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From the Editor:

Transfer Pricing: The International Tax Topic of the Day

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There has been a lot of noise in the past year about the transfer pricing component of the U.S. international tax system — from the Ninth Circuit's decision in *Xilinx* to intense discussions at conferences among tax practitioners and the government, to fascinating aspects of transfer pricing brought to light in analyses published in the pages of *Tax Notes*. In an environment dominated by a monumental fiscal deficit and the Obama administration's crusade to find ways to curb it, any source of tax revenue is given much thought and weight these days. Of many potential sources, transfer pricing is a big ticket. As Tax Analysts' authors have pointed out, current transfer pricing practices have cost the U.S. fisc about $28 billion in tax revenue.

After examining the effects of transfer pricing practices by drug companies that have resulted in excessive profit shifting offshore over the past decade (see *Tax Notes*, Mar. 8, 2010, p. 1163), this week Martin Sullivan argues that the government's transfer pricing problems are getting worse and that aggressive transfer pricing planning by multinationals has resulted in a loss of at least $28.3 billion in revenue for the United States (p. 1439). Sullivan presents data indicating that from 1999 to 2007, profits in foreign subsidiaries of U.S. corporations grew far more quickly than measures of real business activity. He further asserts that the estimated $28 billion revenue loss is probably on the low side because of the exclusion from the computation of holding companies that multinationals have been extensively using in recent years, and the exclusion of mining businesses, which have a limited ability to manipulate transfer prices due to the wide availability of market comparables.

Lee Sheppard also discusses transfer pricing this week. She asserts that the OECD's approach to analyzing contractual arrangements between affiliates of multinational corporations is ineffective. Under that approach, taxing authorities tend to respect contractual relationships and legal documents even if group members are acting in a commercially irrational manner. The author reports on the recent Philadelphia meeting of the USA branch of the International Fiscal Association, where the discussion focused on the effects of the economic downturn on previously established business structures of multinationals. Sheppard says that under current economic conditions, affiliates may no longer be able to meet some contractual obligations on which their worldwide corporate structures were premised. Thus, in her view, the downturn has put a wrench into multinationals' artfully crafted contractual arrangements, and high-tax countries' tax authorities should be able to take advantage of the inconsistencies between affiliates' business performance and the contracts to which they are subject. For Sheppard's analysis, see p. 1435.

Legislation

The most significant legislative action taken last week was the president's signing into law of the jobs bill (the Hiring Incentives for Restoring Employment Act of 2010). The bill provides tax incentives for employers to hire unemployed workers for newly created positions (that is, not displacing current workers), and most significantly, it enacts into law the Foreign Account Tax Complicance Act of 2009, which contains certain offshore disclosure and compliance provisions. For coverage of the jobs bill, see p. 1443.

Commentary

The Bush tax cuts expire this year. The estate tax will return to its 2000 levels after a one-year hiatus, barring further legislative action. It would seem that these issues might force Democrats and Republicans to compromise, since the default outcomes appeal to neither party. So far, however, this has not proven to be the case. Tax reform and bipartisanship both seem like far-fetched concepts in a critical election year, but Diana Furchtgott-Roth sees a glimmer of hope for both in the Wyden-Gregg tax reform proposal (p. 1543). Senate Finance Committee member Ron Wyden, D-Ore., and Senate Budget Committee ranking minority member Judd Gregg, R-N.H., have crafted a proposal to simplify individual income taxation by reducing the total number of tax brackets to three and lowering corporate tax rates by broadening the base. Furchtgott-Roth thinks this bill has a chance of passing because of widespread popular support for both concepts. According to a conversation she had with Gregg, the groundwork for tax reform usually has to be laid well before anything is accomplished.

Furchtgott-Roth concludes that the Wyden-Gregg proposal is a promising start.

Partnerships that convert to corporations under state and local law usually may rescind that election in the same year. These types of rescissions have been receiving increased attention from the IRS, write Monte Jackel and Craig Gerson in The Partnership Tax Report on p. 1529. The authors review a recent letter ruling in which the IRS concluded that a conversion to corporate status can be rescinded in the same tax year without triggering a liquidation. They believe this is a more progressive stance on rescissions than the IRS's past position. Despite the IRS's increasing leniency on rescission elections, Jackel and Gerson recommend that the Service issue safe harbor guidance to clarify the prerequisites for application of this doctrine and avoid the need for letter rulings.

The taxation of derivatives is likely to receive attention this year as financial regulatory reform makes its way through Congress. As one of the products blamed for the financial collapse in 2008, the tax treatment of derivatives is unlikely to emerge unscathed. Michael Farber tries to sort out both the current treatment of derivatives and the history of derivatives taxation (p. 1493). His primary focus is on section 1234A, which was enacted to prevent a taxpayer from deciding ex post the most tax-advantageous way to terminate its exposure to a position. Farber does not view the section favorably, concluding that it is unnecessary and undermines the straddle rules. Although he does not explore how to fix the straddle rules in depth, he does recommend that they undergo some ''basic repair.''

A great many things can be taken as business deductions. Many of these deductions fall under the category of business entertainment expenses. In May 2009 Richard Schmalbeck and Jay Soled submitted a Shelf Project proposal calling for the elimination of business entertainment expense deductions, both to raise revenue and to end taxpayer subsidies for business entertainment (*Tax Notes*, May 11, 2009, p. 757). In a follow-up to that article, the authors take aim at deductions for one specific type of business entertainment expense: luxury skyboxes at sports venues (p. 1524). Schmalbeck and Soled write that the deductibility of skybox purchase costs has contributed to their ubiquity in new sports arenas. They also point out that these skyboxes usually crowd out seating for lower-income fans and even result in higher ticket prices overall. If Congress doesn't want to end the deductibility of skybox costs, then the authors hope it will at least consider placing a cap on the deductions.

It is no secret that the government has become more aggressive in seeking documents from taxpayers that might be covered by either the work product doctrine or attorney-client privilege. This effort is at the heart of disputes in cases such as *Textron*, which is currently awaiting a grant or denial of certiorari by the Supreme Court. Robin Greenhouse, Joseph Selby, and Barbara Halevi argue that while it is debatable whether these efforts are justified to close down tax shelters, it is not debatable that the government holds taxpayers' privilege claims to a higher standard than when defending its own claims (p. 1523). The authors believe that this double standard was recently put on display in the *Cencast* decision by the claims court. This double standard has led to inconsistent arguments being proffered by the government and the development of conflicting case law governing privilege disputes, according to Greenhouse, Selby, and Halevi.

The federal False Claims Act dates back to 1863 and is designed to prevent fraud in the federal government. From 1987 through 2009, the government collected more than $24 billion in False Claims Act claims. In this week's Woodcraft, Robert Wood looks at the treatment of income received by so-called relators — those who file suit on behalf of the government under the act's *qui tam* provision (p. 1537). Although no court has addressed the issue, Wood is convinced that capital gain treatment is appropriate. He believes that a *qui tam* claim is demonstrably capital under several traditional theories because its value is tied to the relators providing key information and know-how to the government. ■

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