



Transfer Pricing Update: Recent Developments

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Introduction

It has been approximately 18 months since transfer pricing legislation was introduced in Ireland, although the legislation has come into effect only for accounting periods commencing on or after 1 January 2011. The details of the transfer pricing legislation have been covered in previous *Irish Tax Review* articles, and therefore we do not propose to go into such details in this article.

The guidance set out by the Revenue Commissioners in *Tax Briefing* Issue 7 (June 2010) stated that counter-party documentation is sufficient to satisfy the Irish transfer pricing documentation requirements. For transactions between Irish companies and associated US companies, it is likely that the US transfer pricing documentation will be relied on for Irish transfer pricing purposes in most cases, to the extent that the documents have been prepared in accordance with OECD standards.

In the recent past, the IRS has stepped up its efforts to prevent US companies transferring profits abroad. In many audit cases of US taxpayers, the IRS has raised large assessments relating to transfer pricing, some of which relate to transactions between the US taxpayer and their Irish subsidiaries.

Many US multinationals continue to set up operations in Ireland. As those companies strive to ensure that the Irish operations are set up in the most tax-efficient manner, the US transfer pricing environment is an important issue to consider, particularly in situations where the approach taken may deviate from OECD principles.

In the last 18 months, there have been a number of changes to the US transfer pricing landscape, including case law and changes in administrative procedures by the IRS. Due to the importance of the US transfer pricing environment for Irish subsidiaries of US

multinational companies, we will explore in this article some of these significant changes.

Xilinx Case

On 22 March 2010 the US Court of Appeals for the Ninth Circuit issued a new opinion in *Xilinx Inc. v Commission*. The court held that stock-based compensation does not have to be included in the research and development (R&D) cost base of companies that have entered into a cost-sharing arrangement (CSA) under Treasury Regulations (Treas. Reg.) s1.482-7 before its amendment in 2003, which is in direct contrast to the original opinion issued by that court.

Background

In *Xilinx* the Commissioner contended that stock-based compensation related to a CSA during the 1997, 1998 and 1999 tax years had to be shared. In August 2005 Foley J, writing for the Tax Court, held that stock-based compensation did not need to be shared, because parties acting at arm's length would not share such costs. The IRS appealed, and in May 2009 the Ninth Circuit issued its first decision in the case, reversing the Tax Court and holding that Xilinx and its Irish subsidiary were required to share stock-based compensation under the pre-2003 cost-sharing regulations. In January 2010 the Ninth Circuit withdrew its first decision without explanation.

Original opinion

In the original opinion, the majority, led by Fisher J and joined by Reinhardt J, found that Treas. Reg. s1.482-1(b), which provides that the arm's-length standard should apply "in every case", was irreconcilable with Treas. Reg. s1.482-7(d)(1), which provides that "all costs" are to be shared in a CSA, and that, in such a case, the canon of statutory construction that the specific controls the general should prevail. In his dissent Noonan J asserted that the canon relied on by the majority was but one of many available and that, in deciding between the two provisions, the overall purpose of the statute (parity with unrelated taxpayers) and the Treasury Department's practice in applying s1.482, particularly in the context of income tax treaties, should prevail.

New opinion

In the new opinion Reinhardt J and Noonan J essentially retain their respective positions, with Noonan J, now writing for the court, focusing on the overall purpose and treaty interpretation, and Reinhardt J, now in dissent, focusing on the canon of the specific over the general, as well as the mandate of "clear reflection of income...to prevent the

avoidance of taxes" of Treas. Reg. s1.482-1(a)(1). Fisher J, however, now agrees with Noonan J, if for different reasons.

In writing his concurring opinion, Fisher J continued his belief that the regulations are "hopelessly ambiguous" but has now concluded that "the ambiguity should be resolved in favour of what appears to be the commonly held understanding of the meaning and purpose of the arm's length standard prior to this litigation".

In reaching this conclusion, Fisher J comments that he considered not only the plain language of the regulations but also various interpretive tools brought before the court by the *amici*, including the regulatory history, the drafting history of the regulations, persuasive authority from international tax treaties and "what appears to be the understanding of corporate taxpayers in similar circumstances".

Ultimately, Fisher J appears to have been persuaded by the difficulty faced by the IRS in seeking to justify its position. Fisher J states that "the Commissioner's attempts to square the 'all costs' regulations with the arm's length standard have only succeeded in demonstrating that the regulations are at best ambiguous". To those ends, Fisher J notes that he was:

"troubled by the complex, theoretical nature of many of the Commissioner's arguments trying to reconcile the two regulations. Not only does this make it difficult for the court to navigate the regulatory framework, it shows that taxpayers have not been given clear, fair notice of how the regulations will affect them."

Thus, Fisher J concludes, "Xilinx's understanding of the regulations is the more reasonable even if the Commissioner's current interpretation may be theoretically plausible".

Impact

As a result of this new opinion, it is likely that taxpayers will challenge the post-2003 cost-sharing regulations, which specifically require the sharing of stock-based compensation. It provides hope for taxpayers who believe that the current rules requiring the inclusion of stock-based compensation are invalid because they are inconsistent with the arm's-length standard.

Implications from an Irish perspective

As stated above, it is likely that the US transfer pricing documentation will be relied on for Irish transfer pricing purposes in most cases, to the extent that the documents have been prepared in accordance with OECD standards. Therefore it is necessary to consider whether the IRS position adopted in the *Xilinx* case (which related to the 1995

cost-sharing regulations) and its current position was/is in line with OECD standards.

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as published in July 2010 (“OECD Guidelines”) (in the section dealing with cost contribution arrangements (CCAs)) state that:

“For the conditions of a CCA to satisfy the arm’s length principle, a participant’s contributions must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to derive from the arrangement.”

In the *Xilinx* case, the taxpayer argued that stock-based compensation did not need to be shared because unrelated parties would not share such costs. This position was accepted by the Tax Court and upheld by the Ninth Circuit.

Therefore, as stated above, there is a risk that the existing US cost-sharing regulations, which require stock-based compensation to be included in the pool of costs to be shared between the parties, are not in line with the arm’s-length standard as set out by the OECD Guidelines. If the Irish Revenue Commissioners took the view that stock-based compensation should not be shared, an issue would arise regarding the deductibility of that element of the cost-sharing payments made by Irish companies and the acceptability of the CSA documentation for Irish transfer pricing purposes. The issue of cost-sharing stock-based remuneration is not confined to the United States. Many other countries are also considering how the issue should be treated. Therefore there are likely to be further developments in this area.

Veritas Decision

Taxpayers won an unequivocal victory in *Veritas Software Corp. v Commissioner*, which dealt with the treatment of a taxpayer’s CSA with its Irish subsidiary to which pre-existing intangible property rights had been assigned. The court rejected the IRS adjustment of the cost-sharing buy-in payment received by Veritas Software Corp. from its Irish affiliate on the basis that it was arbitrary, capricious and unreasonable.

Background

The background to the case is that in November 1999 Veritas–US and Veritas–Ireland entered into several inter-company agreements, including a CSA, a licence agreement and an agreement to assign to Veritas–Ireland certain European sales agreements. After auditing the

inter-company transactions, the IRS issued a notice of deficiency in March 2006 based on an expert’s valuation report that valued the transferred rights at \$2.5bn, using a combination of forgone profits, market capitalisation and third-party acquisition price methods. Veritas–US objected to the determination and filed a petition in the Tax Court. In the Tax Court, the IRS abandoned the original expert’s opinion on which the notice of deficiency was based and submitted a new analysis. The new analysis valued the intangibles and other property transferred to Veritas–Ireland in the aggregate by applying a discounted cash-flow or “income method” using a perpetual life. The new analysis appeared to be consistent with the IRS methods contained in the

“Coordinated Issues Paper on Cost Sharing Buy-In Adjustments” and the new cost-sharing regulations.

The Tax Court rejected the IRS’s approach and held that the IRS’s \$1.482 allocation was arbitrary, capricious and unreasonable because:

- › the IRS’s valuation method inappropriately aggregated the transferred property even though there was no evidence that such aggregation was appropriate under the regulations,
- › the IRS’s valuation using a discounted cash-flow or income method that assumed a perpetual life (characterised by the court as “akin to a sale”) was not a reasonable valuation method for short-lived intangibles in this case,
- › Veritas–US’s distribution relationships and customer lists had no value outside the United States,
- › access to Veritas–US’s R&D and marketing teams was not transferred or had no value apart from the services of individuals engaged in those activities and
- › the IRS’s valuation was not limited to pre-existing technology as required by the applicable regulations but rather included the value of technology subsequently developed under the CSA.

The court determined that the best method to determine the value of the buy-in payment was a comparison of the buy-in licence agreement to Veritas–US’s third-party licences with original equipment manufacturers (OEMs) for technology in which Veritas–US did not have any requirement to update the software.

As a result of this new opinion, it is likely that taxpayers will challenge the post-2003 cost-sharing regulations, which specifically require the sharing of stock-based compensation.

IRS's Action on Decision

It had been expected that the IRS would appeal the decision, but the appeal deadline of 8 November 2010 passed without its filing a notice of appeal. However, the IRS issued an Action on Decision on 10 November 2010 stating that it does not acquiesce in the result or reasoning of the opinion issued by the US Tax Court in the *Veritas* case. The IRS stated that it disagrees with the court's factual findings and that the court's broad assertions on the governing law were unnecessary and "could be inappropriately relied on by taxpayers in planning future transactions".

The Action on Decision confirms that the IRS:

"will continue to apply an aggregate valuation to interrelated transactions related to a cost-sharing agreement where, under the facts and circumstances, such valuation provides the most reliable measure of an arm's length result".

Impact of *Veritas* decision

We are not aware of any cases pending in the courts in which the IRS and taxpayers are disputing the amount of a buy-in payment in a CSA.

Even if a case is docketed, the timespan from docketing a transfer pricing case to the issuance of the court's opinion is usually several years. Therefore, another decision is not likely to be issued for many years. Thus, for many taxpayers that made buy-in payments subject to the pre-2009 regulations, another court decision is unlikely to affect the resolution of the amount of their buy-in payments for most, if not all, years. For those taxpayers, the *Veritas* decision may be the final word on buy-in payments under the old regulations.

As a practical matter, for years governed by the pre-2009 regulations that are currently under IRS examination or in appeals, the IRS must address the Tax Court's decision in *Veritas* when examining cost-sharing buy-in payments computed under the prior regulations. In many cases, the large adjustments made by IRS field economists based on the income method using a perpetual life are not likely to be sustained in full.

There are many factual aspects of *Veritas* that taxpayers seeking the best settlement position may need to prove. For example, in *Veritas* the taxpayer presented evidence on both useful life and the royalty ramp-down, crucial factors in determining the value of the

technology intangibles. In addition, the court reviewed each of the intangibles transferred to *Veritas*-Ireland and the value assigned to each of those intangibles. In some cases, taxpayers may have to examine whether their buy-in analyses took those intangibles into account and whether they have adequate support for the valuation of those intangibles.

The court also examined the underlying factual support for the taxpayer's comparable uncontrolled transaction (CUT) method in *Veritas* and made certain adjustments to the taxpayer's CUTs. Taxpayers should be prepared to support factually the assumptions they make in their valuation analyses, whether the method used is the CUT, the residual profits method or any other. Although the court did not accept the IRS's income method, the taxpayer in *Veritas* was still required to support the appropriateness of its method. In appeals, taxpayers can expect any settlement to be very fact-specific, and the stronger the factual support, the more likely that a satisfactory resolution will result.

The Treasury Department issued temporary cost-sharing regulations on 5 January 2009. The Tax Court's decision has no direct bearing on

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those regulations. As a practical matter, the IRS's position in *Veritas* is likely to be much stronger when litigated under the temporary regulations. The temporary regulations prescribe the income method as a specified method and arguably provide stronger rules permitting the IRS to aggregate transactions. The additional guidance in the Action on Decision on intangible property useful life, however, may reduce or eliminate the IRS's assertions of a perpetual life and open the door to meaningful discussions of the useful life of pre-existing intangibles.

Implications from an Irish perspective

As stated above, the IRS raised the assessment on *Veritas* using the forgone profits, market capitalisation and third-party acquisition price methods but subsequently changed its approach to a discounted cash-flow using a perpetual life. We consider below whether the IRS's approach was in line with OECD standards.

The OECD Guidelines state that "any transfer of pre-existing rights from participants to a new entrant must be compensated based upon an arm's length value for the transferred interest". Therefore it suggests that the buy-in payment should relate only to the pre-existing intangibles and should not take into account any future development. The guidelines do not include the concept that pre-existing intangibles

have an indefinite life. In fact, future development is provided for in the CSA if it is based on arm's-length principles, as each party should contribute its share of the costs in line with its expected benefits. On that basis, any valuation methodology used should only be in respect of the pre-existing intangibles.

In the *Veritas* case some of the arguments made by the IRS were based on the current regulations. To the extent that a US taxpayer adopts a position in accordance with those regulations and based on the concept of perpetual life, there is a risk that that position may not be in line with the OECD Guidelines; however, it will depend on the specific facts of the case. The suitability of a transfer pricing methodology will depend on the particular facts of the case; however, Irish subsidiaries need to ensure that any arrangements entered into with their US related parties that are compliant with US transfer pricing legislation and regulations are also compliant with OECD Guidelines and therefore acceptable from an Irish transfer pricing perspective.

Introduction of Schedule UTP

At the beginning of 2010 the IRS announced that it was implementing a “game-changing strategy”, which included the development of a schedule on which taxpayers would report uncertain tax positions as determined for financial accounting purposes on their US federal income tax returns. The schedule (Schedule UTP) was finalised in September 2010.

The taxpayer must satisfy the following conditions before it is required to file a Schedule UTP:

- › it is a corporation that files one of a number of US tax returns,
- › it has assets equal to or exceeding \$100m for the year ending in 2010 (reduced to \$50m in 2012 and \$10m in 2014),
- › it issues audited financial statements or is included in audited financial statements issued by a related party, whether filed under US GAAP or IFRS, that cover all or a portion of the taxpayer's operations for the tax year and
- › it has one or more tax positions that must be reported on the Schedule UTP.

A taxpayer must report uncertain tax positions if a reserve for the tax position is recorded in the taxpayer's financial statements, or if no reserve is recorded because the taxpayer expects to litigate the tax position (where the probability of settling with the IRS is less than 50% and the taxpayer is more likely than not to prevail on the merits).

The schedule requires that transfer pricing positions are identified separately from general tax positions.

The IRS is expected to focus its audit efforts on the information gathered through the Schedules UTP submitted by taxpayers, and therefore whether something is reported as an uncertain tax position in a company's financial statements will require even further consideration than before, due to the potential impact from a tax audit perspective. This in turn brings added focus to transfer pricing and demonstrates the need to devote specialist skills to the analysis so that the nuances between the US and Ireland are adequately dealt with in this analysis.

Proposed Legislation

In the past number of years some members of Congress, as well as Treasury Department and administration officials, have suggested that the current transfer pricing rules are inadequate to protect the tax returns. Recent developments include the following:

- › On 20 July 2010 the staff of the Joint Committee on Taxation prepared a document for the House Committee on Ways and Means, based on a review of public and private information on six unnamed companies, to identify business structures that facilitate possible income shifting or deficiencies in the application of the transfer pricing laws.
- › On 22 July 2010, at the Ways and Means Committee hearing for which the Joint Committee report was prepared, several witnesses testified that the current transfer pricing rules were inadequate and allowed taxpayers to shift substantial amounts of income offshore.
- › The President's Fiscal Year 2011 Budget Proposal contained a proposal to tax currently “excess returns” associated with transfers of intangibles offshore and a proposal to clarify the fact that goodwill, going-concern value and workforce in place are intangibles under ss1.482 and 1.367(d).

Conclusion

The US transfer pricing landscape is expected to continue to evolve, and the changes will continue to have an impact on Irish subsidiaries of US multinational companies. Also, as time passes, there is likely to be further guidance in relation to the Irish transfer pricing legislation as practical issues in relation to its application arise. Therefore it will be necessary for Irish subsidiaries of US multinationals to monitor closely the developments in both jurisdictions.