TRANSFER PRICING DEVELOPMENTS

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Competent Authority Update

- Memorandum of Understanding (MOUs) signed between Canadian and U.S. CAs have not been utilized
- 10 Advanced Pricing Agreements (APAs) were completed in 2006; 17 were accepted into the APA program
- Consignment manufacturing continues to be an obstacle for Canada/U.S. negotiations
- Significant changes are being made to APA rollbacks and the application of potential penalties

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Competent Authority Update

- The CRA will not negotiate adjustments to Canada-US transactions that are past 6 years if the U.S. returns are closed
- Telescoping
- Accelerated Competent Authority Procedure (ACAP) continues to be utilized
- The CRA has not granted interest relief in any competent authority cases

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Competent Authority Update

- 3 MOUs signed between the Canadian and U.S. CA's were designed to improve the process
  - June 3, 2005 a MOU was signed establishing the guidelines for CA analysts
  - July 27, 2005 a 2nd MOU was signed delegating senior officials to work on issues identified as likely resulting in double taxation
  - December 8, 2005 a MOU was signed on resolving factual disputes
- There has been minimal use of the MOUs to date

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Competent Authority Update

- Summary of APA Program over the 2004-2006 year

Taxation Year	Completed APA's	Accepted APA's	Closing Inventory	Prefiling Meetings	Unresolved
2006	10	17	41	18	1
2005	17	14	35	25	1
2004	17	18	39	23	0

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Competent Authority Update

- Files involving consignment manufacturing continue to be a contentious issue facing IRS/CRA negotiations
- The CRA and IRS have a fundamental disagreement on how to approach the issue resulting in large gaps between agreed results
- Cases involving consignment manufacturing still in negotiation stage - both governments have stated a desire to resolve the issue through principled negotiations

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Competent Authority Update

- A rollback will no longer be considered for Unilateral APAs
  - The CRA has a concern that corresponding adjustments are not being made to the tax returns of non-residents in situations where downward adjustments are allowed in Canada

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Competent Authority Update

- A rollback, requested as part of an APA, will no longer be considered for a taxation year where the CRA has issued a 90 day letter
- However, if a taxpayer requests a rollback before the 90 day letter has been issued, it is equivalent to a voluntary disclosure
  - Rationale: rollback is not intended to replace an audit or as a mechanism for avoiding an audit

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Competent Authority Update

- If a 90 day letter has not been issued, an auditor will not make a referral to the Transfer Pricing Review Committee (TPRC) if an upward adjustment in a rollback year exceeds the penalty threshold
  - This may create an incentive to apply for an APA in situations where contemporaneous documentation was not prepared for prior years as it reduces exposure to transfer pricing penalties that could come about in a random audit

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Competent Authority Update

- Canadian CA is facing significant staffing issues
- Many staff are leaving:
  - Retirements
  - Private sector
  - Moving on to other governmental departments
- Hiring process is underway to increase the number of auditors and managers. Approx. 12 new staff to be hired.
- Lack of trained staff will delay the speed in which cases are resolved.
- New Director just hired

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Competent Authority Update

- Stated policy of the Canadian CA is to not negotiate field adjustments past the 6-year mark if the return is closed domestically in the U.S.
- The Canadian CA will neither review or negotiate such files
- This NEW approach puts taxpayer's in an unfair position with no mechanisms in place to alleviate double taxation, other than Appeals
- IRS/CRA meetings have been changed from quarterly meetings to 3 meetings per year

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Competent Authority Update

- ACAP allows taxpayers who request CA assistance to apply the CA decision to subsequent taxation years when the same issues/facts are present
- ACAP is being utilized
- ACAP will be more restrictive

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Competent Authority Update

- No interest relief has yet been granted by CA
- Competent Authority and Appeals are still discussing the reasons for a January 2005 start date

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Competent Authority Update

- Small Business APAs have not resulted in significant numbers of requests
- Small Business APAs have resulted in companies not abiding by positions presented in requests

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Competent Authority Update

- Significant changes have recently occurred in the Canadian CA
  - Rollbacks no longer considered for unilateral APAs
  - A rollback will no longer be considered for a taxation year where the CRA has issued a 90 day letter
  - If a 90 day letter has not been issued, auditors will not make a referral to the TPRC

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Competent Authority Update

- CRA adjustments to Canada-US transactions beyond the 6 year time limit will likely result in double tax
- Over the next year Canadian CA resources may be insufficient to resolve cases in a timely manner
- The CRA and IRS negotiations still face significant challenges, though mechanisms in place can relieve taxpayers of potential double taxation

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IRS Field Directive on 936 Exit Strategies

- The § 936 Credit for "Possessions Corporations" was phased out over a 10-year period ending in 2006
- On 2/2/07, the IRS issued a directive related to the auditing of "Section 936 Exit Strategies"
- Designated a "Tier I" compliance issue
  - Hence, LMBS-wide coordination and oversight required
  - Designed to ensure consistent development and resolution of issues
  - Field agents' discretion will be curtailed

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IRS Field Directive: Practical Effect

- The primary focus of the directive is on intangible transfers
  - Outbound transfer to New CFC typically treated as tax-free under "active business exception"
  - New CFC licenses IP from the U.S.
- IRS position is that "assembled workforce in place" does not qualify for active business exception
  - States that section 367(d) applies to all IP other than goodwill and going concern value
  - Relies on *Ithaca Industries* holding that workforce in place is separate from going concern value
  - Ignores limitation of section 367(d) to IP described in section 936(h)(3)(B)

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Legal Advice Regarding Taxpayer Use of § 482 and Commensurate with Income Standard (3/15/07)

- CWI standard must be interpreted consistently with the arm's length standard
- The "income" in the phrase "commensurate with income" refers to "reasonably and conscientiously" projected income
  - Actual profits used to assess reasonableness of taxpayer's projections
  - Taxpayer can rebut presumption created by actual results

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Legal Advice Regarding Taxpayer Use of § 482 and Commensurate with Income Standard (3/15/07)

- Taxpayer can apply section 482 affirmatively only:
  - On a timely filed original return
  - To the extent provided in setoff rules following IRS adjustment
  - Generally, CWI not available to discredit taxpayer's own projections
- Taxpayer's specified form of buy-in payment under a cost sharing agreement will be respected if consistent with economic substance
- IRS Appeals should base settlements on US internal law without reference to the OECD guidelines
  - U.S. law is consistent with OECD guidelines
  - The guidelines exist to provide a "common reference point" for Competent Authorities

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Field Directive on Transfer of Intangibles Offshore/§ 482 Cost Sharing Buy-in (4/5/07)

- The transfer of intangibles offshore/§ 482 buy-in determination is designated a Tier I issue
- Final cost sharing regulations are expected mid-2007
- Reference to proposed regulations seems to endorse the "investor model" as a "fundamental principle" applicable to current determinations

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Current Enforcement Environment

- Feedback from IRS Field regarding "abusive" transfer pricing practices
- Media attention on "abusive" transfer pricing practices
- Pressure to act from Congress
  - Call for study of transfer pricing issues in 2004 JOBS Act
  - Senate Finance Committee investigation of Competent Authority and APA Programs
  - Grassley/Snow exchange regarding cost sharing
- Transfer Pricing and the Tax Gap

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Current Enforcement Environment

- Consequences:
  - Increased focus by Treasury and the IRS on transfer pricing enforcement and rulemaking
  - Potential for overreaching
    - Assertion of significant adjustments and penalties
    - Theoretical purity at the expense of practical standards and empirical evidence
    - New rules that overturn longstanding business arrangements
  - Increased resources to back up rhetoric?

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Retrospective Application of Policy Developments

- Line between prospective regulatory developments and retrospective audit activity is becoming increasingly blurred
  - *Xilinx* – attempt to apply standards in 2003 stock option regulations to prior tax years
  - Cost sharing buy-ins – attempt to apply standards of proposed 2005 cost sharing regulations to current cases
  - Cost safe harbor – attempt to apply standards of proposed 2003 services regulations to current cases
- Courts historically have rejected such attempts

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Transfer Pricing: Regulatory Developments

- Proposed Cost Sharing Regulations to be finalized
  - Viewed as "anti-abuse" rules
  - Intended to address so-called "buy-in" issue
  - IRS has indicated that it is open to input on some issues, including grandfathering of existing arrangements
- Updated Temporary Services Regulations in force
  - Pre-2007 cost safe harbor for "non-integral" services available in modified form for 2007 only
  - Temporary regulations otherwise applicable, and come into force in full in 2008

Transfer Pricing: Regulatory Developments

- Issues in Temporary Services Regulations
  - New standard for stewardship expenses
  - Applicability of services cost method narrower than 1968 cost safe harbor
    - Addressing business judgment test (2007)
    - Post-2007, relatively routine services may require mark-up
  - Treatment of stock option costs
  - Companies must review and update transfer pricing policies

U.S. Transfer Pricing Litigation: *GlaxoSmithKline*

- *GlaxoSmithKline Holdings (Americas) Inc. v. Commr,* Nos. 5750-04 and 6959-05
  - GlaxoSmithKline pays $3.4 billion of tax and interest to settle longstanding transfer pricing dispute
  - Issue in case: whether U.S. marketer/distributor of pharmaceuticals invented in the U.K. received a sufficient share of system profits from U.S. sales of the products, e.g. blockbuster anti-ulcerant *Zantac*
  - IRS has trumpeted settlement, and is predicting future settlements and/or victories of similar magnitude
  - Implications for other cases unclear

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U.S. Transfer Pricing Litigation: *Xilinx*

- *Xilinx Inc. v. Commr,* 125 T.C. 37 (2005), on appeal
  - Tax Court's holding: arm's-length standard applies for purposes of determining whether stock option expense must be cost-shared; taxpayer proved that unrelated parties would not share such expenses
  - Government has appealed
    - Concedes that "uncontrolled parties dealing at arm's length in a joint venture to develop intangibles would not share the cost of compensatory stock options"
    - Pressing legal argument: sharing of all costs required under comprehensive regulatory scheme

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U.S. Transfer Pricing Litigation: *Xilinx*

- *Xilinx*, cont'd
  - Implications:
    - Arm's-length standard applies *in every case*
    - Commensurate with income standard merely supplements and supports arm's-length standard
    - Imperfect comparability evidence trumps theoretical arguments
    - Treasury's view of cost-sharing

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U.S. Transfer Pricing Litigation: *Symantec*

- *Veritas Software Corp. (subsidiary of Symantec Corp.) v. Comr.*, T.C. No. 12075-06
  - Issue in the case: buy-in payment due in context of cost sharing arrangement for pre-existing IP
  - Amounts at issue: $2.4 billion allocation of income
  - First of many buy-in disputes that are working their way through the administrative process and may be litigated
  - Trial scheduled for summer 2007

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U.S. Transfer Pricing Litigation: *Claymont*

- *Claymont Investments, Inc. v. Commr,* TC Memo 2005-254 (10/31/2005)
  - Facts: US sub's 8-year-old debt to foreign sister company assumed by domestic sister company, resulting in deferred exchange gain; interest rate no longer arm's-length at time of assumption
  - IRS objective: recast assumption as a new loan, requiring immediate inclusion of exchange gain by US consolidated group

U.S. Transfer Pricing Litigation: *Claymont*

- *Claymont*, cont'd
  - Holding:
    - Commissioner may not collapse independent transactions under authority of section 482
    - But could adjust intercompany interest rate to reflect arm's-length rate
  - Case shows IRS is still aggressive in pushing the limits of its discretion under section 482

Canadian Transfer Pricing Litigation: Settled or Heard

- *Glaxo Smithkline* – settled
- *BMO Nesbitt Burns* – settled
- *Glaxo Wellcome Inc.* – heard in Summer 2006

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Canadian Transfer Pricing Litigation To Watch For

- *Wyeth-Ayerst Canada Inc.*
  - highlights an increasingly common fact pattern
  - Canadian company providing contract R & D services to a related party
  - dispute is over the mark-up to be earned by Canadian company for R&D – cost plus?
  - Minister accepted the taxpayer's methodology but disagreed with the mark-up – the taxpayer was charging cost plus 8%; CRA reassessed at cost plus 10% and 12%

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Canadian Transfer Pricing Litigation To Watch For

- *Bridges Brothers Limited*
  - a small case in terms of dollar value
  - sales of blueberries by producer to related broker; CRA argues intercompany price is too low
  - taxpayer arguing CUP method applies
  - case is interesting because of the Crown's reliance on multiple year data (contrary to CRA policy)

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Canadian Transfer Pricing Litigation To Watch For

- *H&R Block Canada Inc.*
  - intercompany management service charges
  - interest on such charges
  - Canadian business development expenses
  - taxpayer argues the fees were reasonable, used cost of supply approach
  - CRA not just looking at mark-up but at justification for fees

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Canadian Transfer Pricing Litigation to Watch For

- *Tregaskiss Limited*
  - Canco incorporates wholly-owned Barbados sub to sell to Canco's existing clients (wholesale distributors); Canco gives BarbCo exclusive rights (outside) Canada
  - CRA argued Canco transferred "its business" to BarbCo for no consideration
  - Canco alleging that CRA recharacterized BarbCo's operations as a call centre and argues that pre-conditions in 247(2)(d) are not met
  - Taxpayer argues the BarbCo did much more than just act as a call centre, and that the Minister ignored the "true" substantive relationship
  - Minister rejecting taxpayer's CUP and relying on TNMM

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Marketing Intangibles

- the issue is a problem the world over – in part may depend on local country IP laws
- audit risk issue in Canada
- start with the arm's length principle

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Marketing Intangibles

- Does a marketing/sales company that creates brand loyalty/recognition and increases overall profit but that has no legal right to any product IP create an asset or intangible for which the company should be compensated?

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Marketing Intangibles

- CRA view: IC87-2R
- what is an intangible?
  patents, trademarks, copyrights
  as well as property the ownership of which is not legally protected (goodwill and know how)
- Canada does not recognize economic ownership
- as one author has argued, how can there be value in something that cannot be legally protected?

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Marketing Intangibles

- CRA: a non legal owner of IP may be entitled to an economic return based on contribution, paragraph 98

  "although one member… often develops a product intangible, another member… may expend considerable effort in developing a marketing intangible in a specific geographical location"

- Paragraph 148 sets out guidelines for allocations of profit to local marketing activities

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The Auditor General's 2007 Report

- In recent years, one of the best forecasting tools for future audit practices has been the annual Auditor General's Report

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The Auditor General's 2007 Report

- Chapter 7 International Taxation
  1. CRA should improve/expand its access to information to identify and assess emerging international tax risks (working with other tax administrations)

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The Auditor General's 2007 Report

2. CRA should improve the use of formal requirements to provide information.

> "*The Agency is still not routinely using these provisions in situations where taxpayers failed to provide the information it requested. In the 2004-05 fiscal year, the Agency only used the treaty provisions to request information from foreign governments 135 times, and, on average, it took over 400 days to receive this information. This is similar to what we found in our 2002 report. In 2004, the Agency – out of the 800 international audits underway or completed that year – only issued eight requirements to taxpayers to produce foreign information.*"

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