" pattern of income fluctuation and a "natural" average level of income for entities engaged in certain business activities—namely, an entrepreneurial pattern and average level—regardless of contractual arrangements that have been entered into among the members of a commonly controlled group. This is essentially a formulary view of transfer pricing, in which income or loss is to be shared among group members based on the relative extent of business activity conducted by the various members; it is a view that, despite the deference for contracts that is inherent in the arm's length approach, rejects the notion of risk allocation by intragroup contractual arrangements. And underlying this view as well, almost surely, is a fundamental distrust of intragroup contracts *per se*; they are viewed as inherently artificial, and reliance upon them is seen as ceding to taxpayers an unhealthy degree of choice concerning their international allocation of tax burdens.

It is this last point that probably lies at the heart of controversies regarding "deemed branches"; there is undoubtedly "in the air" today a perception among government officials that the entity-based arm's length approach to transfer pricing, involving as it must respect for contracts among entities, provides excessive scope for taxpayers to be able to arrange tax burdens to their advantage.

From a policy standpoint this perception may or may not have merit; it may well be worthwhile debating the perception that existing transfer pricing rules and practices, including respect for intercompany contracts, do not always give rise to appropriate results. Such a debate probably should take place as part of a general global reassessment of transfer pricing rules now that more than ten years have passed since the promulgation of the OECD Transfer Pricing Guidelines and U.S. regulations in the mid-1990s. Recent OECD discussion papers on comparability and on the role of profit based transfer pricing methods suggest that such a fundamental assessment may already be underway. But pending such a reassessment, the assertion of the "deemed branch" approach in the context of case-by-case enforcement is an extralegal practice that is likely to cause only mischief. Use of the approach threatens to turn transfer pricing enforcement—already an area plagued by excessive subjectivity and unpredictability—into even more of a free skating competition, with beauty judged more according to the eyes of the beholder than according to clearly articulated legal standards.

Tax authorities dissatisfied with the results of particular principal structures, or other arrangements involving risk limitation by contract, should take care to couch their objections in terms consistent with the OECD Guidelines, and particularly the Guidelines' respect for the separate-entity status of incorporated affiliates and intercompany contractual arrangements. Thus, such objections where appropriate should be couched in terms of claims of transitional transfers of assets, or in terms of principled and clearly articulated critiques either of the commercial reasonableness of the contracts on which risk limitation is based, or of the extent to which taxpayers have in fact abided by those agreements. Claims by revenue authorities should not, however, be based on subjective claims that a local entity is performing "key entrepreneurial risk taking functions" or the equivalent, and that revenue authorities accordingly are free to "deem" the existence of a branch or to allocate income on some unstructured apportionment basis.

The OECD, for its part, should take care to meet the challenge of risk-limited structures—if in fact such structures do represent a serious challenge of some kind—in a manner that plainly articulates the legal principles on which its advice is premised, with an eye toward uniform applicability and predictability in enforcement.

Given the apparently deep-seated nature of revenue authorities' opposition to the establishment of structures based on risk-limiting contracts, it is possible that the OECD's continuing review of such structures will lead to a surprisingly fundamental review of current conceptions of the arm's length standard, and particularly the standard's necessary respect for related entities as contracting parties. Wherever the review leads, however, the OECD should be encouraged to pursue it energetically and without preconception as to the result. The existing understanding of the arm's length standard among companies, government officials and private practitioners does not appear to be leading to a satisfactory common view of the uses and limitations of risk-limiting arrangements such as "principal" structures. The orderly administration of multinational business requires that a common understanding emerge.

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"…there is undoubtedly 'in the air' today a perception among government officials that the entity-based arm's length approach to transfer pricing, involving as it must respect for contracts among entities, provides excessive scope for taxpayers to arrange tax burdens to their advantage."

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