

# US Tax Update

Margreet Nijhof  
Jan-Willem Gerritsen



# Agenda

- The 9th Circuit: Curbing the IRS' View of Section 482
- FY2011 International Tax Proposals
- Reporting of Uncertain Tax Positions
- Treaty Update

A profile photograph of Barack Obama, looking towards the left. He is wearing a dark suit, a white shirt, and a blue striped tie. The background is a blurred American flag. The text is overlaid in the lower-left quadrant.

The 9th Circuit –  
Curbing the IRS' View  
of Section 482

# Veritas – The Tax Court’s Opinion on IP Valuation

- December 10, 2009 – Major taxpayer victory
- Tax Court decided first buy-in valuation case under section 482.
- IRS originally proposed \$2.4 billion in income adjustments and \$300 million in penalties. At time of trial, IRS conceded all penalties and reduced its proposed adjustment to \$1.6 billion.
- Litany of IRS errors in Veritas (e.g., wrong intangibles, wrong useful life, wrong discount rate, wrong regs etc)
- Complete Taxpayer victory: Tax Court accepted Veritas’ CUT analysis with some adjustments and rejected the IRS’s income method.
  - Judge Foley held that the Income Method, specifically advocated by the IRS in the Veritas case and the IRS’ 2007 CIP in buy-in audits was arbitrary, capricious and unreasonable.

# Veritas – The Tax Court’s Opinion on IP Valuation

## *Hatch’s Testimony (IRS Expert Witness)*

*“Hatch ultimately conceded that a 1.42 beta could not to a reasonable degree of economic certainty, be the correct beta.”*

*“Did they have any value? I don’t have any opinion on that. I have no idea.”*

*The Tax Court: “His testimony was unsupported, unreliable and thoroughly unconvincing. Indeed the credible elements of his testimony were the numerous concessions and capitulations”*

# Veritas – The Tax Court’s Opinion on IP Valuation

Judge Foley ruling:

“Arbitrary, Capricious and Unreasonable”

Reasons:

- Short life intangibles
- No separate valuations
- IRS allocation relied upon items not transferred or of insignificant value
- Insufficient evidence to conclude that “access” to VUS R&D was transferred
- Subsequent development of IP (add-ons) were improperly taken into account
- Hatch’s method employed the wrong useful life, the wrong discount rate, and an unrealistic growth rate
- Hatch employed the wrong beta, the wrong equity risk premium.

# Xilinx – Stock Option Expense

- Another major tax payer victory.
- Issue: Should the stock option related expenses be included in the cost pool of R&D expenses that are shared under the cost sharing arrangement entered into by two related parties?
- Years at issue: 1997-1999
- Cost sharing regulations
  - 2003 Amendment
  - 2009 Temporary cost sharing regulations

# Xilinx – Stock Option Expense

## – Procedural history

- August 30, 2005: Tax Court rules in favor of Xilinx - unrelated parties would not share any stock option costs
- May 27, 2009: 9th Circuit reverses the Tax Court - the cost-sharing Regulations for 1997-99 required that related companies had to share all costs, including the cost of employee stock options.
- January 13, 2010: 9th Circuit opinion withdrawn.
- March 22, 2010: 9th Circuit issues a revised opinion – affirms Tax Court decision



FY2011

International Tax Proposals

# FY2011 International Tax Proposals

- The “2011 Green Book” - Published February 2010
- Proposals continue the fiscal objectives and the tax policies of the Obama Administration from the 2010 Green Book.
- Generally a scaled back version of the 2010 Green Book.
- Set to Raise \$122 Billion over ten year (down from \$151 billion last year).
- Generally effective for taxable years after December 31, 2010.
- Post-healthcare legislative environment.

# FY2011 International Tax Proposals

- Free Pass for Check-the-Box?
  - The 2011 Green Book does not contain a proposal which would have limited the availability of the “check-the-box election” with respect to certain wholly-owned foreign entities.
  - Acting Treasury Secretary for Tax Policy Michael Mundaca: “We remain concerned about these structures.”

# FY2011 International Tax Proposals

- Less draconian on Deferral of Deductions
  - In 2011 Green Book, deferral only applies to interest expense properly allocated and apportioned to a taxpayer's foreign-source income that is not currently subject to U.S. tax.
  - In 2010 Green Book, all expenses other than research and development expenses also were subject to deferral.
  - Principal bucket of income no longer subject to the limits on deferral relate to headquarter expenses.
    - Mundaca: “We are very focused on producing and maintaining jobs in the U.S.”
  - Transfer pricing as a backstop?

# FY2011 International Tax Proposals

- New subpart F Rule for Excessive Returns from Migrated Intangibles
  - The proposal would treat, as subpart F income, any “excessive returns” on income from intangibles shifted out of the U.S. to related CFCs subject to a low effective tax rate.
  - Mundaca: “Baseline of 10% or less as a low effective tax rate and 30% or more as an excessive return subject to such a rate.”
  - Reason: IP migrations have put significant pressure on the enforcement and effective application of the transfer pricing rules (witness Veritas).

# FY2011 International Tax Proposals

- Limit Shifting of Income through IP Transfers
  - Clarifies the definition of intangible property for purposes of sections 367(d) and section 482.
    - Workforce in place, goodwill and going concern value to be included in the definition of intangible property.
    - Valuation based on an aggregated basis where multiple intangible properties are transferred.
    - Commissioner may take into consideration in the valuation the price/profits the transferor could have realized by choosing a realistic alternative to the controlled transaction.
    - Inconsistencies with non-US tax rules?

# FY2011 International Tax Proposals

## – Foreign Tax Credit Reform – Pooling

- Current rule: FTC is limited to an amount equal to pre-credit U.S. tax on the taxpayer's foreign source income. FTC limitation is applied separately to foreign-source income that is from the passive category and general category.
  - Cross crediting opportunities & selective distributions
- Proposal: FTC on a consolidated basis based on the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries (including lower tier subsidiaries).
  - Based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. in the taxable year.

# FY2011 International Tax Proposals

- Codification of Economic Substance
  - Current law - Economic Substance:
    - Common law doctrine: Denies tax benefits from a transaction that does not meaningfully change a taxpayer's economic position, other than tax consequences, even if the transaction literally satisfies the requirements of the Internal Revenue Code.
      - Courts have applied the judicial doctrine but not uniformly.

# FY2011 International Tax Proposals

- Included in Health Care Bill!
  - Effective once signed
- Transaction shall be treated as having economic substance if (i) it changes in a meaningful way (apart from the federal tax effects) the taxpayer's economic position and (ii) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.
  - Present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the net federal tax benefits arising from the transaction.
  - Foreign taxes shall be taken into account as expenses in determining pre-tax profit



# Reporting of Uncertain Tax Positions

# Reporting of Uncertain Tax Positions

- Announcement 2010-9 (as clarified by Announcement 2010-17)
  - IRS considering requiring certain business taxpayers to disclose their uncertain tax positions with respect to their U.S. federal income tax liability on a schedule that would be attached to their Form 1120 U.S. CIT return, or other return.
    - Focus examination resources on issues of particular interest or of sufficient magnitude
    - Quick and efficient identification of issues

# Reporting of Uncertain Tax Positions

- Schedule would require a concise description of each uncertain tax position and for which the taxpayer has recorded a reserve
  - Report all federal income tax positions except those for which the taxpayer has concluded, after applying the two-step process, that are more likely than not to be 100-percent sustained.
  - In addition, taxpayer will be required to report any position for which it or a related entity has not recorded a reserve either because the taxpayer expects to litigate the position (and prevail) or because the taxpayer has determined that IRS has a general administrative practice not to examine the position (e.g., because of materiality threshold).

# Reporting of Uncertain Tax Positions

- Description must include, *inter alia*:
  - The rationale for the position
  - General statement of the reasons that the position is an uncertain tax position.
  - Description of the Code sections implicated
  - Taxable years to which it relates.
  - Schedule will require the taxpayer to disclose the maximum amount of potential federal tax liability attributable to each uncertain tax position, determined without regard to the taxpayer's risk analysis regarding the likelihood of prevailing on the merits.



Treaty Update

# Overview of Recent Treaty Developments

- Recently, four treaties signed containing mandatory arbitration provisions – “baseball style arbitration”
  - Belgium (2008)
  - Canada (2009)
  - France – not yet ratified
  - Germany (2008)
  - One more expected

# Overview of Recent Treaty Developments

- U.S. – Hungary Treaty signed
  - Introduction of LOB clause
  - Limits use of many Hungarian royalty and interest structures
- Renegotiation of treaty with Poland on last round.
  - Will finish round of renegotiations of treaties where LOB concern
- Opening of treaty renegotiations with Spain.
- Swiss treaty protocol pending before the Senate.
- No expectations regarding treaty negotiations with Singapore unless significant taxpayer interest.



Wrap Up

# Thank You!

Pursuant to requirements relating to practice before the Internal Revenue Service, any tax advice in this communication (including any attachments) is not intended to be used, and cannot be used, for the purpose of (i) avoiding penalties imposed under the United States Internal Revenue Code, or (ii) promoting, marketing or recommending to another person any tax related matter.

Baker & McKenzie International is a Swiss Verein with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a “partner” means a person who is a partner, or equivalent, in such a law firm. Similarly, reference to an “office” means an office of any such law firm.