Lead Report

Practitioners Say Recent Comments by Maruca, JCT Could Signal Changes to U.S. Cost Sharing Regime

Recent comments from an Internal Revenue Service official as well as those from the Joint Committee on Taxation could signal major changes to the U.S. cost sharing regime, according to practitioners interviewed by BNA Tax Management.

Practitioners welcomed the June 8 statement by Samuel Maruca, the IRS's newly appointed director of transfer pricing operations, that the IRS's experience with cost sharing "teaches a valuable lesson, which is this: coordinated issue papers, however flexible and nuanced, are likely not the best vehicle for transmitting guidance to the field, except maybe with respect to true 'cookie-cutter' tax strategies" (20 *Transfer Pricing Report* 152, 6/16/11).

Maruca's comment is being interpreted as a welcome move away from a September 2007 CIP that, according to practitioners, caused auditors to assume a specific, aggressive fact pattern on the part of taxpayers in cost sharing cases.

Meanwhile, language on cost sharing in the Joint Committee on Taxation's June 14 description of the Obama administration's revenue proposals provoked a different response. The committee raised the fundamental question of whether it is appropriate to respect cost sharing arrangements, saying that "the appropriateness of respecting cost sharing arrangements among related parties could be explored. . . . Examining the extent to which the existing framework encourages outbound transfers of intangible property may lead to reconsideration of the merits of respecting cost sharing arrangements and suggest a new, more limited framework" (20 *Transfer Pricing Report* 151, 6/16/11).

According to the principal author of the 2008 temporary cost sharing regulations, abolishing or even limiting those regulations would put U.S.-based multinational companies at a competitive disadvantage with entities that are allowed to cost share.

Understanding the Taxpayer

Practitioners said Maruca's comments could signal a move toward increased efficiency and transparency in audits of cost sharing cases.

Following his remark about coordinated issue papers, Maruca said the IRS in future audits plans to focus more on understanding the taxpayer's operations: "In the majority of transfer pricing cases, we need to use more fundamental building blocks that are focused on old-fashioned, rigorous fact development and analysis. Put another way, the methodology comes second—the first priority of the IE will be to understand the business and its economics. It takes more time and effort, for sure, but it will optimize outcomes."

Robert Kirschenbaum of Miller & Chevalier in Washington, D.C., said the IRS too often in the past has ignored pertinent facts respective to the case under review.

"There was too great of a tendency during the last several years following the issuance of the CIP to default to the CIP method without giving sufficient thought to the underlying facts associated with the particular transaction in question," he said.

Soon after the release of the CIP—which advised examiners on how to analyze common positions taken by taxpayers in reporting reduced amounts for buy-in payments—practitioners said the paper wrongly assumed a number of facts about cost sharing arrangements, including that the foreign partner plays a limited role and that the value of the originally contributed intangible property does not diminish over time (16 *Transfer Pricing Report* 479, 10/18/07).

Now, however, Kirschenbaum said, the IRS is "trying to improve their case development [procedure] during the audit process." Noting that this could benefit the Service as well as taxpayers, he said that "when they get to Appeals they will hopefully have a more well developed case and have a better opportunity to sustain their position."

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>
> KENNETH CHRISTMAN, ERNST & YOUNG LLP

Maruca, interviewed June 28, agreed that the IRS needs to improve its case development. "The feedback we are getting from Appeals suggests that, in many cases, unless we moderate our position, we are going to continue to fare poorly," he said. "At a minimum we will need to address directly and carefully the taxpayers' economic analysis in these cases."

Beyond CIPs

Kenneth P. Christman Jr. of Ernst & Young LLP in Washington, D.C., said that while the IRS needs some way to disseminate guidance to the field, CIPs—which typically are between five and 10 pages long and concentrate on narrow legal issues—"are not well adapted to deal with transfer pricing, which is primarily factual." The 2007 cost sharing CIP "is undoubtedly the longest CIP ever written and the only one ever written on transfer pricing,'' he added.

Christman said Maruca's remarks suggest the Service is considering a different approach—perhaps using case studies prepared by field specialist economists that ''focus on the facts of a particular case and analyze how the economist determined and applied the best method that case.'' Assuming taxpayer confidentiality is appropriately protected, he said, ''this may well represent a significant improvement.''

Kirschenbaum said he had seen an improvement in audits already. ''I've absolutely noticed over the course of last several months that the [field examiners] seem quite determined to do a better job at factual development,'' he said. ''We can certainly see evidence of the LB&I initiatives at the field level already.''

'Clearer Lines of Authority'

Christman said Maruca's comments also suggest that transfer pricing audits ''will have much clearer lines of authority in the future. Hopefully, this will make dealing with the Service on transfer pricing matters much easier.''

Speaking to audits generally, Maruca said June 8 that he was aware of taxpayers' concerns about the IRS issue management teams (IMTs), introduced in 2007 as part of the IRS's tiered classification system for audits. The transfer pricing practice, he said, ''will not be run like an IMT'' and the IRS will ''make sure you always know who the decision maker is, in every case.''

New Cost Sharing Framework?

Christman, addressing the JCT's comments on cost sharing, said the language reflects a broad concern about those transactions.

''Obviously, [the] JCT is concerned that the [cost sharing] regulations encourage what might be viewed as abusive transactions by providing a framework for moving intangibles offshore,'' said the attorney, who previously worked in the IRS Office of Associate Chief Counsel (International) and was the principal author of the 2008 temporary cost sharing rules. ''However, [cost sharing arrangements] exist for a good reason—they are an effective way to manage R&D in a [multinational enterprise]. Abolishing or even limiting the [cost sharing] regulations would put U.S.-based MNEs at a competitive disadvantage with MNEs that can cost share.''

David Bowen of Grant Thornton in Washington, D.C., however, suggested the current cost sharing framework, rather than examiners' failure to understand the taxpayer's business, could be responsible for problems in cost sharing audits.

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>
> Patricia Lewis, Caplin & Drysdale

''Certainly, we see instances where an individual [international examiner], and particularly one new to the case, has not had the opportunity to fully develop a comprehensive understanding of the facts surrounding a particular industry, business, product, or commercial enterprise,'' Bowen said. ''However, some—perhaps many—of the more experienced IEs will take exception to suggestions that the true problem lies with a purported lack of a full understanding of the taxpayer's particular facts or the business.'' Rather, he continued, ''those IEs might instead cite day-to-day, down-in-the-trench difficulties and frustrations with implementing and applying rules and regulatory frameworks that are overly complex, overly nuanced, and arguably divorced in certain respects from true arm's-length practices and business realities.''

Patricia Lewis with Caplin & Drysdale in Washington, D.C., agreed that there is room for improvement in the current cost sharing framework.

''I do think the CIP and the temporary regulations have established a largely in administrable and inhospitable version of cost sharing for non-abusive cases, which could stand amelioration. To the extent the JCT comments suggest a broader pulling back from cost sharing altogether, that would be unfortunate—again, in the non-abusive context,'' Lewis said.

Meanwhile, Alan Shapiro of Deloitte Tax LLP in Chicago said he believes that neither the JCT's statements nor Maruca's comments suggest changes in the law or regulations—at least not immediately.

''I don't think [Maruca] is suggesting any fundamental change. I think he is looking at how to deploy and manage resources more efficiently,'' Shapiro said.

As for the JCT, he said that ''given current congressional dynamics, it's hard to put too much weight on these types of statements in the near term.''

John Peterson of Baker & McKenzie in Palo Alto, Calif., however, said he remains optimistic about Maruca's comments despite the realities of IRS bureaucracy. ''We'll see how much one man can turn the battleship,'' he said. ''It's a large organization, but he's certainly getting off on the right foot.''

By Steve Schuster

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