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Biweekly report on legal & financial issues affecting direct investment and cross-border trade in Mexico, the U.S., and Canada

Canada: Foreign Investment

Recent Developments in Canadian Foreign Investment Law

By Mark Katz and Jim Dinning
(Davies Ward Phillips & Vineberg LLP)

Three recent highly publicized events have brought the debate about Canada's foreign investment policy and the effectiveness of Canada's foreign investment laws into the public spotlight once again. In July 2009, the federal government filed a notice of application in the Federal Court seeking to force US Steel Corp. to fulfill undertakings it gave to the government in connection with its acquisition of Canadian steelmaker Stelco Inc. in 2007. Later that month, as part of its bankruptcy proceedings, Nortel Networks, the former Canadian telecommunications giant,

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Mexico: Procurement

Providing Services to the Mexican Government: Where is the Trend Going?

By Jorge Jiménez and Manuel Cervantes
(Lopez Velarde, Heftye y Soria)

How Did We End Up Where We Are?

Whether in the context of building an infrastructure project such as a road or a plant, providing a long-term service to a public utility, leasing or even selling goods under a short-term contract to an agency, government procurement in Mexico has for several years been an art of itself. In an effort to provide transparency, level-playing field rules and to open access to foreign and local vendors and suppliers, Mexico adopted along the years a series of intricate rules that have created a slow-moving, bureaucratic and inflexible system of contracting that for some time resulted in over-regulation and in orienting the contracts not towards efficiency, quality and cost-saving, but rather, to assuring compliance with regulation by those in charge of overseeing

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HIGHLIGHTS

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Three recent highly publicized events have brought the debate about Canada's foreign investment policy and the effectiveness of Canada's foreign investment laws into the public spotlight once again.
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Mexico's federal government recently enacted a series of amendments to the two federal statutes that regulate government contracting. The reform calls for a much more streamlined process, increased discretion for Pemex in securing the best combination of top-edge technology, price and contracting conditions, while assuring transparency and simplicity in the procedures.
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The IRS issues final regulations in connection with a controlled services transaction. The definition of services demands a careful review of the activities performed by the members of the group that may benefit other members, which will require US corporations to spend more time preparing detailed analyses of transactions.
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NOTE TO READERS:

Only one issue is published in August. We will resume our twice monthly schedule with the September 15, 2009 issue.

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MEXICO

Snapshots

By Cacheaux, Cavazos & Newton

Two Upcoming Vacant Seats in Mexico's Supreme Court of Justice

The anticipation related to the upcoming vacant seats in Mexico's Supreme Court of Justice shows the importance of Mexico's highest court. Mexico's Supreme Court of Justice ceased to be exclusively considered as the court of last resort for judicial proceedings and instead has become the arbiter of political, economic and social life in Mexico. Mexico's 1995 judicial reform altered its structure, composition and powers. The number of justices was downsized from 26 to 11, who are selected by Mexico's Senate out a list of candidates prepared by Mexico's President. Mexico's Supreme Court of Justice has new powers for constitutional challenges and constitutional controversies that enable the court to declare, with general effect, the unconstitutionality of a law or to adjudicate conflicts among the federal, state, federal district and/or municipal governments. This illustrates the relevance of the upcoming designation of the two new justices for Mexico's Supreme Court of Justice. The outgoing justices were at some point chief justices of such court.

The process for appointing a chief justice in Mexico's Supreme Court of Justice is different to the one in the U.S. Supreme Court. In the U.S., the head of the executive power, the President, decides who will be the next chief justice of the U.S. Supreme Court. In Mexico, the Court's justices appoint a chief justice every four years. Mariano Azuela and Genaro Góngora are two renowned judges and outstanding law professors. Gongora had a liberal tendency and is well liked by Mexico's left; Azuela, on the other hand, was considered a conservative and ideologically to the right. The opposing views of both justices clashed many times during their tenure while deliberating cases at Mexico's highest court for nearly 15 years. Notwithstanding the above, both left their marks in the opinions they drafted and the votes they cast. It will be important to watch closely who their replacements will be. — *Opinion by Dr. Mario Melgar-Adalid*

Suspension of IMMEX Programs

On July 14, 2009, the Department of Economy (Secretaría de Economía or SECON) published in the Official Journal of the Federation orders for the suspension of certain IMMEX programs of various program participants. The reasons given for suspending such participant's programs can be classified into two categories: i) failure to submit the annual sales and exports report for the fiscal year of 2008; and/or ii) failure to update their electronic signature, maintain an active tax identification number (Registro Federal de Contribuyentes or RFC), and/or to update the registered domicile and the domiciles of any additional locations for tax purposes.

The first legal basis for suspension is set forth in article 25 of the Decree for the Development of the Manufacturing Industry, Maquiladora and Export Services (Decreto para el Fomento de la Industria Manufacturera, Maquiladora y de Servicios de Exportación or IMMEX Decree), which requires IMMEX Program participants to submit to the SECON an annual report in electronic format with information concerning total sales and exports of the prior fiscal year. Such provision sets the last business day of the month of May as a deadline to submit such report. The second legal basis for suspension is set forth in article 11, section III of the IMMEX Decree which requires all IMMEX Program participants to have an electronic signature at all times, an active RFC and domicile for tax purposes and all additional locations registered, accounted for and active in the RFC. Pursuant to article 29 of the IMMEX Decree, the SECON is responsible for enforcing compliance with such obligations on an annual basis.

In order to cure the second cause for suspension, IMMEX program participants that are listed in such order must visit the web page www.siicex.gob.mx to find out the specific cause for suspension that applies to each individual case and cure such default at the corresponding Local Taxpayer Assistance Administration (Administración Local de Asistencia al Contribuyente). The second article of the published order allows those participants that had their IMMEX programs suspended to submit their annual report, update their electronic tax signature or cure any discrepancies with their RFC no later than the last business day of August, 2009. The companies that fail to comply on time with the necessary requirements to revoke the suspension of their IMMEX Programs will have their programs cancelled permanently on September 1, 2009.

Canada Requires Visas for Mexican Visitors

The government of Canada, through its Ministry of Citizenship, Immigration and Multiculturalism, announced that effective July 14, 2009 all Mexican nationals will require a visa in order to enter Canada. This new requirement was implemented on July 16, 2009. According to the corresponding official press release, the tripling of refugee applications from Mexican nationals since 2005 led to the imposition of this visa requirement. Mexico is the country with the highest number of refugee status applications in Canada. Canada's new policy requires Mexican nationals planning to travel into Canada to first apply for a Temporary Residence Visa and meet all the requirements to qualify for such visa. Visa applicants will be required to prove that their visit into Canada is temporary, that they will not overstay their visas, that they have sufficient money to cover their travel expenses in Canada, and that they are healthy and do not amount to a risk for Canadians. The above requirements apply to all Mexican nationals that want to enter into Canada, including business travelers, who will have to apply for a visa before they travel to Canada. Within the first five days of implementation of the new visa requirement, the Canadian government issued five thousand three hundred five visas for tourists, students and workers. Canada's new visa policy caused negative reactions from Mexico. Mexico's Secretary of Foreign Relations (Secretaría de Relaciones Exteriores or SRE), Patricia Espinosa, announced the imposition of visa requirements on Canada's diplomatic personnel and government officials. Secretary Espinosa described such measure as a "minimum response" to the consequences that Canada's new visa requirements will have on Mexicans. Espinosa explained that the number of Canadian citizens visiting Mexico every year, approximately three hundred thousand, represent a substantial source of revenue for various industries, such as tourism, and, therefore, Canadian citizens traveling into Mexico will not require visas "to avoid any losses of these revenue streams." The new visa requirement does not affect other immigration designations for Mexican citizens in Canada, such as those under the temporary farm worker program or visas provided under the North American Free Trade Agreement, such as visas for professionals, inter-company transfer employees, traders and investors. The previous applicable requirements will remain unchanged for those visas and programs for which the new visa requirement does not apply.

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performance. This approach became more evident and its critics became more eloquent with the recent discussion and enactment of the energy reform, where it was argued that if Pemex – the state-owned monopoly of the oil and gas industry – was to continue contracting under inflexible rules, its decline in production and revenues and its inability to increase its economic value would be insurmountable. As discussed below, Congress decided that Pemex should take a different route: to allow the company (the largest tax revenue producer in Mexico) to be exempted or excluded from the application of this intricate system of government procurement rules and to issue on its own – through its Board of Directors – an *ad hoc* system of contracting for oil and gas related projects. While Pemex is yet to issue such new framework, which is in the works, it is anticipated that the system will evolve towards more commercially oriented contracts and to procurement procedures that are more concentrated on securing good commercial terms and good quality of goods or services, rather than concentrating on procedural or formalistic issues.

Can We Cut the Red-Tape Please?

Energy reform coupled with the global economic downturn and the need to support public investment in infrastructure and public works and the labor sector has also served as a catalyst for the government to acknowledge the need to streamline government procurement procedures in general. On that basis, the federal government recently enacted a series of amendments to the two federal statutes that regulate government contracting: The Law of Acquisitions, Leases and Services of the Public Sector (*Ley de Adquisiciones, Arrendamientos y Servicios del Sector Público*), and the Law of Public Works and Related Services (*Ley de Obras Públicas y Servicios Relacionados con las Mismas*). On the one hand, the amendments are aimed at providing more certainty to the contracting proceedings, and on the other hand at providing more flexibility to directly contract certain types of works (such as labor-intensive contracts) especially in the midst of the global economic slowdown and what may be expected as a slow recovery. Likewise, the amendments incorporate the principle that the government procurement shall seek the best conditions as to economic development, employment creation, energy efficiency, responsible use of water, optimization and sustainable use of resources, and protection of the environment.

Among the most relevant changes, one may refer to the following:

(a) Pre-bid review – the amendments improved the mechanism for the early publication (online) of bids and project documents to become available for comments, before the definitive bidding guidelines are officially released; unlike in the past, there will be no need to purchase bidding guidelines.

(b) Changes to the bidding guidelines – the amendments provide increased flexibility to modify/improve project documents during a bid process; such changes will be subject to a mechanism to keep any interested bidder apprised thereof (e.g. any modifications shall be published with sufficient time in the government online site).

(c) Increased flexibility for corporate/bidding structures – in a step that should be very useful for improved bidding structures that allow more efficiencies from the project finance, tax, risks and liability perspectives, the amendments provide more flexibility for setting up special purpose companies that undertake the role of contractors and limit the liability of its parents

(d) Faster contracting process – significant reduction of the period of time for the execution of the public work and service contracts after the award is issued. In addition, changes in the structure and organization of the internal "procurement committees" of the federal agencies and instrumentalities were included, in order to expedite the process of approval of the public works and service projects.

(e) Single Registry of Contractors – formerly each agency was entitled to have its own registry of contractors; now in order to ease the process and to have a single source of alternatives for government procurement contracting, the amendments provide that a single Registry of Contractors at the federal level shall be created. Such registry shall be permanent and remain available to any agencies and to the general public, but subject to the confidentiality principles set forth in Mexican law.

(f) Flexibility in evaluation – by allowing a possibility to make clarifications and corrections to the bidders' proposals, the amendments are privileging substance over formality, which has been one of the major problems of the system. This will allow the public agencies to avoid dismissing proposals that perhaps did not meet all the technical, legal or economic requirements due to a mistake, leaving out sometimes a very sound and competitive proposal.

(g) A sort of "Dutch-auction tender method" for some supplies and services is incorporated – an optional "points and percentages" evaluation mechanism, which should be preferred by the agencies over the traditional price analysis is included. Guidelines for the application of the points and percentages mechanism will be issued shortly by the Federal Comptroller Bureau (known as SeFuPu, which is the federal agency in charge of supervising the government procurement process and interpreting the applicable legal framework).

(h) "Strategic Alliances" – between governmental agencies and engineering and technology firms in order to get top-edge technology for infrastructure projects (this scheme was not considered in the former legal framework).

(i) New direct contract cases – for construction and maintenance projects which labor costs are at least 50% of the total project cost, if contracted before December 31, 2009. This is one of the measures of the federal government to face the international financial crisis; with this amendment the construction and maintenance firms may seek to get contracts directly, by increasing the labor force.

(j) Increased flexibility to participate in future stages of infrastructure projects – the former legal framework prevented the engineering firms specialized in the preparation of bid specifications and preliminary studies, to participate in the bid for the development of the project if they were involved in the design of the bid specifications. Now the amendments allow that the engineering firms that have prepared any studies, plans or programs for infrastructure projects – in which the preparation of specification of construction, budget, selection and approval of materials or equipment is included – participate in the bid for the performance of the relevant infrastructure project, to the extent that the information used by such firms is provided to the rest of the interested bidders.

(k) Specific ability to provide for commercial arbitration for disputes resolution.

(l) Challenges - The statutory remedy to challenge the award of a contract was substantially improved (terms and deadlines materially reduced; events of dismissal clarified, rules for the enforcement of the guarantee posted to enjoin the contracting procedure during a challenge, etc.)

Who is Moving Forward?

Although there are several inertial forces to defeat, including cultural aspects, the agencies and instrumentalities that, in addition to Pemex (which produces close to 40% of the tax revenues) have the most considerable weight in the domestic economy as a whole (including the power utility CFE, the Ministry of Communications and Transportation (SCT), the National Water Commission (CONAGUA) and the National Infrastructure Fund (known as FONADIN)) are undergoing a change of mindset and adopting an approach of interests alignment between them and their contractors or suppliers. The government procurement system still needs to evolve more in assuming that a contract that is well-balanced provides the government better contract conditions, better prices and even attracts better participants. This requires an understanding that providing a benefit to a contractor in a contract is not a detriment to the agency, but – if well structured and balanced and if it has a legitimate basis – can provide enhancements to the projects.

Will Pemex Show the Path?

Many have qualified Pemex as "*anti-cyclic,*" since multi-million projects will continue being launched in the subsequent months by the national oil company. Great expectations have arisen in connection with the new system that Pemex will approve in the immediate future for implementing contracts under its new contracting rules. The reform, however, calls for a much more streamlined process, increased discretion for Pemex in securing the best combination of top-edge technology, price and contracting conditions, while assuring transparency and simplicity in the procedures. Pemex needs to develop considerable amounts of projects in all its areas, from exploration and production to reviving the petrochemical industry and modernizing its refining capabilities. This can only be done with efficient decision making procedures that eliminate or limit rigid procedures. Contracts will be allowed to incorporate incentive-based compensation mechanisms that reward efficiency, quality, value added and increased revenue for the client. Although originally thought for oil and gas E&P contracts, this scheme is not limited to those areas. One would anticipate that if Pemex structures its contracting rules properly and they show efficiencies to the market, other government agencies or instrumentalities would follow the lead. CFE, CONAGUA and SCT should be clear examples of that.

At the local level, municipal and state governments are expected to require considerable private participation and local and international financing for developing much needed infrastructure in all areas: waste management and landfills, DBFO and DBO water treatment, water distribution, local bridges and roads, are only some examples of projects where private investors are called to play a major role. Many of these projects will receive federal grants or funding to make them economically feasible, and through that, will become regulated by federal rules. This should increase the level of the contracts and provide for more commercially-feasible projects.

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UNITED STATES

Taxation

Treasury, IRS Publish Section 482 Services Regulations

By David J. Canale, Steven C. Wrappe, Miller Williams, Dan Karen, Leigh Anne Pasak, Carlos Mallo and Diana Organista (Ernst & Young)

On July 31, 2009, the IRS and Treasury Department issued final regulations[1] (T.D. 9456) (final regulations) under Internal Revenue Code Section 482 (Section 482) relating to taxable income in connection with a controlled services transaction. The final regulations replaced Treas. Reg. Section 1.482-9T (temporary regulations).

The final regulations implement the temporary regulations with relatively few modifications. This article focuses on these modifications and the implications of the final regulations.

The changes adopted make certain clarifications and improvements without fundamentally altering the policies reflected in the temporary regulations. The final regulations also clarify the temporary regulations by providing more guidance in the following areas:

1. The requirements for the Services Cost Method (SCM) have been reorganized to clarify that potential SCM services must meet all of the following conditions conjunctively: *(i)* the service must be a covered service; *(ii)* the service cannot be an excluded activity; *(iii)* the service cannot be precluded from constituting a covered service by reason of the business judgment rule; and *(iv)* adequate books and records must be maintained.[2]

2. The application of the SCM is confirmed as a pre-

rogative of the taxpayer if applied in accordance with the regulations.

3. The business judgment rule is determined by reference to a trade or business of the controlled group[3] versus the prior more ambiguous reference in the temporary regulations to the "renderer, the recipient, or both." The business judgment rule requires a reasonable conclusion by the taxpayer. Whether the taxpayer's conclusion is reasonable may be subject to examination by the IRS in the course of an audit. The IRS reiterates that the final regulations incorporate a high threshold for application of the business judgment rule to exclude services otherwise eligible for SCM.[4]

The final regulations are effective on July 31, 2009 and applicable to tax years ending after July 31, 2009. Taxpayers may elect to apply the regulations to any taxable year beginning after September 10, 2003.

Background

On July 31, 2006, Treasury and the IRS released temporary regulations in T.D. 9278. The temporary regulations provided guidance on the treatment of controlled services transactions and on the allocation of income under Section 482. The temporary regulations updated the proposed regulations released on September 5, 2003. Consistent with the rules governing transfers of tangible and intangible property, the temporary regulations provided guidance concerning selection and application of the appropriate method by explicitly incorporating the general rules in Treas. Reg. Section 1.482-1 (including the best method rule of Treas. Reg. Section 1.482-1(c), the comparability analysis of Treas. Reg. Section 1.482-1(d), and the arm's length range of Treas. Reg. Section 1.482-1(e) of the existing regulations). The IRS extended the coverage of the general rules of Treas. Reg. Section 1.482-1 to intercompany services for a number or reasons. First, the IRS and Treasury considered the revisions necessary to achieve consistency with the guidance for other types of transfer pricing transactions and international standards. Next, the revisions coordinate and harmonize the rules applicable to services with the rules applicable to other transactions to prevent "inappropriate results," such as the possibility that characterization of the transaction as a services transaction would produce a different result than an economically similar transaction characterized as an intangibles transaction.The temporary regulations introduced the SCM and the "business judgment rule," expanded the definition of services, provided specific provisions for determining whether an activity results in a "benefit," provided a narrow definition of shareholder activity cost, and made mandatory the inclusion of stock-based compensation in total services costs.

Service Cost Method

Under the SCM, services that meet certain quantitative and qualitative conditions and requirements can be priced at cost only. The final regulations make it clear that it is the taxpayer's prerogative whether to select the SCM, as long as it is applied in accordance with Treas. Reg. Section 1.482-9(b) (including a statement "evidencing the taxpayer's intention to apply the services cost method to evaluate the arm's length charge for such services.")[5]

In response to requests from commentators, the final regulations reorganized the requirements for the SCM, without substantively changing the SCM rules. The reorganization is intended to clarify that the SCM requires that the service meets all of the following conditions: *(i)* the service must be a covered service; *(ii)* the service cannot be an excluded activity (previously referred as excluded transactions); *(iii)* the service cannot be precluded from constituting a covered service by reason of the business judgment rule; and *(iv)* adequate books and records must be maintained.

A covered service is one that *(i)* is either a service that the Treasury and IRS have identified in Revenue Procedure Rev. Proc. 2007-13 (white list) or *(ii)* qualifies as a low-margin covered service. The preamble to the final regulations indicates that the Treasury Department and the IRS will be open to consider new recommendations for additional services to be added to the white list in the future where appropriate.

For the business judgment rule, taxpayers should evaluate key advantages of the subject services by considering "all facts and circumstances." Taxpayers must conclude in its "business judgment" that the services are not:

1. fundamental to the success or failure of the business;
2. related to the company's core competence; or
3. part of the company's competitive advantage.

According to statements in the preamble to the temporary regulations, the IRS would only in "the most unusual cases" challenge the taxpayer's reasonable business judgment. As implied in one of the examples in the final regulations, the IRS might rely on public information available including websites, SEC documents, press releases, company statements, etc., to assess whether the controlled service provides significant contributions to the success or failure of a business. The preamble to the final regulations clarify that the taxpayer's business judgment is only the starting point of the analysis, and the taxpayer must make a reasonable conclusion in that regard. Whether the taxpayer's conclusion is reasonable may be subject to examination by the IRS in the course of an audit. Consistent with the temporary regulations, the SCM has significant scope limitations. The SCM is intended to reduce compliance and administrative burdens for routine and low-margin services but requires taxpayer's substantial record-keeping and contemporaneous documentation efforts with respect to the cost of the covered services.

Definition of Services and Benefit Test

The temporary regulations expanded the definition of services to include "any activity" provided by a member of a controlled group that results in a "benefit" to one or more members of the group. The recipient would benefit if any of the following occurs:

1. the activity increases the commercial value or enhances the recipient's commercial position;
2. the recipient would be willing to pay for the same or similar activity;
3. the recipient would have performed the activity for itself; or
4. the activity increases the value of a recipient's intangible.

In the absence of a benefit, the final regulations do not require compensation for an activity, (i.e., the allocation of cost or expenses to the services recipient). An activity does not provide a benefit if a third party under circumstances similar to the recipient would not be willing to pay for it, or if the activity is duplicative and does not provide an additional benefit to the recipient. Additionally, a controlled taxpayer will not be considered to have obtained a benefit if the benefit derives from its status as a member of the controlled group (i.e., passive association) or if the services constitute shareholder activities.

Although "stewardship" is not defined directly in Section 482, the final regulations also include conforming changes to Treas. Reg. Sections 1.861-8(b)(3), (e)(4), (f)(4) and related examples under Treas. Reg. Section 1.861-8(g) concerning stewardship expenses to align with the changes made to the regulations under Section 482. The temporary regulations provided guidance on what constitutes "shareholder activities." The definition of shareholder activities focuses on the outcome and result of the services. Accordingly, the activity does not provide a benefit if "the sole effect" is to protect the capital of a member or is for legal or regulatory compliance. Treas. Reg. Section 1.861-8(e)(4) states that stewardship expenses include the expenses of an activity the sole effect of which is either to protect the corporation's capital investment or to facilitate compliance. A literal interpretation of the "sole effect" concept reduces the list of potential activities that constitute "stewardship" as many of those may eventually result in a benefit for the recipient. However, it is still necessary to pass the "direct benefit" test before allocation to subsidiaries is required. Allocations are not required or permissible for indirect or remote benefits. This implies that there remains a category of activities that, while not shareholder activities per se under the new definition, are still not direct enough to be allocated, and thus remain an expense of the parent or renderer.

Stock-based Compensation

One of the most controversial issues for taxpayers and non-U.S. tax authorities with regard to the final regulations is the mandatory inclusion of stock-based compensation expenses (SBC) in the total services costs for cost-based or profit-based methods. Treasury and the IRS did not incorporate any changes or additional guidance relating to the inclusion of SBC in the total services costs for cost-based methods following the U.S. Tax Court's and the Ninth Circuit's decisions in Xilinx, despite the fact that both decisions raise certain technical arguments relating to the inclusion of SBC for intercompany services. According to the preamble, the IRS will continue to consider technical issues involving SBC in the services and other contexts and intends to address those issues in a subsequent guidance project.

Additional Considerations

- The final regulations have not modified any of the transfer pricing methods for controlled services transactions included in the temporary regulations. However, some examples regarding application of the SCM have been edited for the purpose of clarifying that they refer to the provision of low value services and not high value services or the transfer of intangibles.[6]
- The final regulations confirm that Shared Services Arrangements (SSA) may be used for controlled services transactions outside of the SCM context; however the "flexible SSA rules for establishing the joint benefits and selecting the allocation key are inapplicable in the non-SCM context."[7] The determination on whether an agreement constitutes a SSA should be based on facts and circumstances on a case-by-case base.
- The final regulations reserve provisions for cross-reference purposes with regard to global dealing operations and pending finalization of the cost sharing regulations.
- Finally, with regard to contingent payment services, the final regulations clarify that whether a specified contingency is related to the controlled services provided should be evaluated based on all the facts and circumstances.[8]

Practical Impact of the Final Regulations

Given the final regulations are not significantly different from the temporary regulations, U.S. corporations will continue to struggle with the same issues that they have been dealing with since the temporary regulations became effective.

- The definition of services demands a careful review of the activities performed by the members of the group that may benefit other members. This process may require that taxpayers spend a fair amount of time gathering specific examples by country or region, consultation with foreign controllers or service recipients to prepare a detailed functional analysis. When determining which activities provide a benefit, some taxpayers may find it challenging to be consistent across the organization. Some taxpayers may encounter a situation where a service may be critical or increase commercial or economic value for one affiliate but not for another. Taxpayers must determine whether a services cost allocation is required and if a mark-up should apply.
- As a result of the temporary and the final regulations, the IRS likely expects the allocation of headquarters cost from U.S. corporations to their foreign affiliates to increase. Activities formerly categorized as stewardship costs may not comply with the "sole effect" provision and therefore may require charges for services that were non-chargeable in the past. Taxpayers were hoping for relief on this point, as foreign affiliates may encounter difficulty in defending these new expenses to local tax authorities. Foreign tax authorities may dispute the additional charges, especially in those jurisdictions, e.g., Germany, where tax authorities expect services to be agreed upon in advance.
- Cost-based allocations should include indirect and direct services costs including SBC. SBC will continue to be rejected in many foreign jurisdictions. The portion of total expense that relates to SBC could result in potential double taxation.
- Treasury and the IRS did not incorporate any changes or additional guidance relating to the inclusion of SBC in the total services costs for cost-based methods following the U.S. Tax Court's and the Ninth Circuit's decisions in Xilinx. SBC is includible under a reasonable accounting method. If a taxpayer has been using a grant date allocation based upon fair value or FAS 123R, it should consider valuation issues that may arise if the business is considering migrating to IFRS. Although not related to the issuance of the final regulations, taxpayers should be aware that the IRS is proposing adjustments to certain taxpayers to include SBC for in years prior to the effective date of the temporary regulations in 2007. Taxpayers that did not include SBC on the total cost base for years prior to 2007 should be prepared to be scrutinized by the IRS on this issue. Taxpayers with pending bilateral or multilateral Advance Pricing Agreements are well-advised to notify competent authority of all stock option matters.
- For the SCM, the taxpayer is responsible for analyzing its own business circumstances. The business judgment rule is a subjective test and U.S. corporations may encounter challenges in considering "all facts and circumstances" given the complexity of their organizations. Taxpayers should be prepared to explain any discrepancies between its conclusions and any public information disclosed such as the annual report or any information on the company website. Taxpayers are advised to evaluate any material that can be viewed by the public to make sure that it accurately portrays their business practices.
- For low margin services under SCM, the Treasury and the IRS rejected a proposal from some commentators to provide markup results for certain group of services or to specify the frequency or timing of transfer pricing analyses to support taxpayers' positions. In both cases, the Treasury and the IRS determined that doing so would be conflicting with an appropriate robust transfer pricing analysis and a proper comparability analysis. Taxpayers are well-advised to annually review their business services practice and transfer pricing analyses.
- Services charged out at cost are not free from controversy. Foreign tax authorities may assert that if the services were to be provided locally, it would have been less expensive. This is especially true in developing countries, or when local comparables are available.
- As foreign jurisdictions are becoming more experienced, they are challenging services allocations and requiring stronger justification for services received. Very large or complex multinational companies must consider either direct or indirect allocation methods but should proceed with caution. An allocation based on a single allocation key may not be sufficient to prove a direct benefit. Generally, foreign tax authorities are skeptical of the arm's length nature of a charge based on a pro rata expense allocation as the determination of the price is generally not precise. In certain jurisdictions, e.g., Mexico, normally, prorated expenses paid abroad are not deductible for income tax purposes.
- In all cases, taxpayer must maintain adequate records and contemporaneous documentation of the activities performed for any member of the group along with sufficient documentation of the cost incurred and the allocation methodology. Consultation with transfer pricing professionals is advised in all circumstances.

[1]26 CFR Parts 1, 31 and 602.
[2]Treas. Reg. Section 1.482-9(b)(2).
[3]Treas. Reg. Section 1.482-9(b)(5).
[4]See Preamble to final regulations.
[5]Treas. Reg. Section 1.482-9(b)(6).
[6]E.g., see Treas. Reg. Section 1.482-9(b)(6) example 1.
[7]See Preamble to final services regulations.
[8]Treas. Reg. Section 1.482-9(i)(2)(i)(B).

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CANADA

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auctioned off its wireless unit to a foreign purchaser. The objections of a potential Canadian suitor, Research In Motion Ltd ("RIM"), set off a public debate in the ensuing weeks about whether the Canadian government should intervene to halt the transaction. Finally, in August 2009, the proposed acquisition of Forsys Metals Corp. ("Forsys") by George Forrest International Afrique S.P.R.L. ("GFI") was abandoned, apparently because of national security concerns raised by the federal government.

Although certainly less publicized, in July 2009 the federal government also released draft regulations relating to amendments to the *Investment Canada Act* ("ICA") enacted in March 2009. These amendments made a number of significant changes to the ICA, including changing the general net benefit review threshold for most acquisitions of Canadian businesses by non-Canadians from $312 million in book value of assets to $600 million in enterprise value, rising progressively to $1 billion over a four-year period, and introducing a national security review process. The draft regulations define the concept of enterprise value and detail the time periods for the national security review process.

US Steel

Under the ICA, foreign companies whose investments in Canadian businesses are subject to review must establish that such investments are "likely to be of net benefit to Canada." Investors typically give undertakings concerning Canadian operations, employment, production, investment and expenditures in order to obtain government approval.

In July 2009, the federal Minister of Industry filed a notice of application seeking to force US Steel to fulfill undertakings it gave to the government in connection with its acquisition of Stelco in 2007. US Steel shut down most of its Canadian operations this past spring, resulting in layoffs and lower production. The filing follows a demand letter sent to US Steel in May and requests that the Federal Court order US Steel to increase steel production, maintain employment levels in Canada and pay $10,000 per day for each day that it fails to comply with its undertakings.

US Steel has asserted that its undertakings require compliance only at the end of their three year term (and not during their term) and that it expects to increase production and recall workers by that time. Additionally, it claims that its inability to fulfill undertakings is the result of factors beyond its control and therefore it should not be held accountable. This latter claim is consistent with guidelines issued by Industry Canada, which state "[w]here inability to fulfill a commitment is clearly the result of factors beyond the control of the investor, the investor will not be held accountable."

There have been several reported incidents of investors re-negotiating undertakings with the Canadian government as a result of an inability to meet their commitments, particularly with the onset of the recent global recession. The US Steel case is notable because it marks the first time that the government has gone to court for an order obliging a foreign investor to fulfill its undertakings since the ICA was enacted in 1985.

Nortel

As part of bankruptcy proceedings initiated in January 2009, Nortel auctioned off its wireless unit to Swedish telecom company Ericsson for US$1.13 billion in July 2009. During the bid process and following its conclusion, RIM, Canadian makers of the Blackberry and one of the companies losing out to Ericsson in the bidding process, attempted to convince the federal government to intervene and prevent Nortel's wireless assets from falling into foreign hands as the transaction could "jeopardize Canada's national interests." Various politicians, including the Leader of the Opposition, Michael Ignatieff, and the Finance Minister of Ontario, Canada's largest province, also voiced their opposition to the transaction. In addition, an emergency meeting of the federal House of Commons' Industry Committee was called to investigate the deal.

Prime Minister Stephen Harper has announced that the Canadian government has no plans to pass legislation to interfere with the transaction. However, he has also noted that it will be examined under the ICA to ensure that it is "in Canada's national interest."[1] As timelines for national security reviews have not yet been implemented (see below), it is currently unclear if or when the parties will receive word that Nortel's wireless unit sale has been approved or will be challenged under the ICA.

GFI

On November 14, 2008, GFI proposed to acquire Forsys, a publicly-traded mineral exploration company incorporated and listed in Canada. Its projects, including a uranium deposit which Forsys describes as being close to production, are located in Namibia. Forsys' financial statements indicate that the book value of its assets is well below the current $312 million threshold for general net benefit reviews applicable to most acquisitions of Canadian businesses under the ICA and Forsys' public disclosure indicated that no ICA approval was necessary.

However, on August 19, 2009, Forsys issued a cryptic press release indicating that it had been provided with a copy of "an unsolicited letter" sent to GFI by Industry Canada stating that "GFI is prohibited from implementing the investment pending further notice from Industry Canada." Six days later, Forsys announced the termination of the proposed transaction. If the proposed transaction was below the general ICA net benefit review threshold, as Forsys previously indicated, the only explanation is that the Minister of Industry invoked the ICA national security review process and issued a letter advising GFI that an order for a national security review of the proposed transaction may be made. The effect of such a letter in respect of a proposed transaction is that the transaction cannot be completed until there is a further communication from the government either advising that a review will not proceed or, if a full review is completed, that approval has been obtained (potentially subject to conditions). If true, this appears to be the first time that the new national security review provisions of the ICA have been invoked.

Neither the parties nor Industry Canada have confirmed that the national security review process was invoked, or publicly commented on the basis for Industry Canada's concerns. It is possible that the Minister may have intervened to seek assurances that uranium from Forsys' projects is not sold to persons or entities that might pose a threat to Canada's national security.

Draft Regulations

Enterprise Value

The March 2009 amendments to the ICA changed the general review threshold from one based on the book value of the target's assets to one based on the "enterprise value" of the target's assets. Draft amendments to the *Investment Canada Regulations* were issued on July 11, 2009 to define this concept.

According to the draft amendments, in the case of an acquisition of control of a Canadian business which is publicly-traded, the "enterprise value of the assets" of the Canadian business would be the market capitalization of the entity plus its liabilities minus its cash and cash equivalents.

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Market capitalization is obtained, generally, by multiplying the average daily closing price of each class of equity security by the average number of that security outstanding, in each case over the last 20 days of trading in the relevant entity's last fiscal quarter, and summing these figures for each class of equity security. In the case of unlisted equity securities, where the average daily closing price is unknown, the draft regulations propose using the average daily closing price of the entity's primary class of security equities as a proxy. It is not clear why the regulations equate the value of a class of unlisted equity securities to the value of the primary class of listed securities.

The entity's liabilities, cash and cash equivalents are determined using the financial statements of the entity for the fiscal year immediately preceding the implementation of the investment. It is not clear why the regulations refer to the end of the last fiscal quarter when valuing equity securities but refer to the last fiscal year when valuing liabilities and cash.

In the case of acquisitions of control of a Canadian business which is not publicly-traded or where there is an acquisition of all or substantially all of the assets, the enterprise value of the assets of the Canadian business would be calculated according to the method set out in the existing ICA regulations (i.e., book value of the assets of the Canadian business as at the end of the last fiscal year, as reflected in the most recent annual financial statements).

National Security Review Timelines

The national security review process permits the Canadian government to review investments that could be injurious to national security and provides that the federal Cabinet may impose any measures that it considers advisable to protect national security. The national security review provisions can potentially apply to any foreign investment in a company operating in Canada and not just to transactions otherwise subject to the ICA (i.e., acquisitions of control of a Canadian business).

Under this process, the federal Cabinet may, on the recommendation of the federal Minister of Industry, order a national security review. If Cabinet orders a review, the Minister is required to send a notice to the investor that the investment will be reviewed, and the proposed transaction cannot be completed while the review is pending. If the transaction has already been completed, a review can still be ordered (and remedies, including divestiture of the Canadian business, can still be required) following implementation of the transaction.

A separate set of draft regulations (entitled the *National Security Review of Investments Regulations)* was issued on July 11, 2009 with proposed timelines for the review process. These timelines are complex and have been criticized on the grounds that parties to transactions that are not subject to notification or review under the ICA, but that are nevertheless potentially subject to the national security review provisions, cannot receive comfort prior to closing that the government will not undertake a national security review.

1 According to the testimony of a Nortel representative at the Industry Committee hearing mentioned above, the book value of the assets sold was only $160 million, less than the current review threshold of $312 million. As such, the only basis upon which the government could intervene under the ICA is if it considered the proposed acquisition to be "injurious to national security". As discussed below, the review threshold will shortly be amended to be determined based on enterprise value (a market value based definition) rather than book value. If these changes had already been implemented, it is likely that the transaction would have been subject to a net benefit review under the ICA given the US$1.13 billion purchase price.

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