

Executive Alert

IRS Releases Three Major Sets of Regulations Addressing Transfer Pricing for Services, Foreign Tax Credits and Cross-Border Merger Rules

In a month when government activity in Washington, D.C., historically comes to a virtual standstill, and without the benefit of its primary office facilities due to recent flooding, the Internal Revenue Service ("IRS") has released three major sets of regulations concerning topics that have been a focal point of taxpayer and practitioner interest for the last several years. With the release of T.D. 9278 on August 1, 2006, the IRS has provided final and temporary regulations updating the rules for determining the arm's-length transfer price for controlled service transactions (i.e., services performed by a taxpayer related to the service recipient). Only two days later, the IRS issued new proposed foreign tax credit regulations (Reg. 124152-06) under sections 901 and 903 of the Code addressing what is commonly referred to as the "technical taxpayer rule." This rule recently received significant attention in the wake of the IRS's defeat in *Guardian Industries Corp. v. United States*, 65 Fed. Cl. 50 (Ct. Fed. Cl. 2005), *on appeal at* Docket No. 06-50-58 (Fed. Cir.). Finally, on August 7, 2006, the IRS released T.D. 9273 addressing the treatment of tax attributes in foreign-to-foreign tax-free reorganizations and liquidations. All three of these regulation packages have potentially significant implications for taxpayers with international activities.

New Cost-Sharing Rules for Services

The IRS issued final regulations providing guidance on establishing an arm's-length transfer price for services performed for related parties in 1968. The 1968 services regulations generally classify services performed for the benefit of a related party as either "integral" or "non-integral" depending on the importance of the services to the provider and/or the recipient. If services are determined to be "non-integral," the 1968 regulations permit the service provider to be compensated for the performance of such services at cost; that is, no arm's-length markup is required. For services that are determined to be "integral," the 1968 regulations require the service provider to be compensated at an arm's-length rate.

In 2003, the IRS proposed new regulations addressing the establishment of an arm's-length transfer price for related-party services. The 2003 proposed regulations provided six new methods for determining the arm's-length standard for services transactions and eliminated the cost-based safe harbor for non-integral services. In its place, the proposed regulations established a new simplified cost-based method ("SCBM") for establishing the transfer price for routine low-margin services. The proposed SCBM received substantial criticism due to its complexity and the increased administrative burden it would impose on taxpayers. Needless to say, the method was anything but "simplified."

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The 2006 temporary regulations abandon the SCBM in favor of the new services cost method (“SCM”) described in Temp. Reg. § 1.482-9T(b). Though the temporary regulations do not revive the taxpayer favorable integral / non-integral distinction of the 1968 regulations, they do provide a new form of cost-based safe harbor for intercompany services in the nature of support activities that generally do not involve a significant arm’s-length markup on total services costs. The IRS has indicated it will publish guidance in the form of a Revenue Procedure listing services that will qualify for compensation at cost. An initial and relatively extensive list of proposed services to be included in the forthcoming Revenue Procedure has been provided in IRS Announcement 2006-50 (2006-34 IRB 321). The proposed list of 48 different categories of services represents a broad range of traditional back-office functions including: (i) accounts payable functions, (ii) accounts receivable functions, (iii) public relations, (iv) staffing and recruitment, (v) training, (vi) treasury and tax functions, and (vii) computer support. The SCM method also permits taxpayers to compensate certain low-margin services other than identified in public guidance at cost. The category of services that will qualify under this rule includes services (not otherwise covered by the Revenue Procedure) for which the median comparable arm’s-length markup on total services costs is less than or equal to 7 percent. Defining low-margin services at the 7 percent threshold is a positive development for taxpayers since, historically, 5 percent was an unofficial guideline for distinguishing “integral” services under the 1968 services regulations.

The temporary regulations also provide guidance on applying the SCM to so-called shared services arrangements (“SSAs”). SSAs represent arrangements between taxpayers for the sharing of costs related to covered services based on each participant’s anticipated benefit with respect to the services. If the taxpayer reasonably concludes that the SSA results in an allocation of costs of the covered services in the manner that most reasonably anticipates the members’ respective shares of the anticipated benefits, then the Commissioner may not adjust the allocation basis. To have a valid SSA, the taxpayer must meet certain documentation requirements establishing the allocation basis and the grouping of services.

In addition to establishing the new SCM, the 2006 temporary regulations generally adopt the remaining five methodologies of the 2003 proposed regulations for purposes of determining the arm’s-length transfer price for services where an arm’s-length markup is required. Although the methods are new in connection to their application to services, the methods are based on the well-known methods that historically have applied to transfers of intangible property among related parties. The 2006 temporary regulations also provide rules for determining whether the services provisions of the 482 regulations, tangible and intangible section 482 rules, or a combination thereof should apply in the context of “integrated transactions” (i.e., transactions that have both service and non-service components). The temporary regulations are generally effective for tax years beginning on or after January 1, 2007, but by election may be applied retroactively to any tax year beginning after September 10, 2003 (if such an election is made, the temporary regulations must be applied for all subsequent years).

New Proposed Technical Taxpayer Regulations

In recent years, the IRS has expressed its displeasure with arrangements entered into by taxpayers that have the result of separating foreign tax credits from the income to which they relate. In the case of *Guardian v. United States*, the IRS was unsuccessful in challenging such a result. Under the facts of *Guardian*, a U.S. corporate taxpayer owned a Luxembourg group of corporations through a Luxembourg holding company. The Luxembourg holding company served as the parent of the Luxembourg consolidated group and, under Luxembourg law, was solely responsible for the payment of the group’s tax liability. The taxpayer caused the Luxembourg holding company to elect to be disregarded for U.S. federal income tax purposes; accordingly, for U.S. tax purposes the U.S. taxpayer was treated as the direct owner of the holding company’s operating subsidiaries. Based on the Luxembourg statute, the taxpayer took the position that it directly bore legal liability for the operating subsidiaries’ Luxembourg income taxes and was therefore entitled to a direct foreign tax credit for the income taxes paid to the Luxembourg government. This resulted in a separation of income and taxes because the earnings of the Luxembourg operating companies that gave rise to the credits had not been repatriated (i.e., there were no actual distributions and subpart F did not apply).

The taxpayer in *Guardian* relied on the plain language of current regulations to support its position. Treas. Reg. § 1.901-1(f)(1) provides the technical taxpayer rule: “the person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes *legal liability* for such tax, even if another person (e.g., a withholding agent) remits such tax” (emphasis added). The IRS has appealed the decision in *Guardian*. Not wanting to rely solely on its chances in court, however, the IRS has released proposed regulations that attempt to eliminate the ability of taxpayers to separate foreign tax credits from the associated income through application of the technical taxpayer rule. The proposed regulations abandon the use of “legal liability” to determine who is considered to pay tax to a foreign government and, instead, provide that the person required to include the income under foreign law to which the taxes relate is the person treated as paying the tax. Accordingly, in *Guardian*, the Luxembourg operating subsidiaries would be considered the parties responsible for paying the tax because they were the parties required to include the income for Luxembourg tax purposes.

The regulations also address various reverse hybrid transactions. In a typical reverse-hybrid partnership structure, a U.S. taxpayer owns an interest in a foreign entity that is treated as a partnership for foreign tax purposes, but that elects to be taxed as a corporation for U.S. tax purposes. The U.S. taxpayer then takes the position that taxes paid by the foreign entity are the legal liability of the U.S. taxpayer as a partner under foreign law, even though the income associated with the taxes may be deferred from being taxed in the United States (i.e., the income is not repatriated in the form of a dividend or required to be included under subpart F). Under the proposed regulations, the foreign reverse-hybrid entity is considered the person that pays the tax for purposes of sections 901 and 903. Accordingly, the U.S. taxpayer will not be entitled to a credit for the tax liability until a distribution is made (or upon a subpart F inclusion), and then, only to the extent the taxpayer qualifies for the indirect credit under section 902.

In addition to addressing the perceived common abuse transactions described above, the proposed regulations could have far-reaching effects on taxpayers that bear the economic burden of foreign taxes through various investment structures. Though issued in proposed form, the regulations instruct that subsequent final regulations that enter into force will

be effective for foreign taxes paid or accrued after December 31, 2006. The proposed regulations reserve on the treatment of hybrid instruments, but provide that forthcoming rules addressing hybrid instruments will have the same effective date.

Final Regulations Regarding Carryover of Foreign Tax Attributes

The IRS has issued final regulations concerning the carryover of tax attributes in reorganizations involving foreign companies that principally adopt the rules of prior proposed regulations issued in 2000. The primary purpose of the new regulations is to address the carryover of earnings and profits and associated foreign taxes in transactions subject to sections 367(b) and 381. Section 367(b) generally provides rules for determining when taxpayers engaging in inbound liquidations of foreign subsidiaries and foreign-to-foreign reorganizations may rely on the general nonrecognition rules applicable to domestic tax-free reorganizations and liquidations. Section 381 provides the general tax attribute carryover rule that permits the acquiring taxpayer to “step into the shoes” of the target company with respect to its corporate tax attributes.

One of the focuses of the proposed regulations that received substantial criticism was the operation of the so-called “hovering deficit rule” of section 381(c)(2)(B). In the domestic context, the hovering deficit rule generally prevents pre-transaction deficits in earnings and profits of an acquiring or target corporation from offsetting the pre-transaction positive earnings and profits of the other corporation that is party to the carryover transaction. Only post-transaction earnings of the surviving corporation that ultimately are attributed to the taxpayer’s accumulated earnings and profits account are permitted to be reduced by such a deficit. In applying these rules to carryover transactions involving foreign corporations, the proposed regulations provided that the hovering deficit rule was to be applied on a separate limitation category basis (i.e., separately for each category of earnings described in section 904(d)). The final regulations retain the separate limitation approach of the proposed regulations with regard to application of the hovering deficit rule. Accordingly, under the final regulations, the hovering deficit rule could result in a distribution being attributed to positive earnings and profits even though the distributing corporation has no or negative earnings and profits on a combined basis. The final regulations

also require a similar isolation of any hovering deficit for purposes of computing the amount of indirect taxes paid by the foreign corporation with respect to a dividend or income inclusion subject to the indirect foreign tax credit rules of section 902.

The proposed regulations provided that excess taxes attributable to a hovering deficit were not to be included in the foreign corporations' tax pools until such time as the entire related hovering deficit was eliminated. In response to public comment, the final regulations provide that excess taxes will be added to the foreign corporations' tax pools on a pro rata basis as the hovering deficit is reduced by post-transaction positive accumulated earnings. Although the hovering deficit rule generally applies for purposes of computing earnings and profits, the regulations provide that qualified deficits and chain deficits for subpart F purposes are taxpayer-level attributes and are not similarly affected by the section 381 transaction.

The final regulations also address the carryover of earnings and profits in certain inbound non-recognition transactions. Consistent with the proposed regulations, the final regulations limit the carryover of net operating losses, capital losses and earnings and profits (or a deficit of earnings and profits) from a foreign corporation to a domestic corporation to the amount of such earnings and profits that were effectively connected to a U.S. trade or business of the foreign corporation. The final regulations apply to transactions that occur after November 5, 2006.

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