[JOINT COMMITTEE PRINT]

PRESENT LAW AND CERTAIN ISSUES RELATING TO TRANSFER PRICING (CODE SECTION 482)

SCHEDULED FOR HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON JULY 10 AND 12, 1990

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JUNE 28, 1990

U.S. GOVERNMENT PRINTING OFFICE

31-319 WASHINGTON : 1990 JCS-22-90

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

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101st Congress, 2d Session

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of present-law tax rules and certain issues relating to transfer pricing under section 482 of the Code. The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing on certain section 482 transfer pricing issues on July 10 and 12, 1990. Due to the nature of the hearing for which the pamphlet is prepared, the pamphlet focuses largely on issues related to sales of tangible property to related party distributors. It is understood that the hearing is expected to focus principally on such sales by foreign corporations to controlled U.S. distributors.

The first part of the pamphlet describes present-law rules and background under section 482. The second part analyzes issues relating to transfer pricing under section 482.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Present Law and Certain Issues Relating to Transfer Pricing (Code sec. 482)* (JCS-22-90), June 28, 1990.

I. PRESENT-LAW TAX RULES

A. Overview

The United States generally taxes all income of U.S. citizens residents, and U.S. corporations, whether or not such income is de rived in the United States. By contrast, the United States taxe nonresident alien individuals and foreign corporations only o income with a sufficient nexus to the United States. In the case o a multinational enterprise under common control that include both a U.S. and a foreign corporation, the United States thus ma tax all of the income of the U.S. corporation, but only so much o the income of the foreign corporation as satisfies the relevant rule for determining a U.S. nexus.[2] The determination of the amount o income that properly is the income of the U.S. member of a multi national enterprise, and the amount that properly is the income o a foreign member of the same multinational enterprise thus is crit ical to determining the amount the United States may tax as wel as the amount other countries may tax.

Due to the variance in tax rates (and tax systems) among coun tries, and possibly for other reasons, a multinational enterprise may have a strong incentive to shift income, deductions, or tax credits among commonly controlled entities to the entity in the most favorable tax jurisdiction in order to arrive at a reduced over all tax burden. Such a shifting of items between commonly con trolled entities might be accomplished by setting artificial transfer prices for transactions between group members.

As a simple illustration of how transfer pricing might reduce taxes, assume a foreign corporation has a wholly owned U.S. sub sidiary. The foreign corporation manufactures a product in its home country which it then sells to the U.S. subsidiary. The U.S. subsidiary, in turn, sells the product to unrelated third parties. Due to the foreign parent's control of its subsidiary, the price which is charged by the parent to the subsidiary could theoretically be set independently of ordinary market forces. If the foreign cor poration is established in a jurisdiction that would subject its prof its from the manufacture and sale of the product to an effective rate of tax lower than the effective U.S. tax rate (and assuming that the foreign corporation's presence in the United States apart from the subsidiary is sufficiently limited so that its profits would not be subject to U.S. tax), then the foreign corporation may be in clined to overcharge the U.S. subsidiary for the product. By doing

[2] In different circumstances, the relevant nexus rules may depend on whether the income has its source in the United States, whether the income is effectively connected with a U.S. trade or business, or whether the income is connected with a business that operates through a permanent establishment located in the United States. In certain situations, special rules treat undistributed income of a foreign corporation owned by U.S. shareholders as the current income of the U.S. shareholders.

so, a portion of the combined profits of the group from the manufacture and sale of the product would be shifted out of a high-tax jurisdiction (the United States) and into a lower-tax jurisdiction (the foreign corporation's home country).[3] The ultimate result of this process would be a reduced worldwide tax liability of the multinational enterprise.

Transfer pricing issues arise regardless of whether the parent corporation is a foreign or a U.S. corporation. The preceding example involves a transfer from a foreign parent corporation to a controlled U.S. entity. Such a transfer from a foreign entity to a controlled U.S. entity is commonly referred to as an "inbound" transfer. However, a U.S. parent corporation with a subsidiary in a country with a low effective tax rate compared to the U.S. effective tax rate would have an incentive to place a larger portion of profits in that subsidiary by artificially understating transfer prices paid to the U.S. corporation from its subsidiary. Such transfers by U.S. entities to their controlled foreign affiliates are often referred to as "outbound" transfers.

In general, as a practical matter, it is understood that many of the cases involving questions of "inbound" transfer prices to date have involved foreign corporations that manufacture tangible property (e.g., various consumer products) and sell such property to affiliates in the U.S. that distribute the property. It is understood that many of the cases involving questions of "outbound" transfer prices to date have involved U.S. corporations that transfer various manufacturing or other intangibles (for example, patents, know how or secret processes) to affiliates in jurisdictions with low effective tax rates which affiliates then manufacture and sell products using the transferred intangibles.

The relative statutory tax rates of different jurisdictions do not necessarily reflect their relative effective tax rates. Thus factors other than relative statutory tax rates may affect a multinational's incentive to place income or deductions in a particular tax jurisdiction. Factors that might reduce a high statutory rate to a low effective tax rate might include, for example, the ability to avoid a high statutory tax rate by timing rules permitting significant deferral; or by tax planning permitted under a country's combined internal and treaty tax rules (including for example, routing income to low-tax third country affiliates so that it is not taxed in the home country). The effectiveness of tax administration in a country may also be a factor. Other factors that can affect the level of tax borne by income reported in a particular jurisdiction include the availability of double tax relief (e.g., a foreign tax credit), and liability for customs or other duties.

Nontax factors, such as remittance or capital controls, or other actual or perceived advantages to be obtained by reporting a high or low level of income in a particular jurisdiction, might also influence the preference of a multinational enterprise regarding which member of the group retains income and thus the level at which transfer prices may be set in transactions with that member.

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[3] By contrast, foreign companies located in countries with effective tax rates in excess of the U.S. rates may have an incentive to undercharge for sales into the United States in order to shift profits, and the resulting tax, into the United States.

Section 482 of the Internal Revenue Code authorizes the Secr tary of the Treasury or his delegate to redetermine the income th is properly the income of a U.S. entity subject to U.S. taxing jur diction, when it appears that an improper shifting of income b tween the U.S. entity and a commonly controlled entity in anoth country has occurred. Section 482 is not limited to reallocations income between different taxing jurisdictions; it permits realloc tions in any common control situation including reallocations b tween two U.S. entities. However, it has significant application multinational enterprises due to the incentives for taxpayers shift income in such situations to obtain the benefits of significan ly different effective tax rates or for other reasons.

Application of section 482 to determine whether income has bee inappropriately shifted between related parties typically requir access to significant amounts of information from each of the rela ed parties to a transaction and may also require significant ec nomic analysis of transactions between other parties that might b considered comparable to the transactions between the related pa ties. In a multinational context it may be difficult for the Intern Revenue Service (IRS) to obtain the desired information from no U.S. members of the multinational enterprise. Various statuto and other procedural rules are intended to bolster the ability of th IRS to obtain information.

Determinations under section 482 that allocate additional incom to the U.S. might theoretically subject a taxpayer to double ta ation, if both the U.S. and another country imposed tax on th same income and the other country did not agree that the incom should be reallocated to the United States. Tax treaties generall provide mechanisms to attempt to resolve such situations in manner that may avoid double taxation if both countries agre Such mechanisms generally include the designation of a "compe tent authority" by each country, to act as that country's represent ative in the negotiation attempting to resolve such situations. Suc competent authority procedures do not guarantee that double ta may not be imposed in a particular case. Rather, the success of th procedure in each case depends on the outcome of the negotiation

B. Code Section 482

In general

Congress originally enacted the predecessor to section 482 of th Internal Revenue Code in 1928.[4] The purpose of that provision wa "to prevent evasion by the shifting of profits, the making of ficti tious sales, and other methods frequently adopted for the purpos of 'milking,' and in order clearly to reflect their true tax liabil ity." [5]

Present-law section 482 grants the Secretary of the Treasur broad authority to allocate income, deductions, credits or allow ances between any commonly controlled organizations, trades, o

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[4] Section 45 of the Revenue Act of 1928. However, the rule was originally established in Regu lation 41, Articles 77 and 78 under the War Revenue Act of 1917.

[5] H.R. Rept. No. 2, 70th Cong., 1st Sess. (1928), pp. 16-17.

business in order to prevent evasion of taxes or clearly to reflect income.[6]

The statute does not generally prescribe any specific reallocation rules that must be followed, other than establishing the general standards of preventing tax evasion and clearly reflecting income. Treasury regulations adopt the concept of the arm's length standard as the method of determining whether reallocations are appropriate. Thus, the regulations attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been uncontrolled parties dealing at arm's length.[7]

The Tax Reform Act of 1986 amended section 482 to require that in the case of certain transfers or licenses of intangible property, the income with respect to such transfer or license shall be "commensurate with the income attributable to the intangible." [8] The legislative history of this provision stated that the relationship between related parties is different from the relationship between unrelated parties and that comparable unrelated party transactions often cannot be found, particularly in the case of intangibles. The legislative history stated that the Treasury Department should conduct a comprehensive study of the intercompany pricing rules.[9]

Treasury regulations dealing with the 1986 Act provision have not yet been issued, but the Treasury Department has released a discussion draft study of intercompany pricing issues (the so-called Treasury "White Paper") discussing the "commensurate with income" standard for intangibles as well as other aspects of section 482. The White Paper generally reendorsed the concept of the arm's length standard for all types of transfers, including transfers or licenses of intangibles.[10]

Persons and activities subject to section 482

Section 482 is applicable to any organization, trade, or business, whether or not incorporated. Treasury regulations define an "organization" as any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation (as each is defined or understood in the Code or regulations), irrespective of the place where organized or operated, or where its trade or business is conducted, and regardless of whether it is domestic or foreign, tax-exempt, affiliated, or a member of a group which files a consolidated tax return.[11] Moreover under the

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[6] Section 482 states in part: "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

[7] See Treasury Regulation section 1.482-1(b)(1). A more specific discussion of the regulations appears in I.C., *infra*.

[8] Section 1231(e)(1) of the Tax Reform Act of 1986.

[9] H.R. Rept. No. 99-426, 99th Cong., 1st Sess. at 423-425 (1985).

[10] U.S. Treasury Department (Office of International Tax Counsel and Office of Tax Analysis) and Internal Revenue Service (Office of Assistant Commissioner (International) and Office of Associate Chief Counsel (International)), *A Study of Intercompany Pricing*, Discussion Draft, October 18, 1988 (hereinafter "White Paper").

[11] Treas. Reg. sec. 1.482-1(a)(1).

regulations, a "trade" or "business" includes any trade or busines activity of any kind, regardless of whether or where organize whether owned individually or otherwise, and regardless of th place where carried on.[12] The regulations thus define these term to be broadly inclusive. The legislative history supports a broad ir terpretation. When the term "organization" was added to the prec ecessor of section 482, the Ways and Means Committee report ex plained that the intent of the addition was to "remove any doub as to the application of this section to all kinds of business activi ty." [13] In certain situations, courts have ruled that the require ments necessary to establish "business activity" for purposes of th application of section 482 are much less stringent than those neces sary to be considered engaged in a trade or business for tax pur poses.[14]

Determination of control

The Secretary may invoke section 482 to reallocate income onl in the case of persons that are under common control. The statut does not provide any specific definition of common control. In thi respect, section 482 differs from and is broader than many Cod provisions that address the treatment of certain related part transactions and that contain precise rules for determining wher parties are related, including requirements of specific levels o stock ownership and specific attribution rules.

The regulations provide that the concept of control under sectior 482 includes any kind of control, however exercised or exercisable whether direct or indirect, and whether or not legally enforceable The "reality" of control in a particular case is determinative, with out regard to the form or mode of exercise of that control. In addi tion, the regulations provide that there is a presumption of control in any case where income or deductions have been shifted between persons in an arbitrary manner.[15]

Section 482 invoked only by the IRS

Section 482 provides that the Secretary may distribute, apportion, or allocate items that are germane to the determination of tax. The regulations clarify that the provisions of section 482 may be invoked only by the IRS. That is, a taxpayer is granted no right under section 482 to compel the IRS to distribute, apportion, or allocate items.[16] However, if the IRS proposes a reallocation under section 482 with respect to an item or transaction, the regulations provide that the taxpayer may claim a setoff with respect to another item or transaction between the same parties in the same year if it can be shown that reallocation with respect to that item or transaction is appropriate.[17]

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[12] Treas. Reg. sec. 1.482-1(a)(2).
[13] H.R. Rept. No. 704, 73d Cong., 2nd Sess. 24 (1934).
[14] See, for example, *Asiatic Petroleum Co.* v. *Commissioner*, 79 F.2d 234 (2d Cir. 1935), *cert. denied*, 296 U.S. 645 (1935).
[15] Treas. Reg. sec. 1.482-1(a)(3).
[16] Treas. Reg. sec. 1.482-1(b)(3).
[17] *See* Treas. Reg. sec. 1.482-1(d)(3), Rev. Proc. 70-8, 1970-1 C.B. 434.

Application of section 482

The rules of section 482 apply whenever necessary to prevent evasion of taxes or to clearly reflect the income of controlled taxpayers. The IRS is not restricted in its application of section 482 to cases of improper accounting, to fraudulent, or sham transactions, or to cases of devices designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. Rather, its authority to determine true taxable income by utilizing section 482 extends to any case in which, either by inadvertence or design, a controlled taxpayer's taxable income is other than it would have been had the taxpayer been conducting its affairs on an arm's length basis with an uncontrolled person.[18]

Relevance of customs valuations in certain cases

The Tax Reform Act of 1986 added section 1059A to the Code. This section limits the transfer price on imported property for income tax purposes to an amount not in excess of the value taken into account for customs purposes. The rule applies to any property imported in a transaction (directly or indirectly) between related persons within the meaning of section 482. The rule reflects a concern that an importer might have an incentive to place a low value on imported property for customs purposes, while at the same time asserting that a high transfer price paid by a related party was appropriate for that party's income tax purposes.[19] In enacting this provision, Congress did not express the view that valuation of property for customs purposes should always determine valuation of property for U.S. income tax purposes. Instead, Congress was concerned only with establishing a limit on the cost of goods sold that an importer could claim for income tax purposes.

C. Regulations Under Section 482

Overview

In evaluating whether income must be reallocated between related parties to prevent the evasion of tax or clearly to reflect income, the Treasury regulations adopt the concept of the arm's length standard. Thus, the regulations attempt to determine what an arm's length charge between unrelated parties would have been and to adjust the income of related parties as necessary to reflect such a charge. The regulations look principally to comparable transactions between unrelated parties where they exist.

The present regulations contain rules addressing several kinds of transactions. Although the goal in each case is to identify the arm's length charge, the regulations provide somewhat different formulations of the approaches to be used for each of five specific types of transactions: the sale of tangible property, the use of tangible property, the licensing or sale of intangible property, the performance of services, and loans or advances. In each of these types of cases, the regulations attempt to prescribe methods to identify the relevant comparable unrelated party transaction and to pro-

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[18] Treas. Reg. sec. 1.482-1(c).
[19] Sen. Rept. No. 99-313, 99th Cong., 2d Sess. 418 (1986).

vide adjustments for differences between such transactions and the related party transactions. In some instances the regulations also provide safe harbors.

Tangible property transfers

In the case of transfers of tangible property, the regulations prescribe three methods to determine an arm's length price and provide an order of priority as to which method must be used if possible.[20] The three methods, in order of priority, are: (1) the comparable uncontrolled price method, (2) the resale price method, and (3) the cost plus method. Each of these methods attempts to determine an arm's length price by looking to "comparable" unrelated party transactions. The nature of the unrelated party transactions and the data required differs under each method. If none of the three prescribed methods is applicable because no sufficiently comparable arm's length situations can be found, the regulations permit the use of another "appropriate" method. The various methods that have been utilized under this catch-all are commonly referred to as "fourth" methods. However, the regulations provide no specific guidance with respect to such other methods.

Comparable uncontrolled price ("CUP") method

The comparable uncontrolled price method determines an arm's length price based on the actual prices charged in comparable sales between unrelated parties.[21] For example, if a parent corporation sells property to its controlled subsidiary corporation, and if identical property is sold between unrelated parties under identical conditions, the price actually charged between the unrelated parties would be the comparable uncontrolled price and would be the arm's length price for the sale between the controlled corporations.

This method must be used if comparable sales between unrelated parties exist. Sales between unrelated parties include sales by the taxpayer to an unrelated party; sales by an unrelated party to the taxpayer; and sales between two unrelated parties. Sales are considered comparable to the sales at issue if substantially the same products are sold under substantially the same conditions. Sales are also considered comparable, even though there may be differences in the products or conditions, if such differences can be shown to have no effect on price or if the effect of such differences on price is definite and reasonably ascertainable and can be reflected with a reasonable number of adjustments to the prices of the unrelated party sales. Differences that may affect intercompany prices include the quality of the product, the terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place.

The question whether unrelated party sales can be considered comparable under this provision in particular cases has been the source of extensive controversy between the Internal Revenue Service and taxpayers. The principal issues are whether there are differences in the property or circumstances and, if there are,

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[20] Treas. Reg. sec. 1.482-2(e).
[21] Treas. Reg. sec. 1.482-2(e)(2).

whether the effect of such differences can be measured with reasonable accuracy and reflected with a reasonable number of adjustments.

Resale price method

If the comparable uncontrolled price method is not available because of a lack of qualifying uncontrolled sales, the regulations mandate the use of the resale price method if the requirements of that method can be met.[22]

The resale price method is typically used for sales to a controlled distributor or "reseller." This method determines an arm's length price based on the resale profit margin realized by distributors that are not related to their suppliers. In order to provide useful profit margin data, these unrelated distributors must perform distribution activities that are comparable to those performed by the controlled distributor.

This method determines an arm's length price by first identifying a resale price (generally, the price at which the property purchased by the related party purchaser is finally sold to unrelated parties) and then subtracting an appropriate markup. The appropriate markup is determined by reference to the markup earned in transactions where unrelated parties purchase and resell property in resales that are considered the most similar to the resales of the property in question. Additional adjustments are made to reflect material differences between the uncontrolled transactions used to determine the appropriate markup and the taxpayer's transactions. The differences must be differences in functions or circumstances that have a definite and reasonably ascertainable effect on price.

The regulations observe that a typical situation where the resale price method may be required is where a manufacturer sells products to a related distributor which resells the products to unrelated parties without further processing or without adding more than insubstantial value to the property. However, the regulations do not expressly limit the method to such cases. Even if the reseller has added substantial value to the property, the regulations permit the use of this method if the adjustments under this method are more feasible and more likely to result in an accurate determination than would be the case if the cost plus method were used. As explained below, the cost plus method would typically require comparing the return earned by the related party seller (manufacturer) to the return earned by sellers (manufacturers) selling to unrelated parties, whereas the resale price method typically compares the return earned by the buyer (reseller) to the returns earned by unrelated party buyers (resellers). Thus, the regulations indicate that the resale price method would generally be preferable if the functions performed by the buyer (reseller), even though adding substantial value, are less extensive and easier to evaluate than the functions performed by the seller (manufacturer).[22a]

As in the case of the comparable uncontrolled price method, extensive controversy between the IRS and taxpayers arises in the determination of appropriate comparables for the resale price

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[22] Treas. Reg. sec. 1.482-2(e)(3).
[22a] Treas. Reg. sec. 1.482-2(e)(3)(iii).

method and the question whether the effect of differences can be measured with reasonable accuracy and reflected with a reasonable number of adjustments.

Cost plus method

The regulations require use of the cost plus method if neither of the two prior methods is available and if the requirements for use of the cost plus method can be met.[23]

The cost plus method determines the arm's length price of property in a sale to a controlled purchaser by looking to the costs and markups of sellers engaged in selling comparable products to unrelated parties. The cost plus method then applies the markup of such unrelated sellers to the costs of the seller involved in the sale to a controlled party. The cost plus method thus requires a determination of the commonly controlled seller's cost of producing the property. It also requires a determination of the appropriate unrelated party markup. This markup reflects the gross profit percentages earned on unrelated sales of property that are the most similar to the controlled sale in question. Adjustments must be made for differences that have a definite and reasonably ascertainable effect on price.

In the context of determining the appropriate transfer price charged by a manufacturer (seller) to a controlled distributor, this method would require examining the costs of the manufacturer (seller) and determining an appropriate markup based on markups of manufacturer (sellers) making sales to unrelated parties. It thus differs from the resale price method, which requires information related to the controlled distributor in question and to other comparable distributors purchasing from unrelated manufacturers.

As in the case of the other two methods, the selection of comparables and the question whether differences have a definite and reasonably ascertainable effect on price can produce extensive controversy between the IRS and taxpayers.

So-called "fourth methods"

The regulations provide that if the standards for applying one of the three specified methods are met, that method must be used unless the taxpayer can establish that, considering all the facts and circumstances, some other method is clearly more appropriate. Where none of the three prescribed methods reasonably can be applied, another method can be used, including variations on the prescribed methods.[23a]

Treatment of other transactions that occur in connection with tangible property sales

The regulations provide guidance for dealing with related party transactions that occur in connection with transfers of tangible property, such as the performance of services or the transfer of intangibles. In general, when services or intangibles are present in connection with a transfer of tangible property, these elements are considered in determining whether the unrelated party transac-

[23] Treas. Reg. sec. 1.482-2(e)(4).
[23a] Treas. Reg. sec. 1.482-2(e)(1)(iii).

tions that are relevant under a particular method can be considered comparable. If unrelated party transactions do not involve comparable services or intangibles, then a determination must be made whether the effect of the service or the intangible can be estimated with reasonable accuracy. If it can, then the unrelated party transactions are adjusted for such effect to determine the arm's length price for the transfer of the tangible property. If the effect of such factors cannot be estimated with reasonable accuracy, then it may be necessary to use another method.

One example in the regulations deals with a situation where a seller (manufacturer) desires to charge a relatively low price (producing less than a normal profit to it) on sales to its controlled distributor, for the primary purpose of establishing or maintaining a market for the manufacturer's products. The example indicates that if the distributor in turn charges a correspondingly low price in its resales to unrelated parties, or if the distributor engages in substantially greater sales promotion activities than for other products, these facts are evidence that the low price charged by the manufacturer may be an arm's length price, because an unrelated distributor might pay a lower price to the manufacturer for the product to take into account such distributor's increased selling and advertising activities to penetrate and establish the market.[24]

The transfer of tangible property may involve an intangible asset—for example, a valuable trademark of the seller (manufacturer) or the buyer (reseller) may be affixed to the tangible property. Similarly, the seller (manufacturer) or the buyer (reseller) may have other valuable marketing or manufacturing intangibles (such as a patent or production know how) that are used in connection with the manufacture or sale of the tangible property. The regulations governing transfers of tangible property recognize that the presence of intangibles in such cases may introduce a factor whose effect on price is not definite and reasonably ascertainable when making adjustments under one or more of the three prescribed methods. However, the regulations permit and even require adjustments using one of the three methods where there are adequate uncontrolled otherwise comparable transactions and the effect of the intangible on comparability can be reasonably determined.[24a]

Services

Related parties may perform services for one another either in connection with the transfer of property or otherwise.

The regulations provide rules for determining the arm's length charge for services when no property transfer is involved, including rules that permit the use of a cost-recoupment measurement (without profit to the service provider) in certain circumstances (where services are not an integral part of the business activity of either the party rendering or the party receiving the services) and safe harbors identifying those circumstances.[25] However, where services are provided in connection with the transfer of property, the regulations require the amount of any allocation with respect to the

[24] Treas. Reg. sec. 1.482-2(e)(2)(iv).
[24a] Treas. Reg. secs. 1.482-2(e)(2)(ii), 1.482-2(e)(3)(iii), 1.482-3(e)(2)(vi)(c), 1.482-2(e)(4)(iii)(c).
[25] Treas. Reg. sec. 1.482-2(b).

transfer to be made under the rules that apply to that type of property transfer, so that no separate allocation to services is made.[26]

Use and transfer of intangibles

Intangibles may be transferred, or permitted to be used, between related parties in connection with the transfer of tangible property or otherwise.

The Tax Reform Act of 1986 modified section 482 in the case of transfers or licenses of certain intangibles to require the use of an income allocation standard under which the income of the transferor with respect to such transfers or licenses would be "commensurate with the income attributable to the intangible." [27] The 1986 Act provision applies to transfers of intangible property after the 1986 Act effective date, whether from a U.S. entity to a related foreign entity, or from a foreign entity to a related U.S. entity. Regulations have not yet been issued under the provision. However, the Treasury Department White Paper sets forth preliminary views and recommendations regarding the "commensurate with income" standard.[28] A discussion of these views and recommendations is beyond the scope of this pamphlet.

Loans or advances

The regulations generally provide for reallocations if there are loans or advances between controlled parties and no interest has been charged or interest has been charged at a rate not equal to an arm's length rate, determined taking account of all the facts and circumstances.[29]

Safe harbor rates are provided if the lender is not regularly engaged in the business of making loans or advances of the same general type to unrelated parties. The regulations provide a specified safe-harbor range between a minimum and maximum rate, based on the applicable Federal rate in effect when the loan or advance is made. In the safe-harbor situations, the taxpayer can establish a more appropriate rate based on all the facts and circumstances under the arm's length standard. If the actual rate charged is less than the safe-harbor minimum rate, however, the taxpayer may not establish that an arm's length rate would be even less than the amount actually charged. Similarly, if the rate actually charged is greater than the safe-harbor maximum rate, the taxpayer may not

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[26] Treas. Reg. sec. 1.482-2(b)(8).

[27] Section 1231(e)(1) of the Tax Reform Act of 1986. Although the statute does not further specify the application of this standard, the legislative history expressed concern that the relationship between related parties is different from that of related parties and that comparable related party transactions often cannot be found, particularly in the case of intangibles. The legislative history expresses a concern that the prior law section 482 provisions may not have operated to assure adequate allocations to the transferor, particularly in cases where a U.S. entity creates manufacturing or other intangibles and transfers them to a controlled affiliate (for example, a controlled manufacturer) in a low effective tax-rate jurisdiction. The legislative history indicates generally that due to concerns about the lack of actual comparables, industry norms for licenses or transfers of intangibles that are transferred to unrelated parties may not be used as safe harbors for transfer prices of intangibles that have not in fact been transferred to an unrelated party, and that consideration must be given to the actual profit experience realized as a consequence of the related party transfer. H.R. Rept. No. 99-426, 99th Cong., 1st Sess. 423-425 (1985).

[28] White Paper, n. 10, *supra*.

[29] Treas. Reg. sec. 1.482-2(a).

establish that an arm's length rate is even greater than the amount charged.[30]

A special rule applies if the loan represents the proceeds of a loan that the lender acquired at the situs of the borrower from an unrelated party. In that case, the arm's length rate is presumed to be the rate paid to the unrelated party increased by any other costs of the lender, unless the taxpayer can show that a different rate is more appropriate.[31]

The regulations generally require interest to be charged for the entire period from the day indebtedness arises to the day it is satisfied. However, interest-free periods are permitted in certain circumstances. As one example, interest is not required to be charged on an intercompany trade receivable in the ordinary course of business until the first day of the third calendar month following the month in which the intercompany trade receivable arises.[31a]

These regulations apply to all loans or advances including indebtedness arising in the ordinary course of business out of sales, leases, or the rendition of services by or between members of the group. They do not apply to loans or advances that are properly characterized as equity.

Special rules explain the relationship of these rules to other statutory provisions that prescribe a minimum or other specific interest rate in certain circumstances.

Use of tangible property

The regulations generally provide for reallocations if tangible property is leased to a controlled party and no rent is charged or rent has been charged at a rate not equal to an arm's length rental, determined taking account of all the facts and circumstances.

The regulations describe factors to be taken into account and prescribe rules permitting the use of certain safe harbors where neither the owner nor the user of the leased property is engaged in the trade or business of renting property.[32]

D. Administrative Procedure

In general

Generally, the examination of a section 482 case, like the examination of other tax issues, involves an Internal Revenue Service audit of a tax return (or returns) filed in the United States. An aspect that sets section 482 audits apart from many others is that they involve not only the taxpayer that filed the return (or returns) in question, but also persons related to that taxpayer, who themselves may or may not be within the taxing jurisdiction of the United States.

The Code requires every taxpayer to keep records and documents relevant to the determination of its tax liability and, if requested,

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[30] Treas. Reg. sec. 1.482-2(a)(2)(iii). Different safe harbors are provided under earlier regulations for transactions before May 9, 1986 or after that date pursuant to certain binding contracts.

[31] Treas. Reg. sec. 1.482-2(a)(2)(ii).

[31a] Treas. Reg. sec. 1.482-2(a)(1)(iii).

[32] Treas. Reg. sec. 1,482-2(c).

to furnish those records or produce statements to the IRS (sec. 6001). Initial requests for information necessary to an audit are generally submitted to the taxpayer under audit by the IRS in the form of Information Document Requests (IDRs). The IRS is empowered, for the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the tax liability of any person, or collecting any such liability, to (1) examine any books, papers, records, and other data that may be relevant or material to such inquiry, (2) to summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries related to the business of the person liable for tax or required to perform the act, or any other person the IRS may deem proper, to appear before the IRS at a time and place named in the summons and to produce such books, papers, records, or other data and to give such testimony, under oath, as may be relevant or material to such inquiry, and (3) to take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry (sec. 7602(a)). The United States district court for the district in which the summoned person is found has jurisdiction by appropriate process to compel such person to comply with the summons (sec. 7604(a)).

In cases involving intercompany pricing of goods manufactured by a foreign parent company and sold to a U.S. subsidiary, for example, it is often necessary to obtain relevant cost and pricing information from the foreign parent in order to ascertain the arm's length price of the goods in question. The scope of the IRS' summons authority in such cases has been the subject of litigation. IRS summonses have been ordered to be enforced against a foreign parent that sells goods in the U.S. through a U.S. subsidiary. See, *e.g., United States* v. *Toyota Motor Corp.*[33] However, as a practical matter it may be difficult for the IRS to enforce a summons and obtain information from parties in foreign jurisdictions for various reasons, including the possibility that the required information is not in existence at the time the summons is issued. Furthermore, enforcement of the summonses in *Toyota* was based on several factors including the fact that the boards of directors of the foreign parent and the U.S. subsidiary had interlocking membership, and the fact that the foreign parent itself had significant business activities in the United States. In the absence of such factors, the courts have not clearly determined the standards for enforcement of summonses against foreign parents of U.S. subsidiaries.

Through the use of whatever information the IRS is able to obtain, it will generally attempt to construct, through economic analysis and other means, what it believes to be an appropriate arm's length price, and to the extent that this price differs from the price actually charged in the transaction under review, make appropriate adjustments to the tax liability of the taxpayer. In situations where the taxpayer believes that the arm's length price constructed by the IRS is erroneous, and is unable to reach a settlement of the issue with the examining agent or through the IRS Ap-

[33] *United States* v. *Toyota Motor Corp.*, 561 F.Supp. 354 (C.D. Cal. 1983); 569 F.Supp. 1158 (C.D. Cal. 1983).

peals Office, it may choose to litigate the matter or go to competent authority when a treaty applies.

Reporting, recordkeeping and related requirements (sec. 6038A)

In general

The rules detailed below generally apply in the case of U.S. entities that have significant foreign ownership (as defined) for taxable years beginning after July 10, 1989, and reflect amendments made by the Omnibus Budget Reconciliation Act of 1989 (the "1989 Act").[34] For audits of tax years beginning prior to or on July 10, 1989, less stringent rules currently apply. However, as noted below, legislation has been proposed that would make the 1989 Act amendments applicable to all taxable years for which the statute of limitations has not closed.

Information reporting and maintenance

Any corporation (U.S. or foreign) that conducts a trade or business in the United States and that is 25-percent owned by a foreign person ("reporting corporation") must furnish the IRS with such information as the Secretary may prescribe regarding transactions with certain foreign persons treated as related to the reporting corporation ("reportable transactions") (sec. 6038A).[35] Under current regulations, the IRS requires the annual filing of an information return reporting all related-party transactions (Treas. Reg. sec. 1.6038A-1).[36] In addition, a reporting corporation is required to maintain (or cause another person to maintain), in the location, in the manner, and to the extent prescribed by regulations, any records deemed appropriate to determine the correct tax treatment of reportable transactions (sec. 6038A(a)).

Application of U.S. legal process to foreign persons

As previously mentioned, the statutory scope of general IRS summons authority extends to certain persons that are not themselves subject to tax in the United States. However, such summonses may not be practically or legally enforceable in all appropriate cases, especially where summoned materials are in the possession of a foreign person. The Code provides that in order to avoid the consequences of the noncompliance rules (discussed below) with respect to certain reportable transactions, each foreign person that is a related party of a reporting corporation must agree to authorize the latter to accept service of process as its agent in connection with any request or summons by the IRS to examine books, records, or other materials, to produce such materials, or to take testimony related to any reportable transaction, solely for the purpose of determining the tax liability of the reporting corporation (sec.

[34] Code section 6038 contains rules relating to information that must be provided by U.S. persons who control a foreign corporation.

[35] Similarly, U.S. shareholders that control foreign corporations are required to report certain information with respect to such foreign corporations and all transactions with such foreign corporations (sec. 6038). Noncompliance with the requirements of section 6038 can be sanctioned by monetary penalties, as well as by the reduction or elimination of foreign tax credits allowed to U.S. shareholders that fail to report the required information (sec. 6038(c)).

[36] However, the regulation has yet to be amended to reflect the broadening in the 1989 Act (sec. 7403(a)) of the definition of a related party.

6038A(e)(1)). Thus, assuming such authorization is given, IRS examination requests and summonses with respect to related-party transactions involving U.S. taxpayers can be served on related foreign persons that do not directly engage in trades or businesses in the United States.

Sanctions for noncompliance

Monetary penalty.—Failure to furnish the IRS with information or to maintain records as required under section 6038A(a) and (b) is sanctioned by a monetary penalty of $10,000, and additional penalties are imposed if the failure continues more than 90 days after the IRS notifies the taxpayer of the failure (sec. 6038A(d)). The additional penalties are $10,000 for each 30-day period (or fraction thereof) during which the failure continues after the 90th day after IRS notification.

Noncompliance rule.—Failure of a related party to designate a reporting corporation as its agent for accepting service of process in connection with reportable transactions (as discussed above), or, under certain circumstances, noncompliance with IRS summonses in connection with reportable transactions, can result in the application of noncompliance rules in computing tax liability. For certain payments to related parties in connection with reportable transactions, this rule permits the IRS to allow the reporting corporation only those deductions and amounts of cost of goods sold as shall be determined by the Secretary in the Secretary's sole discretion, based on any information in the knowledge or possession of the Secretary or on any information that the Secretary may obtain through testimony or otherwise (sec. 6038A(e)).

Proposed amendments to statutory information provisions

Earlier this year, the Foreign Tax Equity Act of 1990 was introduced in both Houses of Congress.[37] Included in this proposed legislation are three provisions affecting transactions undertaken between U.S. taxpayers and foreign related persons. First, the proposed legislation would make the amendments to section 6038A enacted in 1989 (i.e., reduced ownership threshold, increased monetary penalty, noncompliance rule, and requirement that related foreign persons designate U.S. agents for service of process purposes) applicable to any taxable year for which the limitations period had not expired as of March 20, 1990. Second, the bill would create a new section 6038C, with substantive rules similar to those found in section 6038A (as it would be amended by the bill) which would apply to foreign corporations engaged in business in the United States through a branch. This provision would apply not only to related party transactions, but, as specified by the Secretary, to other items related to the determination of the foreign corporation's U.S. tax liability. Third, the legislation, if enacted, would authorize the Secretary to extend the period for assessment for up to three additional years in certain cases involving deficiencies of either a foreign-owned domestic corporation (as defined in section 6038A) or a foreign corporation, without the consent of the taxpay-

[37] H.R. 4308 (introduced March 20, 1990), and S. 2410 (introduced April 3, 1990) (101st Cong., 2nd Sess.).

er. The authority to extend the assessment period would apply to any case where the Secretary is unable to accurately assess a deficiency prior to the expiration of the regular assessment period (including extensions thereof) by reason of delay or other actions of the taxpayer, and where the deficiency is related to a transaction (or other item) reporting for which would be required under section 6038A or 6038C.

Section 982

The Code also provides a specific sanction for the failure to comply with certain IRS requests to produce foreign-based documentation. If, in connection with the examination of any item, a taxpayer fails to timely and substantially comply with a request issued by the IRS for any relevant or material documentation which is located outside the United States, the requested documentation becomes inadmissible as evidence in any subsequent civil proceeding in which the examined item is an issue. However, this sanction does not apply if the taxpayer establishes that the failure to provide the documentation was due to reasonable cause (Code sec. 982).

IRS consideration of advance determination process

It has been reported that the IRS is considering and probably will propose a method for granting advance determination rulings on international transfer pricing. According to these reports, one approach under consideration would permit the taxpayer to provide the IRS in advance with a full explanation of its pricing method and to seek an advance determination letter. Such an advance determination letter would typically be effective for three years with the possibility of unlimited three year extensions. However, an agreed method would not bind the IRS if the taxpayer provided inaccurate information or failed to comply with the conditions of the letter, or if critical assumptions on which the letter was based proved to be substantially invalid.[38]

E. Tax Treaties

"Associated enterprises" provisions of treaties generally

As a general rule, tax treaties are entered into for two purposes. One purpose is to avoid double taxation by the two treaty countries of the income of a resident of either country. The other is for the prevention of fiscal evasion with respect to the income taxes of the two countries.

Most treaties include an article dealing with "associated enterprises." As an example of such an article, Article 9 of the 1981 proposed model income tax treaty (the "U.S. model") provides a special rule applicable to cases where either an enterprise of a treaty country participates directly or indirectly in the management, control, or capital of an enterprise of the other treaty country, or the same persons participate, directly or indirectly in the management, control or capital enterprises of both treaty countries. In either of

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[38] *See, e.g.*, Bureau of National Affairs Daily Report for Executives No. 113, G-5 (June 12, 1990); *see also* Tax Notes International, 565 (June 1990) 47 Tax Notes No. 10, 1151 (June 4, 1990).

these cases, if conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between two independent enterprises, then any profits which, but for those conditions would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.[39] In addition, the U.S. model expressly permits application of internal law provisions which permit the distribution, apportionment, or allocation by the government of a treaty country of income, deductions, credits, or allowances between persons, whether or not residents of a treaty country, owned or controlled directly or indirectly by the same interests, when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons.

The distribution, apportionment, or allocation by the government of a treaty country of tax items between related enterprises could, in some cases, give rise to actual or economic double taxation. For example, if an amount is originally included in the income of a treaty country enterprise, thereby becoming taxable in that country, and is subsequently included in the income of a related enterprise located in the other treaty country (by way of the associated enterprises article of the relevant treaty), and thus is also taxed in that other country, double taxation of the same item of income would occur. In an attempt to avoid this result, treaties often provide that if the first country agrees that the allocation by the other country was correct then it shall make an appropriate adjustment (often referred to as a correlative adjustment) to the amount of the tax paid by the first enterprise which was attributable to the amount that was so allocated. It should be noted that under the OECD model treaty, a correlative adjustment is not automatically required to be made by the first country. Rather, it is generally required only if the first country considers that the amount of adjusted profits correctly reflects what the profits would have been if the transaction had been conducted at arm's length.[40] The method by which such an adjustment is to be carried out is generally not specified.[41]

Competent authority

In general

Administration of the associated enterprises provision discussed above is generally handled by the "competent authorities" of the two treaty countries. In the case of the United States, the competent authority is the Secretary of the Treasury or his delegate.[42] In 1973, responsibility for administration and implementation of tax treaties was delegated to the Commissioner of the Internal Revenue Service, and since 1986 has been the responsibility of the Office of the Assistant Commissioner (International) of the Internal

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[39] A similar provision is included in Article 9 of the Organization for Economic Cooperation and Development (OECD) Model Double Taxation Convention on Income and on Capital.

[40] See, e.g., *The Model Double Taxation Convention on Income and on Capital of the OECD: Report of the OECD Committee on Fiscal Affairs (1977)*, Commentary on Article 9, p. 88, paragraph 3.

[41] *Id.* at 88-89, paragraph 4.

[42] Paragraph 1(e)(i) of Article 3 of the U.S. model.

Revenue Service, acting in conjunction with the Associate Chief Counsel (International) in the case of interpretive issues.[43]

The U.S. model permits a resident (including a corporation, partnership, or other person) or national of a treaty country to present his case to the competent authority of the country in which he is a resident if he considers the actions of one or both of the treaty countries have resulted (or will result) for him in taxation not in accordance with the treaty.[44] An example of taxation not in accordance with the treaty resulting from actions of one or both of the treaty countries might be where one of the countries allocates income to a related enterprise under the provisions of the associated enterprises article, thereby causing that income to be taxed by both countries. Where the objection appears justifiable and if the competent authority is not able in and of itself to arrive at a satisfactory solution, then the U.S. model states that the competent authority shall endeavor to resolve the case by mutual agreement with the competent authority of the other treaty country.[45] Once reached, an agreement between the Competent Authorities may be implemented, under a treaty like the U.S. or OECD model, without regard to any time limits or other procedural limitations in the domestic law of the two countries. Thus, such an agreement may be implemented under some treaties even though the time period for granting relief under domestic law has expired with respect to the taxable year at issue, though some treaties do not contain this provision and others limit the time period to some other specified period. As a practical matter, even where authority is granted to override the statute of limitations, it might not be exercised. In light of this and the fact that some treaties do not even contain authority to override the domestic statute of limitations of treaty countries at all, a standard form letter is generally issued by the IRS in section 482 cases which advises the taxpayer that it should consider taking action to keep open the statute of limitations in other countries.

The mutual agreement procedure provided in tax treaties differs in theory from other procedures that might be available to a taxpayer to contest a proposed adjustment in that it not only takes account of the merits of the allocation as viewed under U.S. law, but also might take account of the merits of a correlative allocation under foreign law and the desirability of avoiding double taxation in a particular case. However, the mutual agreement procedure does not guarantee a taxpayer that the competent authorities will agree that the internal laws of each country support the allocation requested by one; nor does it guarantee that in the absence of such agreement relief from actual or potential double taxation will in fact be granted.

Guidelines for invoking competent authority procedure

Guidelines for seeking the assistance of the U.S. competent authority in cases where either the United States or a treaty partner

[43] Treasury Department Order No. 150-83, 1973-2 C.B. 508, and Delegation Order No. 114 (Rev. 8), 1988-1 C.B. 470.

[44] Paragraph 1 of Article 25 of the U.S. model.

[45] Paragraph 2 of Article 25 of the U.S. model.

has allocated income pursuant to the associated enterprises article of the relevant treaty are currently provided in Revenue Procedure 82-29.[46] This Revenue Procedure states that in seeking an agreement with the competent authority of the other treaty country, the U.S. competent authority will be guided by the standards of arm's length dealing under section 482 and the equivalent standard of arrangements or conditions that would have been made between independent persons (referred to in a number of treaties). A person should file a written request for U.S. competent authority consideration as soon as practical after a treaty country has sufficiently developed its position regarding an allocation of income or deductions, and in no case later than 90 days after a formal proposal to allocate has been made by that country. If the IRS allocates or proposes to allocate income or deductions attributable to transactions involving a U.S. taxpayer subject to the tax jurisdiction of a treaty country, a written request for competent authority assistance should be submitted as soon as the adjustment is determined, communicated in writing to the taxpayer, and agreed to by the taxpayer subject to competent authority relief. Taxpayers who do not agree with the correctness of the adjustment are encouraged to pursue their right of administrative review before the Appeals Division before requesting competent authority relief.

The U.S. competent authority will only accept cases involving citizens or residents of the United States. Nonresident alien individuals and foreign entities must seek assistance from the competent Authority of their country of residence. The U.S. competent authority may refuse a taxpayer's request for assistance if (1) under the facts and circumstances the taxpayer is not entitled to such assistance (e.g., actual or economic double taxation does not exist), (2) the taxpayer indicates unwillingness to be bound by a competent authority agreement except under certain conditions, (3) the taxpayer is not willing to be excluded from the negotiation process with the other government, (4) the taxpayer fails to furnish in a timely manner all of the information necessary for administration of the case by the competent authority, (5) the taxpayer is under the jurisdiction of another competent authority, or (6) the taxpayer is unwilling to extent the period of limitations on assessment of tax for the years under consideration.

A taxpayer who requests competent authority assistance must present details (and documentation translated into English) regarding the facts of its case, the proposed adjustment, and the positions taken by the governments involved. In addition, the taxpayer must supply additional information required to achieve a resolution of the case, as well as inform the competent authority of any relevant proceedings in the other country or of any other pertinent developments affecting the case.

If the competent authorities of the two countries are unable to reach an agreement, the taxpayer may proceed with other administrative and judicial remedies. If the competent authorities of the two countries involved are able to resolve a case, the taxpayer is not necessarily bound by the resolution. If an agreement (or partial

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[46] Rev. Proc. 82-29, 1982-1 C.B. 481. (For the procedures applicable to U.S. competent authority assistance in other cases see Rev. Proc. 77-16, 1977-1 C.B. 573.)

agreement) reached by the competent authorities of the two countries is not acceptable to the taxpayer, it may withdraw the request for competent authority consideration and may then pursue all rights to administrative and judicial review otherwise available under the laws of the treaty country and the United States. Conversely, if the taxpayer is satisfied with the resolution, a binding closing agreement will generally be signed by the taxpayer and both tax authorities.

II. ISSUES AND ANALYSIS

A. Inherent Difficulties in Determining Transfer Prices

In general

Determining accurate transfer prices between related parties operating in multiple jurisdictions is a major concern in the proper measurement of net income subject to income tax in each jurisdiction. With different rates of tax in each jurisdiction, business enterprises may have an incentive to set transfer prices among affiliates so as to reduce total taxation.

Outbound transfer prices

One area of controversy is the pricing of goods and services transferred to overseas subsidiaries of U.S. corporations, sometimes referred to as "outbound" transfer pricing. For example, assume a U.S. multinational enterprise manufactures a product in the United States, and transfers the product to a foreign marketing affiliate. If the United States imposes tax at a higher effective rate than the affiliate's residence country, and the enterprise enjoys deferral of U.S. tax for income earned abroad, then there is an incentive to establish a low related-party price for the product. A low related-party price would cause income in the United States (which is subject to tax at a high rate) to be artificially low, while income in the affiliate's residence country would be artificially high.

By thus manipulating transfer prices, taxable income can be shifted and the total tax burden on the enterprise can be reduced below the level that would result from using a transfer price which reflected real value and measured economic income. In the absence of restrictions these manipulations are likely because, unlike prices between unrelated parties which directly affect overall before-tax profitability, transfer prices between related parties do not affect overall before-tax profitability of the group. In brief, by adjusting transfer prices, related parties in multiple jurisdictions can significantly increase their combined after-tax profitability with no significant effect on their real business activities.[47]

Inbound transfer prices

Another area of controversy is the pricing of goods and services transferred by foreign manufacturers to their controlled U.S. subsidiaries, sometimes referred to as "inbound" transfer pricing. For example, assume a U.S. corporation distributes a product at the

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[47] Adjustment of transfer prices between related parties will change how profits are allocated between related parties and could distort accounting information that is important to the firm for other purposes. For example, if a firm relied solely on this information for decisions about allocation of funds for new capital and research expenditures and for amounts of executive compensation, these allocations of funds would be distorted.

wholesale level which is manufactured by a foreign corporation which controls or owns a majority interest in the U.S. corporation. If the United States imposes income tax at a higher effective rate than the residence of the foreign parent (or of third countries to which the parent can allocate income), then there is an incentive for the foreign parent to set a high price for sales to its controlled U.S. subsidiary. The higher the price, the higher the foreign profits, and the lower the U.S. profits. Since it has been assumed in this example that the U.S. income taxes are effectively higher than the foreign income taxes, the controlled group can reduce its worldwide tax.

As in the case of outbound transactions, in the absence of restrictions, by adjustment of accounting entries, these related parties can substantially reduce their tax with no commensurate change in their business activities. This has been noted in an 1979 OECD report: "The prices charged for such transfer do not necessarily represent a result of the free play of market forces, but may, for a number of reasons and because the [multinational enterprise] is in a position to adopt whatever principle is convenient to it as a group, diverge considerably from prices which would have been agreed upon in the same or similar transactions in the open market." [48]

Analogous allocation issues

Issues analogous to those arising in the determination of transfer prices for sales between U.S. corporations and related foreign corporations arise in the allocation of income and expenses to U.S. branches of foreign corporations. For example, interest expense of the multinational corporation may be incurred on behalf of both its U.S. and foreign operations, and may not be identified economically with any separate part of the enterprise. Rules have been developed to allocate interest expense between the U.S. and foreign components of the enterprise, but the extent to which these rules achieve the appropriate allocation of interest expense between jurisdictions often engenders dispute.

B. The Arm's Length Approach Versus Formulary Methods

Issues related to the arm's length standard

The international norm for transfers between different countries taxing jurisdictions has generally been the arm's length standard and the Treasury Department has recently reendorsed the arm's length concept in its "White Paper" study of intercompany transfer pricing issues. The Treasury Department quoted Stanley Surrey, in defense of the arm's length method:

> Presumably, most transactions are governed by the general framework of the marketplace and hence it is appropriate to seek to put intra-group transactions under that general framework. Thus, use of the standard of arm's length, both to test the actual allocation of income and ex-

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[48] *Transfer Pricing and Multinational Enterprises—Report of the OECD Committee on Fiscal Affairs*, Organisation for Economic Co-operational Development, Paris, 1979, at para. 2.

pense resulting under controlled intra-group arrangements and to adjust that allocation if it does not meet such standard, appears in theory to be a proper course.[49]

Given the inherent difficulties in determining arm's length prices for transactions between related parties, some commentators have criticized the arm's length standard as unworkable. In addition, some argue it is not being currently enforced because, in a majority of cases, *ad hoc* methods, such as the profit split method, are employed.[50] Such critics argue that comparables are difficult to find in practice. As a result, the arm's length method imposes large administrative burdens on the Internal Revenue Service and large compliance costs on taxpayers. Because of the wide range of possible results, taxpayers face an inordinate amount of uncertainty with regard to their ultimate tax burden. Critics also note that the arm's length method will often fail to result in the correct allocation of income in practice, and is likely to result in significant overtaxation or undertaxation, which is only determined after a period of many years.[51]

Besides these practical problems, some critics have also emphasized the theoretical shortcomings of the arm's length standard. They point out that related parties within a multinational enterprise do not exchange goods and services on the same terms as unrelated parties. Vertically- and horizontally-integrated firms may have "operational interdependence" [52] or "a variety of synergistic effects" [53] which make it impossible to compare sales of even similar products. Furthermore, it has been argued that the very existence of integrated firms indicates that, in a variety of business situations, intra-firm transactions may be more efficient than market transactions. In this case, since by assumption the integrated firm is more efficient than separate firms, transactions between unrelated parties may not be economically viable and, therefore, comparable prices between unrelated parties may not exist.[54]

The formulary method

The most often cited alternative to the arm's length standard is a formulary or unitary system. Under this method, the total worldwide net income of an enterprise is first determined. This net income is then allocated to each of the relevant taxing jurisdictions on the basis of objective apportionment factors associated with that jurisdiction. Such factors might include the fraction of employment, assets, and sales in that jurisdiction. The formulary method, while having certain disadvantages of its own, avoids numerous allocation problems of present law.

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[49] Stanley Surrey, "Reflections on the Allocation of Income and Expenses Among National Jurisdictions," Vol. 10, *Law and Policy in International Business*, (1978), quoted in White Paper n. 10, *supra*, p. 80.

[50] Stanley I. Langbein, "The Unitary Method and the Myth of Arm's Length," *Tax Notes*, February 17, 1986, pp. 625-681.

[51] See Langbein and references he cites, p. 658.

[52] Jerome R. Hellerstein, "The Basic Operations Interdependence Requirement of a Unitary Business: A Reply to Charles E. McClure, Jr.," *Tax Notes*, February 28, 1983, pp. 723-731.

[53] Note, "Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code," 89 *Harvard Law Review*, 1202 (1976).

[54] Ronald Coase, "The Nature of the Firm," reprinted in *American Economic Association, Readings in Price Theory*, G. Stigler and K. Boulding, eds. (1962).

The unitary or formulary approach is in widespread use for interstate allocations within the United States. Under the most commonly adopted unitary system, an entity's taxable income is based on the total income, both from sources within and without the State, of the "unitary group" of related entities carrying on similar or related business activities.[55] These similar or related business activities are treated as one enterprise consisting of a number of entities through which it is anticipated that there will be some sharing or exchange of value which cannot be accurately measured and allocated to specific members of the enterprise. The total income of the unitary group is apportioned to sources within the State on the basis of factors such as the fraction of payroll, property, and sales located in the State.

However, the Treasury Department has supported the arm's length method, rather than the formulary method:

> The current regulations adopt a market-based approach, distributing income among related parties the way a free market would distribute it among unrelated parties. Some critics have suggested that a unitary business approach, eliminating the fiction of arm's length dealing and accounting for economies of related party dealing through a formulary method, might be more theoretically sound. [The White Paper] examines these arguments and concludes that the market-based arm's length standard remains the better theoretical allocation method.[56]

The OECD echoes these sentiments:

> Proposals for radical reformulations of the approach to intra-group transfer pricing which would move away from the arm's length approach towards so-called global or direct methods of profit allocation, or towards fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates, are not endorsed in this report. . . . Such methods would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management's own allocation of resources, thus producing an allocation of profits which may bear no sound relationship to the economic facts and inherently running the risk of allocating profits to an entity which is in truth making losses (or possibly the contrary).[57]

There is, however, a good deal of common ground between the two sides of the debate for and against the formulary method. Often arguments for the formulary method are only arguments against inappropriate application of the arm's length method:

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[55] While the United States taxes U.S. persons on their worldwide income, U.S. localities (including States) tend to impose tax on a more territorially limited basis, at least with respect to corporate taxpayers.

[56] White Paper n. 10, *supra*, pp. 3-4.

[57] *Transfer Pricing and Multinational Enterprises—Report of the OECD Committee on Fiscal Affairs*, Organisation for Economic Co-operational Development, Paris, 1979, at para. 14.

> Both formula apportionment and separate accounting are techniques for dividing the income of corporations among jurisdictions. *If* all transactions between affiliates were at arm's length and there were no shared and unallocable costs and benefits, such as those of central management, research and development, etc., separate accounting would clearly be the preferred approach to the problem of allocating income among jurisdictions where it originates, and formula apportionment would be an arbitrary second best solution. But inter-affiliate transactions do not necessarily occur at arm's length and there are shared costs and benefits. Under these conditions separate accounting is not straightforward or necessarily satisfactory, and it can easily be argued that formula apportionment and unitary combination, despite defects in certain cases, may be the preferred approach.[58]

And proponents of the formulary method often argue on the practical grounds of reduction of administrative complexity and of uncertainty, and not in the theoretical basis of the formulary method achieving the correct result:

> Suppose for a moment . . . that our purpose is to isolate corporate income originating in a given state. Geographic separate accounting cannot satisfactorily subdivide the income of a unitary business operating across state boundaries. Formula apportionment has been accepted as a reasonable way to achieve such a subdivision, even though there should be no illusions that it attributes income accurately to its state of source.[59]

Proposed legislative alternatives to the arm's length standard

1962 Ways and Means Committee proposal

In 1962, the Ways and Means Committee expressed concern that, notwithstanding the restrictions in section 482, certain taxpayers were able to shift profits away from the United States through the use of various related-party pricing techniques. The Committee acknowledged that even though section 482 gave the Secretary broad powers to prohibit intra-group pricing abuses, in practice the difficulties in determining a fair price under this provision severely limit the usefulness of this power. These difficulties are especially apparent when there are thousands of different transactions engaged in between related persons.[60]

In recognition of this problem, the Committee proposed an amendment to section 482 as part of the Revenue Act of 1962 ("the 1962 Act"). This amendment would have authorized the Secretary of the Treasury to allocate income in the case of sales or purchases between a U.S. person and a related foreign person on the basis of the proportion of the amounts of assets, compensation of the officers and employees, and advertising, selling, and sales promotion

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[58] Charles E. McClure, Jr., "The Basic Operational Interdependence Test of a Unitary Business: A Rejoinder," *Tax Notes*, October 10, 1983, p. 98.
[59] *Id.* p. 97.
[60] H.R. Rept. No. 1447, 87th Cong., 2nd Sess. (1962), p. 28.

expenses attributable to the United States and attributable to the foreign country or countries involved. The 1962 Committee Report explained that this formulary approach would enable the Secretary to make an allocation of the *taxable income* of the group involved to the extent it is attributable to the sales in question, whereas in the past the attempt was made only to determine the fair market sales price of the goods in question and build up from this to the taxable income; the latter process being far more difficult and requiring more detailed computations than the former in the Committee's view.[61]

The formulary approach suggested by the Committee would not have been utilized in cases where a fair market (arm's length) price for the product in question could be determined based on comparable sales between independent parties. Moreover, the amendment would have permitted entirely different allocation rules to be mutually agreed upon by the Secretary and the taxpayer in specific situations.

The Conference Committee deleted the amendment to section 482 from the 1962 Act. In doing so, however, it stated the following:

> Section 482 already contains broad authority to the Secretary of the Treasury or his delegate to allocate income and deductions. It is believed that the Treasury should explore the possibility of developing and promulgating regulations under this authority which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.[62]

The Treasury regulations issued since the 1962 Act have continued to follow the arm's length concept.

1990 proposed legislation

More recently, a bill (commonly referred to as the Foreign Tax Equity Act of 1990) was introduced in both the House of Representatives and the Senate.[63] This bill contains four provisions (some of which are discussed in Part I of this pamphlet) aimed at facilitating the examination of inbound transactions and enforcement of the transfer pricing rules. In addition, Chairman Rostenkowski mentioned in his written statement accompanying the legislation upon introduction that future consideration may be given to a fifth provision that would establish a rule which would limit transfer prices in certain transactions. This rule would provide that in determining the taxable income of a U.S. corporation from the sale of property acquired from a foreign person, a transfer price would be used that results in the U.S. corporation having taxable income from the sale of not less than 50 percent of the combined taxable income of the U.S. corporation and any related person from such property, unless the taxpayer is able to prove otherwise to the satisfaction of the Secretary of the Treasury.[64]

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[61] *Id.* at 29.
[62] H.R. Rept. No. 2508, 87th Cong. 2nd Sess., pp. 18-19.
[63] H.R. 4308, 101st Cong. 2nd Sess. (introduced on March 20, 1990, by Ways and Means Committee Chairman Dan Rostenkowski and others). A companion bill (S. 2410) was introduced in the Senate by Senator Levin.
[64] "Statement of Chairman Rostenkowski Relating to Legislation Affecting Investment and Operations by Foreign Companies in the United States," March 20, 1990, p. 2.

C. Problems of Implementing Methods of Directly Estimating Arm's Length Prices

The central issue in application of any of the three methods set forth in the current regulations for determining transfer prices is availability of data. Closely related to the issue of data availability is the issue of comparability that arises in the application of all three of these methods. In order to apply the comparable uncontrolled price method, data on prices of comparable products under comparable circumstances in transactions between unrelated parties are required. In order to apply the resale price method, data on price markups by comparable businesses purchasing and subsequently reselling comparable products are required. In order to apply the cost plus method, data on profit margins of comparable businesses selling similar products are required. In practice, the difficulty of identifying comparable products and of identifying similarly situated businesses can severely limit the application of these methods of determining prices under an arm's length standard. Furthermore, even if data can be obtained, great care must be exercised in interpretation of the data.

The priority assigned to the comparable uncontrolled price method over the other two methods in the regulations is based on the assumption that it is unnecessary to estimate an arm's length transfer price (by the second or third methods) if it can be observed directly.[65] The most easily observable prices of comparable goods are those of goods that are actively traded in existing markets, such as commodities. However, such goods are probably only a small fraction of goods transferred between related parties in multiple jurisdictions. In the absence of goods traded on public markets, it may be possible to observe prices on an individual transaction or series of transactions between unrelated parties. However, identifying comparable goods implies that products for which comparable transfer prices are to be identified should be significantly standardized, as in the case of products with a high degree of homogeneity traded on public markets.[66] Therefore, it is difficult to apply the comparable uncontrolled price method to products which are not significantly standardized. To the extent there are differences in products being compared, the value of differences must be standardized, such as those attributable to freight and insurance charges.

With regard to the resale price method, the regulations require that a markup, expressed as a percentage of the resale price, be determined preferably from uncontrolled purchases and resales by the same buyer purchasing the intermediate product for which the

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[65] In the White Paper (Chapter 3) n. 10, *supra*, the Treasury Department endorses the priority given to the comparable uncontrolled price method in the current regulations. However, the White Paper does question the priority in the current regulations of the resale price method over the cost plus method, and argues that preference for either of the two methods should be determined by availability of data.

[66] There are other reasons for additional difficulty in applying the comparable uncontrolled price method to products not traded in public markets. Conditions for sale of products with prices publicly quoted are usually standardized, while conditions for sale of otherwise comparable products which are not publicly traded are not standardized. Such conditions as enumerated in the regulations include volume of sale, quality of product, intangible property associated with the product, the level and nature of risks assumed in connection with resale and time and place of delivery.

transfer price is being determined. If such information is not available from the same buyer, markup percentages may derived from comparable buyers if such comparability can be established. The regulations emphasize that in order to apply this method, the buyer of the intermediate product generally should not have contributed more than an insubstantial amount of value to the product. However, the regulations permit this method to be used in certain other circumstances, in particular where the adjustments that would be required under this method are less extensive and easier to evaluate than the adjustments under the cost plus method.[66a]

The cost plus method requires data on costs to the seller of producing the intermediate product sold to a related party and determination of a gross profit margin, determined as a percentage of costs.[67] As in the case of determining the markup percentage, a gross profit percentage requires determination of gross profits of similarly situated firms. It is worth noting that the resale price method, which depends on information provided by the reseller, may be more administrable for determination of transfer prices of inbound sales from a foreign entity to a U.S. affiliate.

The difficulties of identifying comparable transactions has been a problem in applying the arm's length standard. In 1986, Congress modified section 482 in the case of transfers of certain intangibles to require the use of a standard under which the income with respect to such transfers would be "commensurate with the income attributable to the intangible." [68] The legislative history expressed a concern that the relationship between related parties is different from that of unrelated parties, and that comparable unrelated party transactions often cannot be found. The legislative history indicated particular concern about the absence of comparables in the case of transfers of intangibles.[69]

D. Proxy Measures of Rates of Return Calculated under the Fourth Method

In general

Return on equity.—Besides the three methods specified in the regulations, which attempt to determine transfer prices between related parties directly, there is an alternative set of approaches which attempt to infer the existence of inappropriate transfer prices by measuring aberrations in various measures and proxy measures of rates of return.[70] For example, if it could be deter-

[66a] See Part I.C., *supra.*

[67] This method entails the additional issue of measuring and allocating costs. Even if, as discussed below, comparable gross profit percentages can be established, the method may not be applicable unless significant problems of adequately determining and allocating costs can be overcome. Because of the relative ease, in general, of determining resale profit margins as compared to the correct allocation of manufacturing costs, one author has suggested that the resale price method is "probably, though not always" more accurate that the cost plus method. See Charles H. Berry, "Economics and the Section 482 Regulations," *Tax Notes*, May 9, 1989, p. 473.

[68] Section 1231(e)(1) of the Tax Reform Act of 1986.

[69] H.R. Rept. No. 99-426, 99th Cong., 1st Sess., pp. 423-427.

[70] Economic accounting rules, which generally would include accrual of unrealized gains (i.e., mark-to-market accounting), often do not coincide with standard financial accounting rules. For purposes of measuring and comparing rates of return, unadjusted financial accounting data could be misleading. In general, proxy measures of rates of return are employed in an attempt to avoid biases that would result from using rates of return measured from standard accounting data.

mined that a U.S. company, which is a subsidiary of a foreign parent from which it purchases intermediate goods, has an abnormally low rate of return, it might be inferred that this low rate of return is attributable to inappropriately high prices from the foreign parent to the controlled subsidiary in the United States. Underlying these comparisons of rates of return is the principle, widely recognized among economists, that in the long run after-tax rates of return measured under economic accounting rules will be equalized. Therefore, the presence of persistent abnormal accounting rates of return for individual members of a controlled group might be indicative of transfer prices that do not reflect the real value of goods transferred between related parties.

If it can be assumed that rates of return can be equalized across industries, use of a rate of return method may not necessarily be restricted to comparison of the rate of return of the firm in question to comparable firms performing the same function in the same industry. However, if it is believed that rates of return among industries may vary (for example, because of differences in risk) or that *measured* rates of return among industries may vary due to systematic errors in the measurement of income and assets, analyses utilizing comparisons of rates of return would be improved by restricting comparison of rates of return to firms within industries.

The main problem with this general approach is that it is difficult in practice to measure rates of return accurately. Since a rate of return is the ratio of income to equity, this calculation requires acceptable measurements of income and equity, both of which may be subject to a variety of estimation methodologies. In application to transfer pricing problems, some of these measurement issues have largely been avoided by development of alternative ratios analogous in various degrees to rates of return on equity.

Return on assets.—If it can be assumed that equity is proportional to assets, a good alternative or proxy measure of the rate of return would be the ratio of income to assets. Since the relationship between equity and assets varies widely across industries, this approach might be most useful in comparisons of a group of firms within an industry. Even then, it must still be assumed that there exists in the industry a fairly uniform relationship between assets and equity, and therefore there is reason to expect a fairly constant ratio of income to assets. Even within narrow industry classifications, differences in financial structure and methods of production could account for observed differences in the ratio of income to assets even where firms did not incorrectly price intra-group transactions and, as predicted by economic theory, earned equal rates of return.

Return on operating cost.—In addition, comparisons of returns on assets may suffer from large disparities in valuation of assets, especially between old and new firms.[71] The problem of asset valuation

[71] In the presence of inflation and methods of accounting for depreciation excess of economic depreciation, a firm with a relatively large proportion of old capital (i.e., a slow-growing firm) will have less capital reported on its balance sheets than a company with the same amount, but newer, capital. To the extent this is true, older, slower-growing companies will have larger *measured* rates of return than newer, faster-growing companies. See Berry, p. 748.

may be avoided by replacing equity or assets in the denominator of the proxy measure of rate of return with operating costs.[72] This method fundamentally assumes operating costs are proportional to equity. Because these ratios do vary widely across industries, meaningful comparisons can only be made within industry groups.[73] As similarly noted in the previous paragraph with regard to the ratio of income to assets, this approach might be used for comparisons of a group of firms within an industry which exhibits uniformity across firms in the relationship between operating costs and equity. Nevertheless, as noted above in the case of ratio of income to assets, even comparisons within industries can only be useful under certain assumptions about similarities across firms in financial structure and methods of production.

Difficulties in interpretation of ratios

In addition to these problems resulting from difficulties in measurement, comparisons of such ratios may be misleading if only one year's data is utilized. Any one firm in any year may have an aberration in its rate of return and still not violate the economic principle of long-run equalization of rates of return. It might be premature to suggest transfer pricing problems exist based solely on disparities in rate-of-return ratios calculated from a single year's data.

A frequent use of measures of rates of return in practice has been not to determine transfer prices but to check the reasonableness of prices determined by alternative methods. An 1979 OECD report notes the following:

> Levels of profit in an industry may for example conform to a pattern and an exception to the pattern might indicate that profits were being shifted by artificial transfer prices. But comparisons of this sort would need to be made with care. It does not necessarily follow that exceptional profits or losses are artificial. . . . [T]he results of the comparison could normally be regarded only as pointers to further investigation.[74]

This approach was adopted in the *Du Pont* case, as the Court used return ratios as a guide to "reasonableness of the result" of the income reallocation determined by other methods.[75]

The rate of return method in the Treasury Department "White Paper"

The Treasury Department has suggested that under certain circumstances, the rate of return ratio methods may be used not only as a check on reasonableness of other methods, but to actually determine and set transfer prices. As discussed in the White Paper,

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[72] The ratio of gross income to operating costs is commonly referred to as the "Berry ratio," after Charles H. Berry, who employed this method for the IRS. See *E.I. du Pont de Nemours & Co. v. United States*, 608 F. 2d 445 (Ct. Cl. 1979).

[73] In *E.I. du Pont de Nemours & Co. v. United States*, 608 F.2d 445 (Ct. Cl. 1979), the Court accepted the Commissioner's reallocation based on a comparison of the foreign subsidiary's rate of return compared to those of 1,100 companies in several industries and on a comparison of the foreign subsidiary's ratio of gross income to total operating costs of those 32 companies "functionally similar, in general" to the foreign subsidiary.

[74] *Transfer Pricing and Multinational Enterprises—Report of the OECD Committee on Fiscal Affairs*, Organisation For Economic Co-operational Development, Paris, 1979, at para. 71.

[75] *E.I. du Pont de Nemours & Co. v. United States*, 608 F. 2d 445 (Ct. Cl. 1979).

the Treasury Department would apply return ratio methods for the pricing of intangibles where no exact or inexact comparable exists. This method, known as the Basic Arm's Length Return Method (BALRM), could only be applied in situations where only one of the related parties has intangible assets without exact or inexact comparables. Furthermore, this method may only be applied after performing "functional analysis" to identify different components of the firm's business, assigning rates of return to each line of business, and subsequently computing the rate of return of the intangibles as the residual from the total. Since comparables are relatively rare for intangibles, the suggested application of the BALRM method would be applied in a significant portion of transfer pricing cases.[76]

E. Procedural Issues

Net basis taxation of income from foreign inbound investment poses administrative issues that are in some ways different from those posed by the taxation of local U.S. investment. As a threshold matter, if a foreign person with U.S.-related income not subject to withholding determines that it has no U.S. trade or business (a determination calling for particularized analysis of facts and circumstances), and for that reason files no U.S. tax return, the IRS is foreclosed from challenging that determination in the ordinary return-examination process. Moreover, differing effective tax rates in different jurisdictions, or other factors, may create incentives to artificially shift income across borders. Accurate allocation and apportionment of worldwide expenses to U.S. income depends on data which may be subject to foreign business and accounting conventions that take little or no account of U.S. tax or accounting rules. The ability of the IRS to examine or obtain materials created abroad is limited by obstacles resulting from, among other things, language differences, geographical distance, and different levels of foreign judicial support available to compel compliance with U.S. tax laws. The substantive U.S. tax rules applicable to inbound foreign investment are supported by certain Code and treaty provisions that respond to these administrative issues.

Despite the regulatory detail, what does and does not constitute an arm's length arrangement remains fundamentally a question of fact, and is, of necessity, largely based on information available only from the taxpayer. The Treasury and IRS, in their 1988 White Paper on related-party pricing, reported on tax administration difficulties in determining arm's length prices:[77]

> A significant threshold problem in the examination of section 482 cases has been IRS access to relevant information to make pricing determinations. In some cases, relevant information is not furnished by the taxpayer to the examining agent. In other cases, long delays are experienced by agents in receiving information, in most cases without explanation for the delays. In many cases, delays in responding to [International Examiner] requests for in-

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[76] White Paper n. 10, *supra*, Chapter 11.
[77] White Paper n. 10, *supra*, pp. 13-15 (references omitted).

formation exceed one year. Because of the emphasis upon timely closing of large cases in the recent past, section 482 cases have been closed without receiving necessary information or without the opportunity for agents to follow up on information that has been provided.

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Because of the dramatic increase in recent years of direct foreign investment in the United States, the examination of transactions between foreign parents and their U.S. affiliates will become an increasingly more important part of the international examination program. A survey of rates of return on these companies based on IRS statistics of income ("SOI") data reveals a substantially lower than average profit in this country reported by these companies, which may involve transfer pricing policies.

In practice, examinations of United States subsidiaries of foreign parents have developed into some of the Service's most difficult examinations. A primary reason for the difficulty is that agents are unable to obtain timely access to necessary data, which is typically in the hands of the parent company. In many cases, foreign parent companies refuse to produce this information upon request. An additional difficulty encountered by agents is that foreign parent corporations may not be subject to information reporting requirements similar to U.S. requirements.

In addition to the procedural steps that can be taken in any domestic tax controversy, a section 482 case involving both foreign and domestic taxpayers can also be thrown into "competent authority" proceedings, bringing the tax administrators of two countries together for the purpose of resolving the income allocation dispute. Competent authority procedures add an additional set of administrative issues to what can already be a fairly lengthy and complex dispute resolution process. In addition to resolving substantive tax issues, the competent authorities may be called upon to coordinate the disparate procedural rules applicable in each country to audit adjustments, such as interest on refunds or deficiencies, and differing statutes of limitations on refunds or additional assessments.

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