Practical US/International Tax Strategies

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New Transfer Pricing Rules for Services, Intangible Property

Implications for US Multinationals and Others

BY DARRIN LITSKY, JOSEPH ANDRUS, ANTHONY CURTIS, AND SEAN O'CONNOR (PRICEWATERHOUSECOOPERS)

As promised in the last issue of *Practical Strategies*, we bring you a detailed discussion of the new proposed transfer pricing rules for services, intangible property, and other matters.

The US Treasury Department and the Internal Revenue Service have issued proposed transfer pricing regulations related to services, economic substance, ownership of intangible property, and application of the residual profit-split method. 68 Fed. Reg. 53448 (Sept. 10, 2003). As reported in the last issue of *Practical Strategies*, the current services regulations were first issued in 1968, and are the only significant part of the 1968 transfer pricing regulations that were not addressed by updated regulations in 1994 and 1995. The Treasury

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Investing in Successful International Assignments

Important Tax Tips

BY PAUL BOUWMEESTER AND KENNETH VACOVEC (BOUWMEESTER & ASSOCIATES AND VACOVEC, MAYOTTE & SINGER)

This article provides a valuable guide to the effective management of international assignments -- from pre-departure to repatriation -- with particular attention paid to corporate and employee tax affairs.

With increased mobility in the workforce and organizations seeking to rapidly deploy resources globally, the importance of proper international assignment management has become paramount. International assignments represent the single most significant investment that a company can make in terms of time, expenses, and opportunity cost in an individual employee. Many assignments fail, not because of poor fit, but because of the stresses and strains caused by poor assignment management and communication between the home and host country.

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Both from an employee's and an employer's perspective, the proper management of an international assignment, from pre-departure to repatriation, facilitates the achievement of assignment objectives, control of costs, and related return on investment. Proper assignment management also requires comprehension and compliance with host and home-country immigration regulations, the management of both personal and corporate tax affairs, adherence to applicable labor laws, management of home and host-country benefits, and other assignment-related matters.

Tax Tip

Other than an employee's salary, the single most expensive cost, and the one that affords the most planning opportunities to minimize assignment-related costs, is the employer's tax burden for an international assignment. A properly developed tax reimbursement policy, correctly administered by the company with competent tax advice and compliance services in both the home and host country, is essential for a successful international assignment. An employer that invests the time and resources to craft an appropriate tax reimbursement program will realize cost reduction benefits from both tax savings and reduced administrative expenses.

Golden Rules of International Assignment Management

The fundamental rules of thumb for the proper management of international assignments are set forth here.

- All parties to the assignment in the home and host country must understand the objectives of the assignment, performance targets / deliverables to be achieved, and anticipated time frame.
- A detailed cost / benefit analysis should be done in advance so that the costs and anticipated return on investment are known. Employers are often surprised at the costs involved in deploying a resource internationally, which on average run two to three times an employee's base compensation.
- There should be a clearly written international

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Regional Focus

Considerations in Canadian Commercial Leases

BY BOB MACDONALD
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Cross-border leasing comprises a significant part of international business activity. This article identifies some of the most important differences in leasing practices in the US and Canada.

Leasing practices in the US and Canada are similar in most respects, including the standard forms utilized for commercial office, retail, and industrial properties. However, there are some principles that are different in Canada from those in the US, the most important of which are outlined in this article.

Letters of Intent

In Canada, agreements to lease (letters of intent or accepted offers to lease) may be enforceable in accordance with their terms without the necessity of entering into a formal lease, unless the parties provide otherwise in their agreement. To be enforceable, an agreement must be in writing, be executed and delivered by the landlord and the tenant, and specify the location, size, and condition of the space, term, commencement date, basic rent, and additional rents.

For example, to be enforceable, it is not essential that matters such as repair and insurance obligations, and restrictions on assignment and subletting, be included, each of which is of fundamental importance to a landlord and / or an investor. As a result, it is important for the agreement to specify an intention to utilize the landlord's standard form lease, the timing of its execution, and the consequences if the formal lease is not so executed.

Security for Rent Payment

In bankruptcy, courts of law in Canada have been reticent to allow landlords to keep proceeds of letters of credit or security deposits in priority to unsecured creditors on the basis that a letter of credit or security deposit is stated to secure lease obligations and / or to be applied against rent not paid, and that upon a disclaimer of lease in a bankruptcy, the obligation to pay rent ceases.

As a result, landlords are even more diligent in re-evaluating the covenant of a prospective tenant and avoiding excessive tenant inducements at the commencement of the term.

Capital employed by a landlord in Canada is subject to a federal capital tax and, in some cases, a provincial capital tax, as well. The federal capital tax is to be phased out over the next five years, however.

Capital Tax

Capital employed by the landlord in Canada is subject to a federal capital tax and, as well, in some provinces is subject to a provincial capital tax. The federal capital tax is to be phased out over the next five years.

Although some landlords (such as pension funds) are exempt from the payment of capital tax, those required to pay it attempt to pass this cost on to tenants as part of operating costs. The taxes can total as much as $2.00 per square foot per annum and, therefore, the landlord's rights to recover them are important.

Like administrative or management fees in operating costs, there must be specific provision allowing for recovery or it will not be permitted.

Goods and Services Tax

Otherwise known as "GST," this seven-percent federal sales tax is relevant to com-

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mercial leases because it is imposed upon rent payable by tenants, including basic rent, operating costs, and taxes. It would not be imposed on utility charges payable by the tenant to the utility supplier when the tenant is separately billed by the utility supplier and nonpayment by the tenant could not result in a lien against the interest of the landlord. The GST paid by the tenant (if registered for GST purposes and exclusively involved in commercial activities) is subsequently recoverable by the tenant, but the landlord is obliged by the taxing authorities to collect it.

In the US, real property taxes are imposed at the state and city levels. In Canada, real property taxes are imposed at the provincial level and vary from province to province, as do tax assessment principles.

Real Property Taxes

In the US, real property taxes are imposed at the state and city levels. In Canada, real property taxes are imposed at the provincial level and vary from province to province, as do tax assessment principles.

For example, since 1997 in the province of Ontario, the imposition of business taxes (a tenant obligation to pay to the taxing authorities) was rolled into the real property tax assessment so that the payment of all of these taxes became the obligation of the landlord as the property owner.

As a result, no separate assessments are provided for individual rentable premises and the allocation of real property taxes in a multi-tenant development becomes the responsibility of the landlord. These allocation principles must be outlined in each lease and can lead to some difficult negotiations with tenants in mixed-use properties.

Other lease provisions found in Canadian standard form leases, including those pertaining to repairs, insurance, restrictions on transfers, subordination and attornment, expropriation, and environmental contamination, are similar to those found in the forms used in the US. ❑

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Transfer Pricing

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Department and the IRS view the 1968 regulations as outdated in light of the transformation of the US into a service-based economy.

Written comments on the proposed regulations are due on December 9, 2003, with a public hearing scheduled for January 14, 2004. PricewaterhouseCoopers expects to submit comments and welcomes thoughts and concerns from readers. Based on public statements, the IRS intends to issue final services regulations by June 30, 2004.

For many taxpayers, the most important elements of the proposed regulations may be those relating to intangible property.

Introduction

The proposed regulations introduce new methods for capturing the arm's length value of intercompany services, as well as guidance on the ownership of intangibles. The proposed rules also place a renewed focus on the contractual terms surrounding particular controlled transactions and revisit the concept of economic substance.

Intangible Property

For many taxpayers, the most important elements of the proposed regulations may be those relating to intangible property. The proposed regulations rewrite the existing developer assister rules, revise the residual profit-split method, adopt new examples relating to the imputations of contractual terms based on economic substance, and require transfer pricing determinations for high-value services under a profit split methodology. If adopted in their current form, the new rules could affect transfer pricing determinations involving intangible property in fundamental ways.

Ownership of Intangible Property

The proposed regulations remove the language of the current regulations regarding multiple owners of intangible property under the "cheese examples." In its place, the proposed regulations identify the sole owner of intangible property as the legal owner pursuant to relevant intellectual property law or a licensee of rights to intangible property, unless the ownership is inconsistent with the economic substance of the transaction. If no such owner is identified, the controlled taxpayer who "controls" the intangible is considered the sole owner.

Controlled taxpayers that are not considered the sole owner of the intangible property may or may not require separate compensation for contributing to the value of the intangible property. If the contribution is embedded within the terms of a controlled transaction involving the intangible, then ordinarily no additional compensation is due. However, if comparable uncontrolled transactions cannot be identified that incorporate a similar range of interrelated transactions and the contributions are considered "nonroutine," then the proposed regulations, in a series of examples, suggest that the residual profit-split method may be the best method.

Because the concept of a "nonroutine contribution" is not particularly well-defined in the proposed regulations, taxpayers need to exercise caution when establishing arrangements involving the maintenance, enhancement, or creation of intangible property.

Residual Profit-Split Method

The proposed regulations amend the current regulations by providing that residual profits will be divided based on the relative value of each taxpayer's nonroutine contributions, which may include contributions of intangible property. A nonroutine contribution is defined as a contribution "that cannot be fully accounted for by reference to market returns or that is so interrelated with other transactions that it cannot be reliably evaluated on a separate basis."

Certain examples in the regulations imply that nonroutine contributions may include high-value services or business opportunities, as well as traditional intangibles.

The current regulations divide residual profit solely on the basis of intangible property contributed by the controlled participants (after assigning a return for the routine functions).

Services Transactions with Embedded Intangibles

Under the proposed regulations, intangibles transferred in connection with the performance of services must be evaluated in a manner consistent with the intangible property transfer pricing rules under §1.482-4 of the Income Tax Regulations, and not exclusively under the services regulations.

The US Treasury Department and the IRS believe that economically similar transactions, particularly transactions that effect the transfer of intangible property, should be evaluated consistently under the transfer pricing rules. Under this approach, the IRS could recharacterize a service as an intangible transfer and vice versa.

The proposed regulations amend the current regulations by providing that residual profits will be divided based on the relative value of each taxpayer's nonroutine contributions, which may include contributions of intangible property.

Significantly, this could result in inter-company services getting caught in the net of the "commensurate-with-income rules" requiring periodic adjustments. It may also require application of the residual profit-split method to many service-type transactions.

Unfortunately, the proposed regulations provide little guidance to determine if intangible property has been transferred in the performance of services and under what circumstances the IRS will respect the form of a taxpayer's transaction. However, the proposed regulations do suggest that research and development services may often involve embedded intangibles.

Economic Substance

Under §1.482-1(d)(3)(ii)(C) of the proposed regulations, the Treasury Department and the IRS added three examples (Examples 3 through 5) describing situations in which the government would, in the absence of a written inter-company agreement, impute contractual terms based on economic substance.

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The first two examples involve US subsidiaries of foreign parents and the third example, although unstated, appears to involve a US parent company. In Example 3, "FP" sells wristwatches to its "USSub," which distributes "YY" trademark wristwatches in the US. FP is the worldwide registered holder of the YY trademark, including in the US.

Beginning in Year 1, USSub is described as having performed incremental marketing activities in addition to functions of a typical distributor. Beginning in Year 7, there is a premium return earned from the enhanced YY trademark.

In Year 7, the IRS may impute a separate services agreement to compensate on a contingent-payment basis for the incremental marketing activities in Years 1 through 6. Alternatively, the IRS may impute a long-term exclusive US distribution agreement to exploit the YY trademark, which would assign intangible income to USSub.

Another alternative suggested is that the IRS may require FP to compensate USSub for terminating USSub's imputed long-term distribution agreement.

The IRS will allow the taxpayer to present additional facts to bear on the question of which alternative best reflects the economic substance of the transactions consistent with the parties' course of conduct.

Significantly, inter-company services could get caught in the net of the “commensurate-with-income rules,” requiring periodic adjustments. It may also require application of the residual profit-split method to many service-type transactions.

The conclusions reflected in Example 3 above place renewed importance on: (1) the existence of inter-company agreements; and (2) language in those agreements, which unequivocally reflects the expectations of the controlled parties.

Services

In addition to the residual profit-split method for intangibles, the proposed regulations provide for six specified transfer pricing methods for services, which are generally consistent with current methods applicable to tangible property: (1) comparable uncontrolled services price ("CUSP") method, (2) gross services margin method ("GSMM"), (3) cost of services plus method ("CSPM"), (4) simplified cost-based method ("SCBM"), (5) comparable profits method ("CPM"), and (6) profit-split method ("PSM") The proposed regulations, like the current regulations, permit the use of unspecified methods, provided they satisfy the "best method" rule.

The comparability standards for the transactional methods outlined above are very strict and the availability of the "safe-haven" method for lower-value services is quite narrow. The regulations seem to have as one of their primary objectives encouraging the application of the residual profit-split method in many transactions involving high-value services, including some services that could have been billed at cost or at low cost plus markup under the existing regulations. This objective is consistent with the US government's perception that many services performed in the US on behalf of multinational groups have not resulted in appropriate arm's length reimbursement to the US affiliate.

CUSP Method

Similar to the comparable uncontrolled price ("CUP") method for transfers of tangible property and the comparable uncontrolled transaction ("CUT") method for transfers of intangibles, the CUSP method evaluates the controlled transaction by reference to the amount charged in comparable uncontrolled services transactions. The CUSP method is ordinarily used where the controlled services are identical or highly similar to the identified comparable uncontrolled services.

The CUSP method is considered the most direct and reliable method if there are no material differences between the controlled and uncontrolled transaction, or there are minor differences for which reliable adjustments can be made. Similarity of services rendered and intangibles used in connection with the performance of services will have the greatest effects on comparability under the CUSP method.

One of the examples provided in applying the CUSP method concludes that the use of intangible property in connection with the provision of services renders the CUSP method unlikely to provide a reliable measure of an arm's length price. If there are material differences for which reliable adjustments cannot be made, the CUSP method ordinarily will not provide the most reliable results.

GSMM

Similar to the resale price method for transfers of tangible property, the GSMM evaluates the controlled transaction by reference to the gross profit margin realized in comparable uncontrolled services transactions. The GSMM is ordinarily used where the controlled taxpayer performs services or functions in connection with a related uncontrolled transaction between a member of the controlled group and an uncontrolled taxpayer.

The GSMM may be used when a controlled taxpayer renders agent services in connection with a transaction between another member of the controlled group and an uncontrolled taxpayer. Similarly, the GSMM may be used when a controlled taxpayer serves an intermediary function to another member of the controlled group in connection with a transaction between the first controlled taxpayer acting as the intermediary and an uncontrolled taxpayer when the second controlled taxpayer actually performs a portion of the services provided to the uncontrolled taxpayer.

The "Appropriate Gross Services Profit" to be earned in a controlled transaction is determined by multiplying the uncontrolled price by the gross services profit margin earned in comparable uncontrolled transactions. The comparable gross services profit margin may be determined by reference to the commission earned in an uncontrolled transaction.

Alternatively, if a controlled taxpayer is performing an agent service or intermediary function comparable to a buy/sell distributor, the gross profit margin earned in uncontrolled sales may be used as the comparable gross services profit margin.

Similarity of services or functions performed, risks borne, intangibles used in connection with the performance of services or functions, and contractual terms will have the greatest effects on comparability under the GSMM. Particular consideration should be given to total services costs associated with functions performed and risks assumed because differences in functions are often reflected in these costs.

CSPM

Similar to the cost-plus method for transfers of tangible property, the CSPM evaluates the controlled transaction by reference to the gross profit markup realized in comparable uncontrolled services transactions. The CSPM is ordinarily used where the controlled taxpayer performs the same or similar services for both related and unrelated parties.

The "Appropriate Gross Services Profit" to be earned in a controlled transaction is determined by multiplying the controlled taxpayer's comparable transaction costs (*i.e.*, the cost of providing services) by the gross services profit markup earned in comparable uncontrolled transactions (expressed as a percentage of the comparable transaction costs earned in uncontrolled transactions).

Under the proposed regulations, comparable transaction costs must be determined on a comparable basis or on a basis that will facilitate comparison with comparable uncontrolled transactions. While generally accepted accounting principles ("GAAP") and federal tax accounting rules are useful for this purpose, they will not be conclusive in establishing comparable transaction costs.

By incorporating this language into the proposed regulations, the Treasury Department and the IRS appear to be providing the US government with significant flexibility to evaluate the comparability of a particular controlled transaction.

In addition to the residual profit-split method for intangibles, the proposed regulations provide six specified transfer pricing methods for services, which are generally consistent with current methods applicable to tangible property.

Similarity of services or functions performed, risks borne, intangibles used in connection with the performance of services or functions, and contractual terms will have the greatest effects on comparability under the CSPM. Comparability factors for which adjustments should be considered include the complexity of services, duration or quantitative measure of services provided, contractual terms, economic circumstances, and risks borne.

Comparable transaction costs may or may not equal total services costs. In evaluating comparability, consideration should be given to the results under this method expressed as a markup on total services costs of the controlled taxpayer and uncontrolled parties because differences in functions are often reflected in service costs other than comparable transaction costs. This guidance is analogous to taking into account differences in operating expenses when applying the cost-plus method for transfers of tangible property.

CPM

The CPM is also applied to services using the general principles of §1.482-5 of the regulations.

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However, the CPM under Prop. Treas. Reg. §1.482-9(e) only applies when the tested party is the renderer of services. The suggested profit level indicator ("PLI") for the test is the ratio of operating profit to "total services cost," a concept defined in Prop. Treas. Reg. §1.482-9(j).

Total Services Costs

"Total services costs" refers to all costs of rendering the controlled services under evaluation, which includes all identifiable direct costs and all other indirect costs reasonably allocable to the services under the principles of Prop. Treas. Reg. §1.482-9(k)(2), as described below.

This objective is consistent with the US government's perception that many services performed in the US on behalf of multinational groups have not resulted in appropriate arm's length reimbursement to the US affiliate.

In determining total services costs, GAAP used for financial statement purposes or tax accounting rules are deemed "useful starting points," but are not conclusive. Again, the proposed regulations provide the IRS with significant latitude to question a taxpayer's cost calculation.

Interestingly, the proposed regulations do not explicitly state that stock options costs should be included in the definition of total services costs.

In August 2003, the Treasury Department and the IRS released final regulations addressing stock options in the context of cost-sharing agreements and, at the same time, added a provision in the CPM section of the regulations requiring taxpayers to consider comparability adjustments for stock options in applying the CPM (although no guidance was provided as to how this is to be applied in practice).

One approach offered by commentators and practitioners has been to identify stock option compensation for both the comparables and the tested party for each year in the analysis and include that amount as an operating expense if not already included there, despite potential differences in methods of stock option valuation.

As stated above, it is not clear under the proposed regulations whether, in the context of services, stock options are considered part of comparable transaction costs for purposes of either the CPM or CSPM (although both Treasury Department and IRS officials have publicly stated that stock options need to be taken into account in the context of services).

Despite these statements, one should recognize that, while the Treasury Department and the IRS had previously amended the comparability rules under the CPM requiring stock option costs to be considered part of the comparability analysis, these rules do not directly apply to the CSPM.

Therefore, if a taxpayer performs the same or similar services for both related and unrelated parties, it may have an incentive to apply CSPM if it wants to avoid charging out stock option costs.

The application of these rules should also be considered in light of the "best method rule" under §1.482-1(c), which requires the use of a method that produces the most reliable measurement of an arm's length price.

In applying the SCBM under Prop. Treas. Reg. §1.482-9(f)(1) (described below), the use of the operating profits-to-total services costs ratio as the PLI refers to the CPM for a description of the PLI set forth in Prop. Treas. Reg. §1.482-9(e)(2)(ii).

In describing the application of the CPM in the context of services, Prop. Treas. Reg. §1.482-9(e)(1) refers back to §1.482-5, which requires consideration of comparability adjustments for stock option compensation.

Simplified Cost-Based Method

Amid much debate about whether the cost safe harbor would be retained, and in what form, the proposed rules provide for a more limited cost safe harbor.

The former cost safe harbor, which distinguishes between integral and nonintegral services, has been eliminated. In its place, the Treasury Department and the IRS have proposed the SCBM, a modified cost-based safe harbor with a narrower scope of application.

The SCBM is intended to apply to "low margin" services (*e.g.*, routine back-office services) and not to "high margin" services. Under the SCBM, "high margin" services are those services in which the arm's length markup exceeds 10 percent. (Although not defined, the examples indicate that the IRS intended the mid-point, usually the median, of the arm's length range to serve as the markup). If an arm's length markup is less than six percent, then a controlled taxpayer may charge low-margin services at cost or with a mark up as described below.

The SCBM evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the markup on "total services costs" earned by uncontrolled taxpayers engaged in similar activities using the ratio of operating profits-to-total services costs as the PLI. If the service performed is eligible for the SCBM, a taxpayer desiring to charge only cost to a related party will still be required to determine the arm's length charge.

Stated another way, the proposed rule places the burden on taxpayers to perform a bench-marking analysis as a prerequisite to determining eligibility for the SCBM.

Using a sliding-scale safety margin, the SCBM compares the arm's length markup with the markup, if any, charged by a controlled taxpayer. If the sum of the markup on total costs charged (if any) in the controlled transaction, plus the "applicable number of percentage points" (*i.e.*, the sliding-scale safety margin) is less than the arm's length markup on total costs, the IRS cannot make a §482 adjustment. The applicable number of percentage points is six if there is no markup in the controlled transaction and declines by one percentage point for every increase of two percentage points markup charged in the controlled transaction

A table set forth in Prop. Treas. Reg. §1.482-9(f)(2)(iv)(C) computes the cost-based safe harbor.

Under the proposed regulations, the SCBM should generally be applied using a multiple-year average. Therefore, both the arm's length range and the taxpayer's results would be evaluated under a multiple-year analysis.

Also, importantly, if a taxpayer does not meet the SCBM test, then it still may avoid adjustment by applying a "best method" analysis of §1.482-1(c), and the general principles of §1.482-1(e). Under these principles, if the taxpayer's multiple-year results under the best method are within the arm's length range (generally using the inter-quartile range), or its results for the tax year under review exceed the median of the comparables' results for the same year, the IRS cannot make any adjustment.

To use the SCBM, books and records must be maintained during the time the services are rendered. Additionally, a written inter-company agreement must be in place throughout the time services are rendered, unless the controlled group has gross income of less the $200 million or the aggregate costs to be evaluated under the SCBM are less than $10 million.

At stated above, the Treasury Department and the IRS have applied a narrow brush to the SCBM by excluding from its application the following transactions:

1) High-margin transactions, which are defined as when the arm's length markup (generally using the median) exceeds 10 percent.
2) The renderer, recipient, or another member in the same controlled group renders or has rendered similar services to unrelated parties, unless those services are *de minimis*. This is analogous to the current cost safe harbor rule where if the renderer or recipient is in the trade or business of rendering the services, then similar services rendered to related parties are considered integral services.
3) The recipient receives services from controlled taxpayers in significant amounts. A recipient is presumed to have received a significant amount of services unless it is established that the aggregate amount paid or accrued by the recipient for controlled services during a tax year is less than 50 percent of the total costs (excluding amounts paid for materials reflected in the cost of goods sold) of the recipient during that year. The current cost safe harbor has a similar rule with respect to integral services. However, the threshold is 25 percent and not 50 percent.

The former cost safe harbor, which distinguishes between integral and nonintegral services, has been eliminated. In its place, the Treasury Department and the IRS have proposed the SCBM, a modified cost-based safe harbor with a narrower scope of application.

4) The renderer uses valuable or unique intangible property or "particular resources or capabilities (such as the knowledge of, and ability to take advantage of, particularly advantageous situations or circumstances)" that contribute significantly to the value of the services and the renderer's costs associated with the services do not include costs with respect to the use of the intangible property or particular resources that are significant. This exclusion is analogous to the current cost safe harbor rule, which specifies that if the renderer is "peculiarly capable," the services provided are considered integral. The peculiarly capable standard has been criticized as being too vague

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to apply in practice.

5) The controlled services transaction and non-services transactions (*e.g.*, transfer of tangible property) are included in an integrated transaction in which the value of the non-services transaction is more than *de minimis*. In those cases, the SCBM could be applied by separating the services element of the integrated transaction.
6) The following categories of transactions are excluded from using the SCBM: manufacturing; production; extraction; construction; reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement; research, development, or experimentation; engineering or scientific; financial transactions; and insurance or reinsurance transactions.

In light of the proposed exceptions to the SCBM, it is unlikely that many transactions will qualify under this method. This result is consistent with the US government's view that most services should warrant a significant mark up.

Profit-Split Method

The PSM is ordinarily used when the controlled services under evaluation are high-value services, or are highly-integrated and cannot be reliably evaluated on a separate basis. The general rules for the profit-split method set forth in §1.482-6 of the regulations apply, and both the comparable profit-split method and the residual profit-split method are available to evaluate controlled services.

Importantly, if a taxpayer does not meet the SCBM test, then it still may avoid a transfer pricing adjustment by applying a "best method" analysis of §1.482-1(c), and the general principles of §1.482-1(e).

Examples applying the residual profit-split method describe taxpayers involved in the business of interactive auction database for spare parts (Example 1) and the business of oil and mineral exploration (Example 2). However, it seems clear that the drafters of the regulations believe a much broader application of the method to a variety of high-value service transactions is appropriate.

Unspecified Methods

The proposed regulations, like the current regulations, permit the use of unspecified methods, subject to the best method rule.

Contingent-Payment Contractual Terms for Services

This section of the proposed regulations addresses contracts involving contingent compensation where the compensation will be paid only in the event that the services yield specified results. The preamble to the regulations indicates that this kind of contract might be entered into in the context of rendering research and development services where the renderer will only receive compensation if a commercially-viable product is developed.

Under the proposed rules, a contingent-payment contract negotiated at arm's length would not require payment to the renderer in the tax accounting period the controlled services were rendered if the contingency did not occur during that period. If the contingency occurs in a subsequent period, the renderer is required to be compensated on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer in the absence of a provision that provides for unconditional obligation to pay for the controlled services in the same tax accounting period in which the services were rendered.

Contingent-payment contracts will be respected if: (1) the arrangement is set forth in a written contract; (2) the contract states that payment is contingent upon a future event; and (3) the contract provides for payment on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer. Additionally, the contingency and the basis for payment must be consistent with the economic substance of the controlled transaction and the conduct of the parties.

Benefit

Under the proposed regulations, an activity provides a benefit to a recipient of services if the activity directly results in a "reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so." Additionally, a benefit is deemed to have been provided if the recipient would be willing to pay an uncontrolled taxpayer to perform the same or similar activity, or would have performed the activity itself.

Importantly, this approach comports with language contained in paragraph 7.6 of the OECD Transfer Pricing Guidelines.

Indirect or remote benefits do not qualify as a benefit to a recipient. Duplicative activities do not provide a benefit to the recipient, unless the duplicative activity provides an additional benefit to the recipient.

In addition, a recipient does not receive a benefit from shareholder activities that protect that renderer's capital investment in the recipient or relate to reporting, legal, or regulatory requirements applicable specifically to the renderer. However, day-to-day management would be a benefit.

For companies undergoing corporate reorganizations, the proposed regulations have a facts-and-circumstances test regarding whether the reorganization provides a benefit to one or more controlled taxpayers. A benefit resulting from a controlled taxpayer's status as a member of the controlled group ("passive association") is not considered a benefit to the controlled taxpayer.

Allocation of Costs

If a service results in a benefit to one or members of a controlled group and the amount charged is determined by reference to costs (*e.g.*, SCBM, CPM using operating profits-to-total services costs), costs may be allocated and apportioned using any reasonable method. Consideration should be given to all bases and factors, including total services costs, total costs for a relevant activity, assets, sales, compensation, space utilized, and time spent. The rule in the current regulations, which creates a presumption of correctness for the taxpayer's reasonable and consistently applied cost-allocation methodology, is deleted from the regulations.

Importantly, the IRS has abandoned its position in Technical Advice Memorandum ("TAM") 8806002, which required allocation based on a general benefit theory. Under the proposed regulations, costs cannot be allocated to a member of a controlled group "based on a generalized or non-specific benefit."

This language will require taxpayers to spend more time identifying pools of costs that have a direct benefit to a particular affiliate.

Similar to the rule regarding GAAP for total services costs, allocations or apportionments used by the taxpayer for other purposes (*e.g.*, management, creditors, shareholders, potential investors, *etc.*) are considered potential indicators of reliable allocation methods, but the IRS need not give them conclusive weight.

Conclusion

If finalized in their current form, the proposed regulations will have important consequences for many taxpayers. For example, the old safe haven rules that have limited controversy over services transactions are virtually eliminated, thereby requiring increased benchmarking. The IRS is also likely to take a narrow view of the safe harbor under the SCBM approach.

For companies undergoing corporate reorganizations, the proposed regulations have a facts and circumstances test regarding whether the reorganization provides a benefit to one or more controlled taxpayers.

The proposed regulations also place a renewed emphasis on economic substance and require consistency with the language contained in taxpayers' inter-company agreements.

In the area of intangible property, transactions involving this type of property will likely give rise to increased challenges as the IRS seeks to apply profit-split methods to the transactions, rather than placing principal reliance on cost-plus and CPM approaches.

The IRS is likely to take a narrow view of the safe harbor under the SCBM approach.

One concern is that, if the rules are finalized in their current form, treaty countries may hold a different view regarding the application of the rules (*e.g.*, whether a particular activity rises to the level of a "nonroutine contribution"). In these circumstances, multinationals may find themselves facing an increased risk of double taxation for transactions involving intangible property and services. ❑

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Foreign Futures Planning: The 60/40 Question

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In this article, the author argues that "§1256 contract status" should be extended to certain foreign futures contracts traded on foreign markets recognized by the US Commodity Futures Trading Commission (the "CFTC").

The US Treasury Department's longstanding failure to exercise a congressionally-mandated duty to extend §1256 contract status to futures contracts traded on appropriately regulated foreign contract markets continues to cause uncertainty and inequities for taxpayers. Tax inequities exist because futures traded on domestic (*i.e.*, US) contract markets receive better tax treatment than futures traded on foreign (non-US) contract markets subject to analogous regulatory standards.

Section 1256 of the Internal Revenue Code requires certain types of contracts to be marked to market at year-end, regardless of the taxpayer's status.

The purpose of this article is to suggest that the CFTC has administratively recognized certain foreign boards, exchanges, and markets as being sufficiently regulated, with the result that §1256 contract status should be extended to futures traded on CFTC-approved foreign contract markets.

Specifically, there is a reasonable basis in fact and law to conclude that futures traded on certain foreign contract markets, with either a CFTC Rule 30.10 Order or "no-action letter" (defined below), are entitled to classification as §1256 contracts (*e.g.*, commodities), with the result that "60 / 40" tax treatment (also defined below) is appropriate.

The 60/40 Question

Section 1256 of the Internal Revenue Code requires certain types of contracts to be marked to market at year-end, regardless of the taxpayer's status. Gain or loss, under §1256(a)(3) of the Code, is 60 percent long-term capital gain and 40 percent short-term capital gain. Long-term capital gains are taxed at a maximum rate of 15 percent for all sales after May 5, 2003. Short-term capital gains are taxed at the normal rate. The maximum short-term ordinary rate is 35 percent, effective January 1, 2003.

Commodities receive preferential tax treatment over securities (*e.g.*, stocks, stock options, narrow based indices, single stock futures, mutual funds, exchange-traded funds (*e.g.*, QQQs) and bonds).

Section 1256 Contracts

Section 1256 of the Code was introduced into law by the Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172 (effective June 23, 1981). Section 1256 contains special rules for reporting gains and losses from §1256 contracts.

Section 1256(b) defines the term "§1256 contract" (*e.g.*, commodities) as including any regulated futures contract, foreign currency contract, non-equity option, deal equity option, and dealer securities futures contract. The Commodities Futures Modernization Act of 2000 (the "CFMA") established that broad-based indices are also considered commodities.

Section 1256(g)(1) provides that the term "regulated futures contract" means a contract: (a) with respect to which the amount required to be deposited and the amount that may be withdrawn depends on a system of marking to market, and (b) which is traded on, or subject to, the rules of a qualified board or exchange.

A futures contract is not defined in §1256. The CFTC defines a futures contract as "an agreement to purchase or sell a commodity for delivery in the future: (1) at a price that is determined at initiation of the contract; (2) which obligates each party to the contract to fulfill the contract at the specified price; (3) which is used to assume or shift price risk; and (4) which may be satisfied by delivery or offset."

Only a futures contract that has actually been traded on a CFTC-designated contract market, or subject to its rules, is a regulated futures contract for purposes of §1256(g)(1).

A regulated futures contract can be traded by either a taxpayer as a principal or by a third party acting on the taxpayer's behalf as an agent. Futures contracts that have been traded by two private parties "over the counter" ("OTC") are not traded on a contract market and are not regulated futures contracts for purposes of §1256(g)(1). *See* Rev. Rul. 87-43, 1987-1 C.B. 252.

A futures contract that does not meet these terms may be a nonregulated futures contract. The difference between forward contracts and futures contracts is that the parties to a forward contact generally intend to make and take delivery. Parties to a futures contract are speculators who intend to close out their positions by offset before delivery.

Section 1256(g)(7) provides that the term "qualified board or exchange" means: (a) a national securities exchange that is registered with the Securities and Exchange Commission; (b) a domestic board of trade designated as a contract market by the CFTC; or (c) any other exchange, board of trade, or other market that the Secretary of the Treasury determines has rules adequate to carry out the purposes of §1256.

While the US Treasury Department has not taken up its congressional mandate to create legislative certainty in this area, it can be argued that the CFTC, by default, has filled the legislative gap.

Why 60/40 Treatment is Viable

Since the enactment of §1256 in 1981, a number of contract markets throughout the world have implemented adequate rules and could be determined to be a "qualified board or exchange," within the meaning of §1256(g)(7). The US Treasury Department's recognition of the appropriate extension of 60 / 40 tax treatment to foreign exchanges, boards of trade, and other markets pursuant to §1256(g)(7)(C) is long overdue, but is not likely to be forthcoming anytime soon.

While a formal designation by the Treasury Department would expressly make futures contracts traded on these foreign exchanges eligible for treatment as §1256 contracts, the lack of this designation by the Secretary of the Treasury does not necessarily preclude 60 / 40 tax treatment.

Operative Analysis

For purposes of determining the tax consequences of a transaction, it is necessary to ascertain the legal relationships that exist between the parties to the transaction. In the typical exchange clearing process for a futures or option contract, an exchange clearinghouse is interposed between the original parties to the transaction -- namely, the clearing members who represent the buyer and seller under the contract.

Although there are a series of steps involved in the typical exchange clearing process, the "step transaction doctrine" provides that these steps are not analyzed separately, but are viewed as component parts of a single transaction.

In the typical exchange clearing process, the legal relationship between the investor and the broker remains unchanged, notwithstanding the fact that an exchange clearinghouse is interposed between the original parties to the transaction.

Relying on this type of analysis, in Rev. Rul. 85-72, 1985-1 C.B. 286, the IRS determined that the International Futures Exchange (Bermuda) Ltd. was a qualified board or exchange.

In *Johnson v. Commissioner*, T.C. Memo (1993-178), stating that the purpose of §1256 is to provide a system of taxation based on the marking-to-market of regulated futures contracts, the US Tax Court held that the taxpayer's trading activities in futures contracts and in futures transactions on the London Metal Exchange were conducted subject to the rules of a board of trade or commodity exchange within the meaning of §1256(g)(7).

Only a futures contract that has actually been traded on a CFTC-designated contract market, or subject to its rules, is a regulated futures contract for purposes of §1256(g)(1).

However, in Rev. Rul. 87-43, 1987-1 C.B. 252, the IRS ruled that Singapore International Monetary Exchange Limited ("SIMEX") was a foreign board of trade that was not a qualified board or exchange. In that ruling, the Chicago Mercantile Exchange (the "CME") and SIMEX established the Mutual Offset System to provide a process by which customers could establish new positions or offset existing positions on one exchange during hours in which that exchange was closed for trading by executing a contract on the other exchange.

Commodity Futures Trading Commission

The same type of legal analysis can be extended to decisions of the CFTC with respect to foreign contract markets.

Part 30 of the CFTC's regulations establishes the regulatory structure governing the offer and sale of foreign futures and options contracts to US persons by persons acting as futures commission merchants, introducing brokers, commodity pool operators, and commodity trading advisors.

Section 30.10 of the regulations allows the CFTC to, among other things, exempt a foreign firm

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acting in the capacity of a futures commission merchant from compliance with certain CFTC rules and regulations. To receive relief under Rule 30.10, the firm's home-country regulator must demonstrate that it provides a comparable system of regulation and must enter into an information-sharing agreement with the CFTC.

Once a firm receives confirmation of a Rule 30.10 Order, the firm may engage in the offer or sale of foreign futures and options contracts to US persons without registering with the CFTC on the terms specified in the Order.

The following regulatory and self-regulatory authorities have received CFTC Rule 30.10 Orders.

Australia	Sydney Futures Exchange ("SFE") ASX Futures Proprietary Limited ("ASXF")
Brazil	Bolsa de Mercadorias & Futuros
Canada	Winnipeg Commodity Exchange Montreal Exchange Toronto Futures Exchange ("TFE")
France	Marché à Terme International de France ("MATIF")
Germany	Eurex Deutschland
Japan	Tokyo Grain Exchange ("TGE")
New Zealand	New Zealand Futures and Options Exchange ("NZFOE")
Singapore	Singapore International Monetary Exchange ("SIMEX")
Spain	MEFF Sociedad Rectora de Productos Financieros Derivados de Renta Fija ("MEFF Renta Fija") MEFF Sociedad Rectora de Productos Financieros Derivados de Renta Variable ("MEFF Renta Variable")
United Kingdom	Securities and Investments Board ("SIB") (now the Financial Services Authority ("FSA")) Association of Futures Brokers Dealers ("AFBD") The Securities Association ("TSA") Investment Management Regulatory Association ("IMRO") Securities and Futures Authority ("SFA") (previously AFBD and TSA)

There is a reasonable basis in fact and law to conclude that futures traded on foreign contract markets with a Rule 30.10 Order in place are entitled to classification as §1256 contracts (*e.g.*, commodities), with the result that "60/40" tax treatment is appropriate. All that is needed is a determination by the US Secretary of the Treasury.

In the absence of this determination, it may be possible to develop an appropriate and reasonable tax return position in support of 60/40 tax treatment for futures contracts traded on the foreign contract markets listed above.

The CFTC has effectively determined that the contract markets listed above are exchanges, boards of trade, or other markets qualified within the meaning of §1256(g)(7) because they have rules adequate to support the purposes of §1256.

Additionally, it can be posited that because of the extensive review conducted by the CFTC's Division of Market Oversight, futures traded through foreign entities (listed below) receiving "no-action letters" from the CFTC should be eligible for §1256 60/40 tax treatment on the basis of the analysis presented in this article. ❑

MEFF AIAF SENAF Holding de Mercados Financieros, S.A. ("MEFF")	Madrid and Barcelona
Bourse de Montreal, Inc.	Montreal
London Metal Exchange, Ltd. ("LME")	London
Eurex Zurich ("Eurex CH")	Zurich
OM London Exchange, Ltd. ("OM")	London
Hong Kong Futures Exchange, Ltd. ("HKFE")	Hong Kong
SGX-DT	Singapore
International Petroleum Exchange of London, Ltd. ("IPE")	London
Eurex Deutschland ("Eurex")	Frankfurt
SFE Corporation, Ltd.	Sydney and Auckland
Euronext Paris	Paris
London International Financial Futures and Options Exchange ("LIFFE")	London

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assignment policy addressing all key aspects of an international assignment so that employees are treated fairly and consistently, and terms are not a factor of individual negotiation.

- Prior to acceptance, brief the employee and any accompanying dependents on the terms and conditions of deployment, host-country management practices, host and home-country points of contact, and the social/economic, cultural, and political environment of the host country.
- For longer term assignments, consider a pre-deployment site visit so that an employee may make an informed decision prior to acceptance.
- There should be a written and executed agreement between the employer and employee prior to departure to avoid the potential renegotiation of terms upon arrival in the host country.
- There should be a single point of contact at both the home and host location for assignment management and related logistics.
- Understand in advance the work permit and residency requirements for the host country so that required applications are made on a timely basis.
- Upon arrival in the host country have a dedicated resource "meet and greet" the employee and provide initial assistance with getting settled.
- Throughout the assignment stay in touch with the employee to address questions and concerns.
- Plan in advance (at least 90 days) for reassignment and repatriation to complete the assignment process.

Tax Tips

- Home and host-country tax counsel should review the international assignment policy and draft assignment terms to provide tax planning advice for the payment of base compensation and assignment-related benefits / allowances for an optimal tax-reduction strategy between the home and host country.
- A pre-departure interview with the home-country tax advisor is a critical point of departure for the employee from a tax cost perspective. This briefing should include a detailed review of the company tax reimbursement policy and the data to be provided by the employee to calculate hypothetical taxes.
- Experienced and dedicated tax counsel must be made available in the home and host country to address both employee and employer tax planning and compliance on a proactive basis.
- Tax planning opportunities should be reviewed, selected, and approved by management and implemented in coordination with the employer, employee, and home and host-country tax advisors.
- Upon relocation, the employee should meet with host-country tax advisors to fully discuss the requirements of the local tax law, and to complete any initial tax registration paperwork.

Getting Started -- Finding the Right Fit

Home and host-country management must have a clear understanding of the assignment's objectives, profile of the preferred candidate, anticipated assignment duration, reporting relationships with both home and host-country management, and allocation of assignment costs and revenues before starting the selection process. Consistent communication and a mutual understanding of the assignment and its objectives by both home and host management are required in selecting and securing the right candidate for an assignment.

An employer that invests the time and resources to craft an appropriate tax reimbursement program will realize cost reduction benefits from both tax savings and reduced administrative expenses.

In selecting the right candidate, consideration should be given to prior international experience, required technical or professional skills, management and communication skills (to include language proficiency) to work effectively in a different work environment, and the candidate's personal circumstances, including accompanying and non-accompanying dependents, health and welfare concerns, and other personal considerations that an employee may wish to raise. Both home and host-country management should be involved in the selection process so that all parties agree on the right candidate, and share the responsibility and accountability in ensuring that the selected candidate is properly guided and supported throughout the assignment.

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Tax Tips

- Of equal importance is the coordination of tax planning and compliance between home and host-country tax counsel. Tax counsel in the home country should have a strong working relationship with the host-country tax advisors to allow for the coordination of advice, planning opportunities, and preparation of returns in both countries.
- Tax support through the minimization of home and host-country tax liabilities falls directly to the bottom line of the assignment cost.
- An estimate of the total tax cost of the anticipated assignment should be prepared by both home and host-country tax counsel, computed in compliance with the company tax reimbursement policy, and based upon projected assignment compensation (base and incentive compensation), benefits, and allowances.

Of equal importance is the coordination of tax planning and compliance between home and host-country tax counsel. Tax counsel in the home country should have a strong working relationship with the host-country tax advisors to allow for the coordination of advice, planning opportunities, and preparation of returns in both countries.

Setting the Framework

Once a suitable candidate has been selected and he or she has agreed to consider an international assignment, a number of steps should be taken to ensure that the employee is fully briefed on both the nature, terms, and conditions of the assignment before final acceptance.

A clear assignment policy should be presented and reviewed with the employee to address the major assignment terms and conditions and supporting benefits and allowances. Comprehensive international assignment policies need to cover the following areas:

- pre-relocation site visits and reimbursed expenses;
- immigration services for the employee and accompanying family members, and a spouse's or accompanying partner's eligibility to work in the host country;
- housing provisions and related allowances and reimbursements;
- transportation and / or storage of personal effects at the home and host locations;
- class of travel for assignment-related travel;
- payment of assignment-related allowances and / or cost-of-living adjustments for the host country. These should be separated from base compensation to avoid base compensation issues with performance reviews, repatriation, or reassignment. Allowances include ground transportation, education expenses for dependents, sign-on bonus, dependent allowances, hardship allowances, club memberships, *etc.*;
- management of time reporting and payroll between home and host location;
- submission and payment of assignment-related expenses;
- management of home and host-country benefits to include medical, dental, life, and disability insurance, retirement savings plans, paid leave benefits, stock options and employee stock purchase plans, medical evacuation, and other group and employee elective benefits;
- performance management and reviews while on assignment;
- assignment-specific paid leave and home leave allowances;
- personal income and social welfare tax management for both the home and host country;
- repatriation and reassignment procedures and related allowances;
- termination and resignation policies and procedures while on assignment.

A detailed briefing should also be provided on any support for accompanying spouses / partners and minor dependents. This is an important factor that often gets over looked on international assignments. Failure to provide support for accompanying family members is one of the key contributors to failed assignments.

Proactive management of the immigration process for both work permits and temporary resident visas is essential. With heightened levels of security and scrutiny of visa applicants worldwide, the immigration process is taking longer. Failure to comply with host country immigration requirements might not only lead to the potential deportation of an employee, but could also subject an employer to significant fines and increased difficulties in securing or renewing visas for other employees.

Finally, a joint briefing of the employee with both home and host-country management should be organized so that all parties are clear on the objectives of the assignment and the reporting relationships. This briefing should include confirmation of home and host country HR contacts, as well as a general briefing on the economic, social, cultural, and political structures of the host country.

Tax Tips

- At this point, the host-country tax counsel should explain fully to the employee the tax realities and related tax policies for the international assignment.
- All compensation, plus benefits and allowances paid to the employee and family, should be included in a home-country (for the US) and host-country income profile for tax planning and compliance purposes.
- Home-country and host-country taxes will generally be borne by the employer under the company tax reimbursement policy.
- The employee will generally be responsible for a hypothetical tax liability that assesses liability as if the employee had remained in the home country. (This tax must be assessed and withheld by the employer as part of the payroll process.)
- Because taxes are the most significant cost of the assignment, the employee must understand that cooperation with home and host-country advisors and the provision of requested personal tax information (on a confidential basis) is necessary to maximize planning opportunities available for the assignment.

Getting Ready to be Deployed Overseas

Once the employee has accepted an international assignment the following pre-departure actions should be completed.

- No employee should be allowed to depart for an international assignment without the execution of agreed deployment terms because the management of outstanding issues becomes increasingly complex and more difficult to resolve post-departure.
- Employees should receive a pre-departure checklist to manage their personal affairs, including items such as updating wills, living wills, and powers of attorney; having medical and dental check-ups; completing immunization requirements; closing or transferring the management of personal accounts; making copies of key personal documents, such as passports, driving licenses, *etc.*; making arrangements for pets; selecting some personal items to help children adapt to the move to a new home; beginning language training, as needed; making arrangements for the rental or sale of the employee's home-country residence, *etc.*
- Briefing should be completed on the cultural, socio-economic, political, and security issues of the host country, including the ability of accompanying dependents to work in the host country with or without work authorization.

Tax Tips

- A pre-departure employee interview with home tax counsel is necessary to explain the company tax policy and applicable tax law fully, which includes a complete explanation of the home-country tax law relating to the assignment, home-country tax liability projections, and the calculation of the hypothetical liability consistent with the company reimbursement policy.
- US home-country issues would include qualification for the earned income and housing exclusions under §911 of the Internal Revenue Code; calculation and use of foreign tax credits for both regular tax and alternative minimum tax purposes; the requirement to maintain a record of travel and days worked outside the home country for §911 qualification and income-sourcing rules; the ability to recapture taxes paid through tax credit carryovers; timing of tax payments (to include estimated taxes), including the hypothetical tax liability; timing and format of the tax return information necessary for return preparation; timing of tax return filings; tax impact of the rental of the employee's home while on assignment; impact on the use of standard or itemized deductions while on assignment, *etc.*
- The pre-departure interview also provides an opportunity for the home-country tax advisor to gather and review all information regarding the employee's personal income tax situation for planning purposes.

Tax support through the minimization of home and host-country tax liabilities falls directly to the bottom line of the assignment cost.

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- Following the interview, home tax counsel tax should prepare a hypothetical tax projection for the employee, which explains the liabilities and the employee's responsibility under the company reimbursement policy.
- For host countries that have a "totalization treaty" with the home country, the tax advisor would assist the employer in obtaining a "Certificate of Coverage" to avoid host-country social welfare taxes.

Because taxes are the most significant cost of the assignment, the employee must understand that cooperation with home and host-country advisors and the provision of requested personal tax information (on a confidential basis) is necessary to maximize planning opportunities available for the assignment.

Arriving and Staying At the Host Location

The first few weeks and months of an international assignment are critical, and the proper management and support of an employee's and accompanying dependents' deployment is vital to a successful assignment. The tone that is set in providing initial support carries key messages in setting the stage for the approach of the employee and his or her dependents to the assignment and their view of the host country.

The employee and dependents on international assignment go through a rollercoaster of emotions. For the majority, the pre-departure and initial arrival in the host country represents a time of excitement and anxiety. After a few weeks, when things are more settled, the employee and dependents come down from the initial excitement and begin to consider the things they left behind. This is very natural, but is an important checkpoint for those managing the assignment to make certain that energies and support services are focused.

To manage both the employee and accompanying dependents upon arrival in the host country the following host-country actions are recommended.

- Prior to arrival, establish an open communication channel between the employee and host-country human resources ("HR") for deployment-related matters.
- Have someone meet and greet the arriving employee upon arrival in the host country, get them settled, and assist them in adjusting to local transport, shopping, customs, business practices, places of interest, points of contact, *etc.*
- Request that the employee and dependents register with their local embassy or consulate in locations where there may be concern for their safety or well-being.
- Make sure temporary housing is ready, available, suitable for the family size, and within easy access to the office and local facilities.
- If assignment housing is ready, it should be stocked with basic necessities for the family's arrival.
- Within the first few days of arrival, organize an employee and dependent briefing on host-country benefits, confirmation of local contacts, and completion of any arrival paperwork and registration forms.
- Stay in touch with the employee and his or her dependents on a regular basis throughout the assignment to address issues and concerns, and communicate with home-country HR on assignment management-related questions as they arise.

Tax Tips

- The host-country tax advisor should meet with the employee to provide a full explanation of the host-country tax law, filing requirements, and payment obligations.
- The employee should be advised of how to provide necessary information for the preparation of tax returns and other filing requirements in the host country.
- Based on the meeting, the host-country tax advisor should also provide current host-country tax projections to the home-country tax advisor to confirm the tax cost of the assignment.

Managing an Employee's Tax Affairs While on Assignment

One of the least understood components of an international assignment, and probably the most important in terms of cost management, is an employee's personal tax affairs. Generally, employees take their own personal tax affairs seriously, but have little or no understanding of host-country tax requirements and the interaction between home and host-country tax systems in the management of their personal tax liabilities. Creating an understanding of the company tax reimbursement policy for international assignments, providing briefings with home and host-country tax counsel, and establishing appropriate payroll, expense payment, and tracking systems is crucial to the proper, timely, and cost-effective management of an employee's tax affairs, related employer taxes, and administrative costs.

Tax Tips

Proper international tax management includes the following practices:

- During the assignment, the home and host-country advisors should work with the employer to coordinate hypothetical tax withholding and payments in the home and host countries, and the revision of these calculations for any material changes in assignment terms or the employee's personal finances.
- Year-end tax projections should be prepared to determine that all home and host-country yearly taxes have been properly withheld and paid.
- Yearly income tax returns in both the home and host country should be prepared and submitted on a timely basis.
- The employer should provide complete information on the compensation package by category including salary, itemized allowances, reimbursed assignment expenses, and taxes withheld from the employee and taxes paid by the employer.
- The tax advisors in both countries must coordinate this information with the employee's personal tax information on the home and host-country returns.
- Based upon information reported on filed returns, the home-country advisor would prepare the reimbursement computation, which compares actual liabilities with the employee's computed hypothetical liability.
- The tax reimbursement calculation must be reported to both the employee and the company on a timely basis and arrangements made to settle-up any amounts due within a specified time frame.
- For amounts due from the employee, the employer must either increase the employees hypothetical tax withholding or collect the amount from the employee.
- For amounts due to the employee, the payment would be made and included in the employee's income in the year of payment.
- All of these computations should be clear and properly communicated to the employee to keep the employee fully apprised of his or her responsibilities and the employer's tax cost.

Other Key Employee Management Issues While on Assignment

One of the other major concerns for employees accepting an international assignment of any significant duration is the "out of sight out of mind" factor. To help overcome this concern, employers need to do the following.

- Have a clear policy with regard to performance management and eligibility for promotion and compensation review while assigned overseas. Be clear about the roles and responsibilities of both home and host management in the review process and related recommendations for compensation changes and promotion.
- Make sure there is a clear reporting structure for the assignment and that the structure includes both home and host-country management, as appropriate.

Foreign tax credit carryovers and foreign-source income generated after assignment should be determined and communicated to management to decide whether tax credits should be claimed in future years and applied to reduce the cost of the assignment.

- Make sure there is a regular assignment review process outside the formal performance review process that includes home and host-country management and HR so that assignment-related issues can be raised and resolved on a proactive basis.

Repatriation, Resignation, or Termination

Finally, the international assignment process must address the process, terms, and conditions of any repatriation allowances and the employee's status should he or she be terminated, with or without cause, or resign while in the host country. It is important to understand the company's responsibilities and liabilities with regard to immigration requirements,

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personal taxation, and any applicable host-country labor requirements for any termination action taken.

Tax Tips

- At the end of the assignment the employee will have a part-year presence in the home and host country, which may provide additional tax planning opportunities.

Following the suggestions in this article on how to manage an international assignment will result in successful, cost-effective relocations all to the credit of the HR department and the profit of the company.

- Home-country tax withholdings must begin and host-country tax liabilities must be fully paid for the year of departure.
- The employee should again meet with the home-country tax advisor for a repatriation interview to explain the tax return and policy computations for the end of the assignment and to determine possible planning opportunities.
- Foreign tax credit carryovers and foreign-source income generated after assignment should be determined and communicated to management to decide whether tax credits should be claimed in future years and applied to reduce the cost of the assignment.
- The final host-country tax return should be prepared by host-country tax counsel, departure paperwork should be completed and filed, and any host-country tax liabilities should be paid.
- The final tax policy calculation should be prepared by home-country tax counsel with tax payments being reconciled.
- The final calculations should be communicated to the employee and the employer.
- Any taxes due from the employee should be collected and any taxes due to the employee, along with the tax gross-up amount, should be paid.

Conclusion

Following these suggestions on how to manage an international assignment will result in successful, cost-effective relocations all to the credit of the HR department and the profit of the company. ❑

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