

Practical US/International Tax Strategies

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Transfer Pricing Documentation For a Global Business

Is "Global Docs" a Realistic Goal?

BY BARBARA MANTEGANI
(DELOITTE & TOUCHE TAX TECHNOLOGIES)

Well-prepared transfer pricing documentation should reduce the time and expense incurred in determining whether transactions between related parties are being conducted on an arm's length basis. However, differences among the transfer pricing regimes in different countries have created a level of complexity that has increased the time and expense spent on transfer pricing issues. This article explains why a rational transfer pricing strategy, set forth in documentation prepared for all relevant countries, is a must for virtually every multinational.

As businesses both large and small take their operations and their search for customers offshore, the task of tax compliance, and more specifically transfer pricing compliance, becomes exponentially more complex. The overwhelming number of countries follow the "arm's length standard," which requires

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The APA Program Annual Report

Part II: Comparables, Ranges and Documentation

The US Treasury Department and the Internal Revenue Service recently published their annual scorecard on Advance Pricing Agreements ("APAs") and their APA program. Part I of this article, which appeared in the last issue of *Practical Strategies*, summarized key points in the report, including how the US APA program works. Here, we continue our summary with a look at the sources, selection, and adjustment of comparables, the nature and adjustment of ranges, and certain aspects of the documentation required for APAs.

As mentioned in Part I of this article, this is the fourth annual report the US tax authorities have issued since being directed by Congress to do so. It covers calendar year 2002. Although the report does not provide guidance on applying the arm's length standard to your transfer pricing practices, it does provide a very useful discussion of what multinational groups and others should keep in mind when initiating or updating an APA with the US tax authorities.

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IN THIS ISSUE

This issue of *Practical Strategies* focuses on two important aspects of international tax -- transfer pricing and cross-border investment vehicles.

Transfer Pricing

Efficient and thorough transfer pricing documentation is valuable to multinational taxpayers, but often difficult to achieve given the differences in transfer pricing regimes around the world. Our lead article examines the criteria for designing a good transfer pricing documentation system and the technology that can make the system work to your advantage. *Page 1.*

We conclude our summary of key points in the US Advance Pricing Agreement program's annual report with a discussion of comparables, ranges, and certain documentation/reporting requirements. The report (and our summary of it) provides a very good guide for multinationals and others who are undertaking an APA with the US tax authorities. *Page 1.*

Investment Vehicles

Canadian income funds have become an attractive vehicle for investing in US businesses. Among other things, they provide the benefits of stable cash flows, minimum entity-level taxation and tax deferrals for sellers. Find out why these funds are being structured to make investments in companies conducting a variety of businesses in the US. *Page 3.*

Finally, *Practical Strategies* explores the US income tax treatment of certain offshore hedge funds -- investment vehicles that have become more popular and subject to closer scrutiny. The article describes the master/feeder fund structure, the tax treatment of US investors, and US tax reporting requirements for partnerships involved in the funds. *Page 10.*

Transfer Pricing

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We resume the discussion with a look at the sources of comparables used in APAs.

In some cases, comparable uncontrolled prices ("CUPs") or comparable uncontrolled transactions ("CUTs") can be identified. In other cases, comparable business activities of independent companies are used to apply the comparable profits method ("CPM") or residual profit split method.

action. In some cases, comparable uncontrolled prices ("CUPs") or comparable uncontrolled transactions ("CUTs") can be identified. In other cases, comparable business activities of independent companies are used to apply the comparable profits method ("CPM") or residual profit split method.

Generally speaking, since the APA program began in 1991, CUPs and CUTs have been derived most often from a taxpayer's internal transactions. For profit-based methods, in which comparable business activities of independent companies are sought, the APA program typically uses a three-part process.

First, a pool of potential comparables is identified using broad searches. From this pool, companies with transactions that are clearly not comparable to those of the party being tested are eliminated using quantitative screens and qualitative business descriptions. Then, based on a review of the available descriptive and financial data, a set of comparable transactions or business activities of independent companies is finalized.

The comparability of this finalized set is then enhanced by making certain adjustments.

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Sources of Comparables, Selection Criteria and Adjustments

According to the IRS report, comparables are at the heart of most APAs. The government's APA program works with taxpayers to find the best and most reliable comparables for each covered trans-

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Planning Advisory

IPO of US Business Through a Canadian Income Fund

BY LESLIE MORGAN AND PETER LEE
(BLAKE, CASSELS & GRAYDON)

In this article, the authors discuss how Canadian income funds can be structured to make investments in companies that are engaged in a diverse range of businesses in the US.

In the past year or so, income funds have been one of the most popular vehicles to acquire and repackage an increasingly diverse range of businesses in an effort to maximize value. In fact, in 2002, over 90 percent of Canadian initial public offerings were through income funds. From a tax perspective, income funds are intended to minimize entity-level taxation for the benefit of potential investors and, in some cases, provide tax deferral for sellers.

Increasingly, income funds are being structured to make investments in shares and debt of corporations which are resident and carry on a diverse range of businesses in the US.

Income funds are structured as mutual fund trusts (which are flow-through entities for Canadian tax purposes and are not subject to capital tax) which, through a series of vehicles such as partnerships, trusts and corporations, invest in underlying businesses. The intervening vehicles are, wherever possible, flow-through entities themselves which do not pay capital tax. If it is necessary to utilize a corporation in order to achieve other objectives, the corporation's income is sheltered to the maximum extent possible.

To achieve the desired tax benefits, the entity in which the public invests is structured as a Canadian open-ended mutual fund trust whose units, while listed on a Canadian stock exchange, are redeemable at the option of the holder in accordance with a specific formula for determining the redemption price. Monthly cash redemptions are usually subject to dollar caps, after which redemptions are to be

made in kind out of assets of the trust. This redemption feature is necessary in order for the fund to qualify as a "mutual fund trust" for Canadian tax purposes, although most dispositions of units are expected to be through market sales.

Often the debt investment in the US corporation is made through a Nova Scotia unlimited liability corporation ("NSULC"), which is treated as a regular taxable Canadian corporation for Canadian income tax purposes.

Units of the fund are also structured to be qualified investments for Canadian tax-exempt entities, such as registered retirement savings plans, registered retirement income funds, deferred profit sharing plans and registered education savings plans. At the same time, the funds are structured so that their units are not subject to the special tax payable by these and certain other tax-exempts under the Canadian *Income Tax Act* in respect of excess investments in "foreign property".

Structures for US Investments

A number of structures may be used by the fund to acquire and hold its interest in the US business.

For example, the fund may invest indirectly through Canadian corporations in the shares and indebtedness of a US operating

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Canadian Income Funds from page 3

corporation. Often the debt investment in the US corporation is made through a Nova Scotia unlimited liability corporation ("NSULC"), which is treated as a regular taxable Canadian corporation for Canadian income tax purposes.

The fund invests in the shares of a Canadian limited liability corporation which invests in a US holding corporation, which indirectly will acquire the US operating corporations. The fund would also invest directly in indebtedness of the NSULC, which is established and controlled by the US holding corporation. The NSULC uses the money it receives on the issue of its debt to subscribe for preferred shares of the US holding corporation.

Provided that the appropriate debt-to-equity ratio can be maintained, that the debt is clearly debt and not equity for US tax purposes, and certain other tests are met, we understand that interest on the indebtedness should be deductible in computing the income of the US operating companies for US federal and certain state tax purposes.

Although the NSULC is treated as a taxable corporation for Canadian tax purposes, we understand that it can be a "disregarded entity" for US tax purposes so that, for most US tax purposes, the indebtedness of the NSULC will be treated as indebtedness of the US holding corporation.

Because the Canadian mutual fund trust can likely be structured as a "fixed investment trust" for US withholding tax purposes, we understand that the interest payable on the indebtedness of the NSULC will be eligible for the US withholding tax exemption for portfolio interest, provided that the ultimate holders of the mutual fund units meet certain requirements. There will be US withholding tax on dividends paid from the US corporations into Canada (other than to the NSULC), but generally these dividends are relatively small.

Provided that the appropriate debt-to-equity ratio can be maintained, that the debt is clearly debt and not equity for US tax purposes, and certain other tests are met, we understand that interest on the indebtedness should be deductible in computing the income of the US operating companies for US federal and certain state tax purposes.

Special Canadian Tax Issues

Because the fund is investing primarily through Canadian corporations, it may be possible to avoid the fund units being characterized as "foreign property" to tax-exempt investors.

Although a Canadian corporation may derive its value primarily from non-Canadian assets and therefore its shares and debt might otherwise be classified as foreign property for purposes of the Canadian *Income Tax Act*, there is an exception to this classification where the Canadian corporation has a "substantial Canadian presence." In many cases, particularly where there is a Canadian element to the business, it may be possible to achieve a substantial Canadian presence within the meaning of the relevant rules so that the fund's investments are not foreign property for purposes of the Canadian tax rules.

Provided at all times the fund holds no more than 30 percent of its investments (based on cost) in foreign property, the fund units will not themselves be foreign property.

Finally, the implications of the Canadian foreign affiliate rules will need to be considered because the fund will control the US corporations. Provided that the investments are in corporations that carry on active businesses in treaty jurisdictions, it should be possible to repatriate earnings from these corporations to Canada through a combination of interest and dividends without incurring significant Canadian tax.

Income funds are clearly worth a second look when it comes to US businesses -- the benefits of stable cash flow, minimum entity-level taxation and tax deferrals for sellers are difficult to resist. □

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Global Docs from page 1

companies to set prices for the products, intangibles and services they transfer to their affiliates that are within the range of prices they would charge to an unrelated party. Generally, there is no easy formula to apply to determine what would be an arm's length price.

While most of the major trading countries are members of the Organization for Economic Cooperation and Development (the "OECD"), which has published a general set of transfer pricing guidelines (*Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 1995*), global businesses must nevertheless comply with country-specific transfer pricing laws and regulations. The failure to comply with those requirements often subjects a company to significant fines or penalties, as outlined in the table on page six. In countries marked with an asterisk (*) in the fourth column, the stated penalties are mitigated, or in some cases avoided, when the taxpayer prepares documentation.

As the table on page six makes clear, tax authorities in many countries expect a certain level of documentation to be offered in support of a company's transfer pricing policy to justify a finding that a company has set arm's length prices with its affiliates.

Ideally, well-prepared transfer pricing documentation should reduce the time and expense incurred by both the taxpayer and the tax authorities in determining whether transactions between related parties are carried out on arm's length terms. In practice, however, the variances between and among the transfer pricing enforcement regimes of different countries create a level of complexity that can increase, rather than reduce, the time and expense incurred by taxpayers on their transfer pricing issues.

X Co's Dilemma

For example, take the rather simple situation of X Co., a US-based multinational company, with manufacturing operations in the US and Canada, and distribution operations in the US, Canada, Mexico, France, the United Kingdom, Australia, and Japan.

- 1) The US plants manufacture tangible goods for distribution through subsidiaries in the US, Mexico, France, and the UK.
- 2) The Canadian plants manufacture tangible goods for distribution through subsidiaries in Canada, Australia, and Japan.
- 3) In addition, the US provides manufactur-

ing process intangibles to Canada, and provides headquarters services to all of its foreign affiliates.

Based on these product flows, X Co. must prepare the following US documentation:

- a US-Canada report for the manufacturing intangibles, the trade name, and the headquarters services;
- a US-Mexico report for both the tangible goods and the headquarters services;
- a US-France report for both the tangible goods and the headquarters services;
- a US-UK report for both the tangible goods and the headquarters services;
- a US-Australia report for the headquarters services; and
- a US-Japan report for the headquarters services.

In addition, documentation must be prepared in each of the following countries:

- Canada, for its transactions with the US, Australia, and Japan;
- Mexico, for its transactions with the US;
- France, for its transactions with the US;

Although it is not recommended, a number of companies do not establish an articulable transfer pricing strategy, particularly for transactions that are not significant in size or that occur in countries that do not have a history of strong transfer pricing enforcement.

- the UK, for its transactions with the US;
- Australia, for its transactions with Canada and the US; and
- Japan, for its transactions with Canada and the US.

Clearly, the overall documentation burden is quite significant, and this hypothetical does not even address the quite common situation of a multinational with regional manufacturing operations conducted in multiple countries completely independent of the parent. In these instances, the product flows within each re-

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The failure to comply with transfer pricing documentation requirements often subjects a company to significant fines or penalties.

Transfer Pricing

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Country	Specific Transfer Pricing Rules?	Specific Documentation Requirements?	Penalty or Fine for Transfer Pricing Adjustment?
Argentina	YES	YES	NO
Australia	YES	YES	YES, 50 percent of additional tax*
Canada	YES	YES	YES, 10 percent of total adjustment*
China	YES	YES	YES, fines imposed
Denmark	YES	YES	YES, up to 200 percent of additional tax
France	YES	YES	YES, fine of €7,500 plus 40 percent of assessment
Germany	YES	YES	No penalties
India	YES	YES	100 percent to 300 percent of additional tax*
Italy	YES	YES	100 percent to 200 percent of additional tax*
Japan	YES	YES	10 percent to 15 percent of additional tax
Korea	YES	YES	Yes, specific penalty for failure to provide documentation plus 70 percent of additional tax*
Mexico	YES	YES	YES, 50 percent to 100 percent of tax deficiency*
Netherlands	YES	YES	YES, up to 100 percent of additional tax*
Poland	YES	YES	YES, higher tax rate imposed*
Russia	YES	YES	YES, additional assessment of interest plus 20 percent of tax due
Singapore	NO	NO	NO
South Africa	YES	YES	YES, up to 200 percent of unpaid tax
Spain	YES	YES	No provision
United Kingdom	YES	YES	YES, up to 100 percent of unpaid tax
United States	YES	YES	YES, up to 40 percent of additional tax on transfer pricing adjustment*
Venezuela	YES	YES	YES, 25 percent to 200 percent of additional tax

gion are subject to additional documentation requirements.

X Co's Potential Solutions

Do Nothing

Although it is not recommended, a number of companies do not establish an articulable transfer pricing strategy, particularly for transactions that are not significant in size or that occur in countries that do not have a history of strong transfer pricing enforcement. In the last decade, as the number of such countries has shrunk and the number of countries enforcing transfer pricing has risen, the "status quo" strategy of not addressing transfer pricing concerns has become increasingly risky and is no longer a truly viable option.

In a recent survey of approximately 4,000 US-based multinational companies, commissioned by the US Internal Revenue Service, four out of five companies that had cross-border transactions with related entities prepared contemporaneous documentation for at least some of these transactions. About half of the companies prepared documentation for virtually all their transactions. *Report of Schulman, Ronca & Bucuvalas, Inc., Contemporaneous Documentation Survey Final Report (December 11, 2001) ("the Survey")*.

Those companies that prepared documentation were glad to have it: more than a third of the companies responding to the survey reported that they had to respond to an IRS request for information since their 1993 tax filing. In more than six out of 10 cases, one or more transactions with contemporaneous documentation were examined, and in more than three-quarters of these cases the IRS requested the company's contemporaneous documentation.

Finally, for companies that were asked for contemporaneous documentation in their most recent examination, more than a third (36 percent) said that the existence of the documentation significantly reduced the time and cost spent to resolve transfer pricing issues with the IRS.

More recently, the Commissioner of the Large and Mid-sized Business Division of the IRS (the "LMSB") has issued a directive to his examiners to issue an Information Document Request for the taxpayer's transfer pricing documentation at the commencement of every audit. LMSB Commissioner Directive: Transfer Pricing Compliance Processes, issued by LMSB Commissioner Larry R. Langdon (January 22, 2003).

Examiners are instructed to strictly enforce the 30-day deadline for submission of the documents and to send the documentation to an international examiner or economist for risk assessment. If the risk assessment indicates the existence of transfer pricing issues, those issues must be added to the audit plan.

In light of this stepped-up enforcement effort, it can safely be assumed that the value of contemporaneous documentation will continue to increase. Thus, the creation and maintenance of a rational transfer pricing strategy, set forth in documentation prepared for all the relevant countries, is a must for virtually every multinational. The real question is not whether, but how?

Outsource the Documentation Work

A common solution to the conundrum of transfer pricing compliance is to outsource the work to professional consulting firms. In responding to the Survey on this point, the vast majority (81 percent) of the companies that prepared contemporaneous documentation sought advice from external sources.

Another solution to the myriad of reports needed to satisfy each affiliate's documentation burden is to require each affiliate to prepare its own documents, with no input from the parent. This reduces the burden on the home office, but it also reduces the amount of control the parent has over the setting of transfer pricing policies.

This advice is not inexpensive. Only four percent of the respondents reported spending nothing on documentation. The majority of companies (53 percent) reported spending less than \$100,000 in the past year on transfer pricing documentation, 15 percent reported spending between \$100,000 and \$200,000, and 12 percent reported spending between \$200,000 and \$500,000.

The percentage of the tax department's budget being spent on transfer pricing has increased, too. Two-thirds of the respondents estimated that the percentage of the total tax compliance budget spent on transfer pricing has increased since the US documentation rules came into effect in 1994.

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Transfer Pricing

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Require Each Affiliate to Do Its Own Documentation

Another solution to the myriad of reports needed to satisfy each affiliate's documentation burden is to require each affiliate to prepare its own documents, with no input from the parent. This reduces the burden on the home office, but it also reduces the amount of control the parent has over the setting of transfer pricing policies.

A technology tool must have the capability of calculating different methods on the same data, or calculating the same method for different countries and regions when appropriate. The tool must also have the ability to store the data in such a way that it can be easily replicated for use in multiple analyses and updated from year to year, assuming there are no major changes to the business model.

With each affiliate acting independently, there is significant potential for inconsistent results that could lead to adjustments by one or more of the taxing authorities involved in reviewing a particular transaction. It is not uncommon for tax authorities to ask for documentation prepared for other countries for the same transaction, so inconsistencies can easily come to light.

Manage the Documentation Process In-House

Managing the global documentation process in-house has many benefits: it creates global consistency in the implementation of transfer pricing policies, it creates efficiencies of scale by having one person (or group of people, with or without assistance from outside consultants) producing multiple documents that are probably going to have significant overlap, and it creates the opportunity to make mid-year corrections if or when a particular pricing strategy is not producing the desired result.

It must be noted that managing the process in-house does not necessarily mean managing the process alone. The in-depth transfer pricing expertise of the outside advisor, when paired with the in-depth knowledge of the business possessed

in-house, and managed through technology familiar to both, can go a long way towards achieving the goal of solid, cost-effective transfer pricing compliance. The technology itself must also have a certain "expertise," as discussed below.

X Co's Solution: Manage In-House via Technology

To summarize the earlier discussion, X Co. has three important goals in managing its transfer pricing processes: consistency, efficiency and flexibility. Technology used to achieve a solution to a multinational's transfer pricing dilemma must therefore have features and functionality to address these goals.

Consistency

As noted above, there are differences in how countries articulate the arm's length standard. There are also differences in which transfer pricing methods are generally accepted in particular countries.

Nevertheless, a multinational company will seek to insure that the underlying logic and economic substance of its transfer pricing calculations are internally consistent, to the extent possible, across countries and also over time. To reach that overall level of consistency, each component of data must be consistent.

For example, the internal financial data, the statement of facts about the company and its industry, and the reasoning behind a particular adjustment made to improve comparability, must all be consistent across countries and regions, even if specific country rules require the use of different methods.

A technology tool, therefore, must have the capability of calculating different methods on the same data, or calculating the same method for different countries and regions when appropriate. The tool must also have the ability to store the data in such a way that it can be easily replicated for use in multiple analyses and updated from year to year, assuming there are no major changes to the business model.

Efficiency

While transfer pricing documentation is not formulaic, there are certainly portions of the documentation that will be virtually the same in every report prepared by a particular company. For example, the general information that must be provided about the company's business and industry could be very similar (depending on the issues,

the facts might need to be presented differently) in every report.

Likewise, a set of comparables that is developed to be used in multiple countries within a region might be used in all of the reports prepared for that region. In fact, the general template for reports from various countries can and should be similar, so that the information put into a project can be pushed out into a document that can be easily edited to create the final report.

An added advantage is quality control. When the documents include much of the same information stated the same way, it is easier to review them for internal consistency and much less risk that conflicting information will be included in different country reports.

Therefore, a technology tool must have the capability to efficiently replicate portions of the analysis, including the financial results, and drop those pieces into other reports. It also must have the capability to quickly and easily import data from other sources to reduce the amount of "cut and paste" and manual data entry.

It must have templates for specific countries that include country-specific explanations of the applicable laws and regulations, which can easily be pushed out into a word processing software for editing and updating in future years.

Finally, it must be familiar to the outside advisers who are working with the company on its transfer pricing strategy. In the best case, the company and its advisers should be able to transfer the files containing the documentation project back and forth throughout the process.

Flexibility

As a company moves through the year, it can be helpful to test its transactions to insure that they comply with the applicable laws, *i.e.*, that they are within an arm's length range. Changing market conditions, technology advances in an industry, significant world events, such as 9/11, all can have an impact on a company's financial results. Therefore, a pricing strategy that might have reasonably been expected to be within an arm's length range at the beginning of the year might not be in that range at the end of the year.

To avoid the need for year-end adjustments, which would most appropriately be done before closing the books, it is important to be able to track performance during the year against an arm's length benchmark and make adjustments as needed. Additionally, when developing a transfer

pricing model it might be necessary to modify the formulas and ratios used to analyze the financial results based on unanticipated events or comparability factors.

To avoid the need for year-end adjustments, which would most appropriately be done before closing the books, it is important to be able to track performance during the year against an arm's length benchmark and make adjustments as needed.

Therefore, a technology tool must have the capability to import interim data, re-calculate the arm's length range based on updated financial data from comparable companies, and easily incorporate modified or additional ratios and formulas for reviewing comparability or calculating an arm's length range.

Conclusion

Multinational companies are increasingly seeking to control their global transfer pricing documentation internally. Whether working completely on their own, or in consultation with outside advisers, one important step in achieving this control is to find a tool for managing the routine, mechanical portions of the documentation process. This technology should provide the consistency, efficiency and flexibility needed to comply with an ever-changing transfer pricing enforcement environment. □

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Offshore Hedge Funds Master/Feeder Compliance Issues

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This article explores the US tax obligations of offshore hedge funds and demonstrates, among other things, how certain funds can file US partnership returns to preserve the advantages of filing for their US partners without compromising the anonymity of the foreign partners.

The number of offshore hedge funds has increased because of the ability of these funds to operate outside the scope of government regulation and disclosure requirements. Offshore hedge funds are generally organized as corporations for

Offshore hedge funds are generally organized as corporations for marketing, tax, and legal reasons. Less frequently, an offshore hedge fund will elect to be treated as a partnership for US tax purposes to attract US individual investors and to participate in master/feeder fund arrangements.

marketing, tax, and legal reasons. Less frequently, an offshore hedge fund will elect to be treated as a partnership for US tax purposes to attract US individual investors and to participate in master/feeder fund arrangements.

Master/Feeder Fund Structure

The master/feeder fund structure allows an investment manager to manage money, on an aggregate basis, for diverse investor groups without having to allocate trades and to produce enhanced performance returns because of the larger critical mass of pooled funds available for investment.

Feeder funds invest fund assets in a master fund that has the same investment strategy as the feeder funds. The master fund, structured as a partnership, engages in all trading activity.

A master/feeder structure minimally includes two "spokes" and a "hub." The spokes consist of a US limited partnership or limited liability company ("LLC") for US investors and a foreign corporation for foreign investors and US tax-exempt organizations. The hub consists of a foreign entity electing to be taxed as a partnership for US tax purposes.

US Tax-Exempt Investors

The typical investors in an offshore hedge fund structured as a corporation will be foreign investors, US tax-exempt entities, and offshore funds of funds.

Although certain organizations, such as qualified retirement plans, generally are exempt from federal income tax, unrelated business taxable income ("UBTI") passed through partnerships to tax-exempt partners is subject to tax. UBTI is income from regularly carrying on a trade or business that is not substantially related to the organization's tax-exempt purpose.

UBTI excludes various types of income, such as dividends, interest, royalties, rents from real property (and incidental rent from personal property), and gain from the disposition of capital assets, unless the income is from "debt-financed property." The latter is any property that is held to produce income with respect to which there is acquisition indebtedness (e.g., margin debt).

Because a fund's income that is attributable to debt-financed property and allocable to tax-exempt partners may constitute UBTI to them, tax-exempt investors generally refrain from investing in offshore hedge funds classified as partnerships, which expect to engage in leveraged trading strategies.

As a result, fund sponsors organize separate offshore hedge funds for tax-exempt investors and have these corporate funds participate in the master/feeder fund structure.

US Individual Investors

If US individual investors participate in an offshore hedge fund structured as a corporation,

they are exposed to onerous tax rules applicable to controlled foreign corporations ("CFCs"), foreign personal holding companies ("FPHCs"), and passive foreign investment companies ("PFICs").

To attract US individual investors, fund sponsors organize separate hedge funds that are either US-based funds or foreign-based funds that elect to be treated as partnerships for US tax purposes. These funds participate in the master/feeder structure as a feeder fund.

Under the US entity classification rules (*i.e.*, the "check-the-box" rules), an offshore hedge fund can elect to be treated as a partnership for US tax purposes by filing IRS Form 8832, *Entity Classification Election*, as long as the fund is not one of several enumerated entities that are required to be treated as corporations.

US Reporting Requirements

An interesting issue that has arisen in the context of the master/feeder fund structure concerns the nature of the US reporting requirements.

Section 6031(a) of the Internal Revenue Code requires every partnership to file a partnership return (IRS Form 1065). However, §6031(e) of the Code provides that a foreign partnership is not required to file a return for a tax year, unless during that year the foreign partnership derives gross income from sources within the US (*i.e.*, "US-source income"), or has gross income that is effectively connected with the conduct of a trade or business within the US (*i.e.*, "ECI").

Similarly, the regulations issued under §6031 generally provide that a foreign partnership is not required to file a US partnership return (IRS Form 1065), if the following two conditions are met:

1. The foreign partnership does not have gross income that is (or is treated as) effectively connected with the conduct of a trade or business in the US (*i.e.*, there is no effectively connected income or ECI).
2. The foreign partnership does not have gross income (including gains) derived from sources within the US (*i.e.*, there is no US-source income).

With respect to a foreign partnership that is not a withholding foreign partnership (*i.e.*, a foreign partnership that has entered into an agreement with the IRS to be subject to the withholding and reporting provisions applicable to withholding agents and payors), the critical inquiry in de-

termining whether a US filing requirement exists is the presence of ECI. To the extent that a foreign partnership generates ECI, it is required to file a US partnership return.

The test for determining whether a US partnership filing requirement exists in this context (*i.e.*, whether the partnership generates ECI) is governed by §864 and the regulations under that section.

Generally speaking, an offshore hedge fund is not considered to be conducting a trade or business within the US merely by investing in the stocks or other securities of US issuers, or by trading in those stocks or securities in the US for its own account.

Additionally, an offshore hedge fund may retain the services of US investment advisers and brokers, and may grant them the discretion to engage in securities transactions, without causing the fund to be deemed to be conducting a trade or business within the US.

However, a fund that is considered a "dealer" in stocks or other securities of US issuers is considered to be conducting a trade or business within the US. The determination of whether a fund's activities rise to the level of dealer activities depends on the facts and circumstances of each case.

Because a fund's income that is attributable to debt-financed property and allocable to tax-exempt partners may constitute UBTI to them, tax-exempt investors generally refrain from investing in offshore hedge funds classified as partnerships, which expect to engage in leveraged trading strategies.

Before the repeal of the statutory basis for the "Ten Commandments" by the Taxpayer Relief Act of 1997, an offshore hedge fund that traded in stocks or other securities of US issuers for its own account was considered to be conducting a trade or business within the US if it maintained its principal office in the US.

Regulations under §864 set forth a "safe harbor" list of 10 administrative functions (*i.e.*, the "Ten

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The typical investors in an offshore hedge fund structured as a corporation will be foreign investors, US tax-exempt entities, and offshore funds of funds.

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Commandments" mentioned above) that, if conducted substantially outside the US, would tend to cause a fund to be treated as if its principal office were outside the US. Although it is no longer necessary to comply with this safe harbor to avoid being treated as conducting a US trade or business, many offshore hedge funds continue to maintain their books and records, and perform certain other administrative functions offshore for privacy reasons and to avoid taxation in a handful of states that have not adopted the repeal.

Generally speaking, an offshore hedge fund is not considered to be conducting a trade or business within the US merely by investing in the stocks or other securities of US issuers, or by trading in those stocks or securities in the US for its own account.

As for offshore hedge funds trading stocks and other securities for their own accounts, and not otherwise engaging in the conduct of a US trade or business, foreign partners are subject to US withholding taxes only on dividend income and non-portfolio interest income.

Reporting Rules for Foreign Partnerships Having No ECI

The US income tax regulations contain three rules that modify the reporting requirements for offshore hedge funds that do not generate ECI. Except for the *de minimis* rule described below, the modified reporting requirements apply only when the following occurs:

1. The foreign partnership or one or more withholding agents files the required IRS Form 1042, *Annual Withholding Tax Return for US Source Income of Foreign Persons*, (Form 1042 reports fixed or determinable annual or periodic ("FDAP") income that a US withholding agent receives, controls, has custody of, disposes of, or pays) and Form 1042-S, *Foreign Person's US Source Income Subject to Withholding*, (Form 1042-S reports the income paid and taxes withheld with respect to a foreign person, as well as the withholding agent's identifi-

cation information) for US-source income allocable to the foreign partners of the foreign partnership.

2. The tax liability of the foreign partners with respect to that income must be fully satisfied by the withholding of the tax at the source.

***De Minimis* Rule**

The first modified rule for foreign partnerships that do not generate ECI is the *de minimis* exception.

A foreign partnership with \$20,000 or less of US-source income and no ECI is required to file a US partnership return only if one percent or more of any item of partnership income, gain, loss, deduction, or credit is allocable in the aggregate to direct US partners.

US-Source Income, But No US Partners

The second modified reporting rule specifies that a foreign partnership with US-source income, but no ECI and no US partners, will not be required to file a US partnership return.

US-Source Income and US Partners

The third modified reporting rule requires that a foreign partnership that has US-source income and one or more US partners, but does not have ECI, must file a US partnership return.

However, the partnership will be required to file Schedules K-1 only for its direct US partners and for its pass-through partners through whom US partners hold interests in the foreign partnership.

Thus, for foreign partnerships that generate only US-source income, but no ECI, the regulations do not require those partnerships to furnish Schedules K-1 for foreign partners because the foreign partners are subject to information-reporting requirements on Form 1042-S under §§1.1441-5(c) and 1.1461-1 of the regulations. Those regulations subject the foreign partners (and not the partnership) to information-reporting requirements for US-source income paid to a foreign partnership that is not ECI.

Reporting Rules for Foreign Partnerships Generating ECI

Unlike the rules in the regulations for foreign partnerships that generate only US-source income, but no ECI, the exception to Schedule K-1 reporting for foreign partners does not apply to a foreign partnership that generates ECI.

Specifically, a foreign partnership that generates ECI must file a complete US partnership return, with Schedules K-1 for all partners, including the foreign partners. Further, that partnership must report to all foreign partners their allocable shares of ECI, as well as their allocable shares of all items of partnership income, gain, loss, deduction, and credit.

Partnership-Level Elections

The US income tax regulations provide simplified reporting rules for foreign partnerships that file US partnership returns only for the purpose of making partnership-level elections.

Generally, a partnership return filed only to make a partnership-level election needs to contain only a written statement referring to §1.6031(a)-1(b)(5)(ii) of the regulations, stating the name and address of the partnership making the election, as well as the specific election being made.

For example, a foreign partnership that is not otherwise required to file a US partnership return may choose to file a partnership return if the partnership has incurred organizational costs and seeks to elect to amortize those expenses over 60 months.

State Tax Concerns

Although offshore hedge funds generally will not have nexus to the states, many states still require partnerships to file state partnership tax returns if they have partners that are residents of their particular jurisdiction. This could result in an offshore hedge fund with US partnership tax status being required to file a state tax return, even though it arguably may not be required to file an IRS Form 1065 because the partnership has no US-source income and no ECI.

For example, an offshore hedge fund with New Jersey resident partners will be required to file a New Jersey partnership tax return, regardless of whether the partnership has New Jersey-source income. The same situation is true in New York. An offshore hedge fund that has New York resident individual partners will be required to file a New York partnership return, regardless of whether the entity has a federal filing requirement.

Thus, while an offshore hedge fund that has US partners but no ECI and no US-source income does not have a federal tax filing requirement, the partnership may still be required to file state and local tax returns if its US partners are residents of certain states. Those state and local partnership

returns may require the identity of all partners (including foreign partners) to be disclosed as part of the return.

An offshore hedge fund electing partnership status should carefully analyze the connection of its activities to the US and the residencies of its US partners to ascertain its federal and state tax filing obligations, as well as to provide the proper disclosure of those filing obligations to the foreign partners.

An offshore hedge fund electing partnership status should carefully analyze the connection of its activities to the US and the residencies of its US partners to ascertain its federal and state tax filing obligations, as well as to provide the proper disclosure of those filing obligations to the foreign partners.

Conclusion

An offshore hedge fund that only trades for its own account and does not otherwise engage in a US trade or business is not required to file Schedules K-1 on behalf of its foreign partners. As a result, the offshore hedge fund can file a US partnership tax return to preserve the advantages of filing for its US partners (e.g., the benefits of a partnership-level election such as the amortization of organizational costs over 60 months) without compromising the anonymity of the foreign partners. □

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Sources

The comparables used in APAs may be US or foreign, depending upon the relevant market, type of transaction being evaluated, and results of the functional and risk analyses described in Part I of this article.

In the US APA process, initial pools of potential comparables generally are derived from the databases using industry and keyword identifiers. The pools are refined using a variety of selection criteria specific to the transaction or business activity being tested and the transfer pricing method ("TPM") being used.

Generally speaking, comparables are located by searching a variety of databases containing information on US publicly-traded companies and on a combination of public and private non-US companies. Table 1 shows the various databases and other sources used in selecting comparables for APAs executed in 2002. Although comparables were identified most often from the databases cited here, in some cases other sources were used, such internal data on taxpayer transactions with third parties.

Selection Criteria and Screening

In the US APA process, initial pools of potential comparables generally are derived from the databases using industry and keyword identifiers. The pools are refined using a variety of selection criteria specific to the transaction or

business activity being tested and the transfer pricing method ("TPM") being used. The databases allow for searches by industrial classification, keywords, or both, and the searches can yield a number of companies whose business activities may or may not be comparable to those of the entity being tested.

As a result, comparables based solely on industry classification or keyword searches are rarely used in APAs. Instead, the pool of comparables is examined closely and companies are selected based on a combination of screens, business descriptions, and other information in the companies' annual reports and filings with the US Securities and Exchange Commission.

Business activities must meet certain basic comparability criteria to be considered comparables. Functions, risks, economic conditions, and the property (product or intangible) and services associated with the transaction must be comparable. See Table 2 on page 15.

According to the IRS, determining comparability can be difficult. The goal is to use comparability criteria restrictive enough to eliminate business activities that are not comparable, but not so restrictive as to have no comparables left. The APA program usually starts out with relatively strict comparability criteria and then relaxes them if it is necessary to create a pool of reliable comparables. The size of a pool of comparables and the business activities that go into a pool are fact-specific and depend on the reliability of the results.

Additionally, the IRS examines the results of comparables over a multi-year period; usually three years, but sometimes more or less, depending upon the circumstances. Using a shorter period could result in the inclusion of comparables in different stages of development or the use of

Table 1. Sources of Comparables

Comparable Sources	Number of Times This Source Used
Compustat	81
Disclosure	50
Moody's	12
Trade Publication	5
Mergent	2
Bureau Van Dijk's JADE (Japan)	2
Other	9

Table 2. Comparable Selection Criteria

Selection Criteria Considered	Number of Times This Criterion Used
Comparable functions	90
Comparable risks	65
Comparable industry	64
Comparable products	57
Comparable intangibles	27
Comparable contractual terms	4

atypical years of a comparable that is subject to business cycles.

Many covered transactions are tested with comparables that have been chosen using additional criteria and screens, including sales levels and tests for financial distress and product comparability.

Common selection criteria and screens have been used to increase the overall comparability of a group of companies and as a basis for further research. For example, a sales level screen has been used to remove companies that, because of their size, might face very different economic conditions from those of the transaction or business activities being tested.

Further, APA analyses have incorporated criteria for removing companies that are experiencing financial distress because of concerns that companies in distress often experience unusual circumstances that would render them not comparable to the business being tested. These criteria include an unfavorable auditor's opinion, bankruptcy, and operating losses over a number of years.

An additional important class of selection criteria concerns the development and ownership of intangible property. For example, when the business activity being tested is manufacturing, several criteria have been used to ensure that if the controlled entity does not own significant manufacturing intangibles or conduct research and development ("R&D"), then neither will the comparables. These criteria have included determining the importance of patents to a company or screening for R&D expenditures as a percent of sales.

Quantitative screens related to identifying comparables with significant intangibles generally have been used in conjunction with an understanding of the comparable derived from publicly available business information.

Selection criteria relating to asset comparability and operating expense comparability have also been used. A screen of property, plant, and equipment ("PP&E") as a percent of sales or assets, combined with a reading of a company's SEC filings, has been used to ensure that distributors (generally lower PP&E) were not compared with manufacturers (generally higher PP&E), regardless of their industry classification.

APA analyses have incorporated criteria for removing companies that are experiencing financial distress because of concerns that companies in distress often experience unusual circumstances that would render them not comparable to the business being tested. These criteria include an unfavorable auditor's opinion, bankruptcy, and operating losses over a number of years.

Similarly, a test involving the ratio of operating expenses to sales has helped determine whether a company undertakes a significant marketing and distribution function.

Table 3 shows the number of times various screens were used in APAs in 2002.

Adjustments

After comparables have been selected, the regulations under §482 of the Code require that if there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of the differences on prices or

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profits can be ascertained with sufficient accuracy to improve the reliability of the results. In almost all cases involving income statement-based profit level indicators ("PLIs"), certain "asset intensity" or "balance sheet" adjustments for factors that have generally agreed upon effects on profits are calculated. In specific cases, additional adjustments are made to improve reliability.

The most common balance sheet adjustments used in APAs are adjustments for differences in accounts receivable, inventories, and accounts payable.

The most common balance sheet adjustments used in APAs are adjustments for differences in accounts receivable, inventories, and accounts payable. The IRS generally has required adjustments for receivables, inventory, and payables based on the principle that there is an opportunity cost for holding assets. For these particular assets, it is generally assumed that the cost is a short-term debt interest rate.

To compare the profits of two business activities with different receivables, inventory, or payables, the IRS estimates the carrying costs of each item and adjusts profits accordingly. Although different formulas have been used in spe-

cific cases, an attachment to the IRS report shows one set of formulas that is used in many APAs.

Underlying the adjustment formulas are the notions that: (1) balance sheet items should be expressed as mid-year averages; (2) formulas should try to avoid using data that are being tested by the TPM (*e.g.*, if sales are controlled, then the denominator of the balance sheet ratio should not be sales); (3) a short-term interest rate should be used; and (4) an interest factor should recognize the average holding period of the asset in question.

The IRS also requires that data be compared on a consistent accounting basis. For example, although financial statements may be prepared on a FIFO basis, cross-company comparisons will be less meaningful if one or more of the comparables uses LIFO inventory accounting methods. This adjustment directly affects costs of goods sold and inventories and therefore affects both profitability measures and inventory adjustments.

In other cases, adjusting for differences in PP&E levels between a tested business activity and the comparables is important. Ideally, according to the IRS, comparables and the business activity being tested will have similar PP&E levels -- major differences can indicate very different functions and risks. Typically, the PP&E adjustment is made using a medium-term interest rate.

Additional (but less frequent) adjustments include those for differences in other balance sheet items, operating expenses, R&D, and currency risk. Accounting adjustments (*e.g.*, reclassifying items from cost of goods sold to operat-

Table 3. Comparability Screens

Comparability Screen Used	Number of Times Used
Comparability screens used	-
Sales	20
R&D/sales	18
Foreign sales/total sales	10
SG&A/sales	10
Non-startup or start-up	4
PP&E/sales	4
PP&E/total assets	3
Operating expenses/sales	2
Financial distress	-
Losses in one or more years	23
Bankruptcy	22
Unfavorable auditor's opinion	12

Table 4. Adjustments to Comparables/Tested Parties	
Adjustment	Number of Times This Adjustment Used
Balance sheet adjustments	-
Receivables	40
Inventory	38
Payables	38
Property, plant, equipment	12
Non-interest bearing liabilities	2
Other	3
Accounting adjustments	-
LIFO to FIFO inventory accounting ¹	51
Accounting reclassifications (e.g., from COGS to operating expenses)	9
Depreciation	5
Other	2
Profit level indicator adjustments (used to "back into" one PLI from another)	-
Operating expense	2
Other	2
Miscellaneous adjustments	-
Goodwill value or amortization	23
Foreign exchange	10
Other	8

¹ The majority of these LIFO to FIFO inventory accounting adjustments regard business activities addressed by a bilateral competent authority agreement that established streamlined resolution guidelines.

ing expenses) are also made when necessary. However, data are often not available for both the controlled and uncontrolled transactions to allow for these types of adjustments.

Table 4 shows the adjustments made to comparables or tested parties in APAs during 2002.

Ranges and Adjustments

The regulations under §482 of the Code state that sometimes a pricing method will yield a single result that is the most reliable measure of an arm's length result. On the other hand, sometimes a method may yield a range of reliable results, known as the arm's length range. A taxpayer whose results fall within the arm's length range will not be subject to a transfer pricing adjustment by the IRS.

Under the regulations, a range is normally derived by considering a set of more than one CUT of similar comparability and reliability. If the

comparables are of very high quality, as defined in the regulations, then the arm's length range includes the results of all of the comparables (from the least to the greatest).

The IRS has rarely identified cases meeting the requirements for a full range.

Some APAs do not specify a point or range, but instead use a floor that requires the tested party's result to be greater than or equal to a particular value. Four APAs in 2002 used a floor.

If the comparables are of a lesser quality, then the reliability of the analysis is increased, when

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possible, by adjusting the range using a valid statistical method to the results of all of the uncontrolled comparables.

One method -- the "interquartile range" -- is usually acceptable, although a different statistical method may be used if it offers more reliability. The interquartile range is defined as, roughly, the range from the 25th to the 75th percentile of the comparables' results.

The interquartile range was used 39 times in 2002. Nineteen covered transactions specified a single, specific result or point. Ten of those cov-

ered transactions involved a CPM in which the taxpayer agreed to a specific result.

Some APAs do not specify a point or range, but instead use a floor that requires the tested party's result to be greater than or equal to a particular value. Four APAs in 2002 used a floor.

Some APAs also look to a tested party's results over a period of years (multi-year averaging) to determine whether a taxpayer has complied with the APA. In 2002, rolling multi-year averaging was used for 12 covered transactions. Eleven of those used three-year averages and one

The IRS has rarely identified cases meeting the requirements for a full range.

Table 5. Required Documentation

Documentation	Number of Times This Documentation Required¹
Description of, reason for, and financial analysis of, any Compensating Adjustments with respect to APA Year, including means by which any Compensating Adjustment has been or will be satisfied	85
Statement identifying all material differences between Taxpayer's business operations during APA Year and description of Taxpayer's business operations contained in Taxpayer's request for APA, or if there have been no such material differences, a statement to that effect	84
Statement identifying all material changes in Taxpayer's accounting methods and classifications, and methods of estimation, from those described or used in Taxpayer's request for APA, or if there have been none, statement to that effect	84
Financial analysis demonstrating Taxpayer's compliance with TPM	84
Description of any failure to meet Critical Assumptions or, if there have been none, a statement to that effect	84
Financial statements as prepared in accordance with US GAAP	73
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its operations, in accordance with US GAAP	73
Organizational chart	60
Financial statements as prepared in accordance with a foreign GAAP	30
Various work papers	30
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its operations, in accordance with a foreign GAAP	24
Book to tax reconciliations	10
Certified public accountant's review of financial statements	4
United States income tax return	3
Schedule of costs and expenses (e.g., intercompany allocations)	3
Other	23

¹ The first seven categories of documentation listed in this table were drawn from the standard APA language used in 2002. The facts and circumstances of some APAs may eliminate the need for some standard documentation requirements.

used a five-year average. Cumulative multi-year averages were used for two covered transactions. Of those transactions, one used a five-year average and one used a seven-year average. Nine covered transactions used term averages.

If a taxpayer's results fall outside the arm's length range, the IRS may adjust the result to any point within the range. Thus, an APA may permit or require a taxpayer and its related parties to make an adjustment after the year's end to put that year's results within the range or at the point specified by the APA.

The IRS may also make adjustments to enforce the terms of an APA. When the APA specifies a range, the adjustment is sometimes to the closest edge of the range and sometimes to another point, such as the median of the interquartile range.

Depending upon the facts of the particular case, automatic adjustments are not always allowed. APAs may specify that there will be a negotiation between the competent authorities involved to determine whether and to what extent an adjustment should be made. APAs may permit auto-

matic adjustments unless the result is far outside the range set forth in the APA.

To conform a taxpayer's books to these adjustments, an APA usually allows a compensating adjustment if certain requirements are met. Compensating adjustments may be paid

All reports received by the IRS APA office are tracked by a designated APA team leader who also has primary responsibility for annual report review. Once received by the APA office, annual reports are sent to IRS auditors in the field.

between the related parties with no interest and the amount transferred will not be considered for purposes of applying certain US tax penalties.

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APA Documentation

APAs executed in 2002 required taxpayers to provide various documents with their annual reports. Those documents are described in Table 5.

The regulations under §482 of the Code state that sometimes a pricing method will yield a single result that is the most reliable measure of an arm's length result. On the other hand, sometimes a method may yield a range of reliable results, known as the arm's length range. A taxpayer whose results fall within the arm's length range will not be subject to a transfer pricing adjustment by the IRS.

APA taxpayers must file annual reports with the IRS to show their compliance with the terms and conditions of their APAs. The IRS considers the filing and review of annual reports a critical part of the APA process. By reviewing these reports, the IRS monitors a taxpayer's compliance

with its APA on a contemporaneous basis. The reports also provide current information about the successes and failures of various TPMs used in the APA process.

All reports received by the IRS APA office are tracked by one designated APA team leader who also has primary responsibility for annual report review. One economist also spends a significant amount of time reviewing the reports. Other team leaders assist in the review, especially when the team leader who negotiated the case is available because he or she will already be familiar with the facts and terms of the APA. Once received by the IRS APA office, the annual report is sent to IRS auditors in the field.

At the end of 2002, there were 101 pending taxpayer annual reports; 330 reports were closed during the year.

Conclusion

This article has summarized key points in the IRS APA program's annual report for 2002. The full text of the report is available in IRS Announcement 2003-19. The report also includes, among other things, a sample APA, with a description of various TPMs, critical assumptions, and required transfer pricing documentation.

Source: IRS Announcement 2003-19, 2003-15 I.R.B. 723. □

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