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TRADING WITH RELATED FOREIGN ENTITIES:
CURRENT AMERICAN TAX PERSPECTIVE*

MORTIMER CAPLIN†

Trading with related entities on other than an "arm's-length" basis is of obvious concern to companies doing business across international boundaries. Crucial here are not only the substantive tax rules under the laws of the particular countries involved, but also the procedural mechanisms available for reconciling possible inter-country differences.

For the past decade, the United States Internal Revenue Service (IRS) has given heightened attention to non-arm's-length dealing—particularly in the context of foreign transactions. The basic question always is: Has the entity subject to United States tax jurisdiction been taxed on an amount of net income that fairly reflects its own activities?

This article attempts to summarize existing United States tax law and government policy on arm's-length dealing, with the hope that it will illuminate the current perspective in this important and complex area.

The Arm's-Length Dealing Standard

We must first define what we mean when we speak of an "arm's-length dealing" standard. In theory, the standard requires that the terms and conditions of transactions between related parties be the same as they would be had the parties been unrelated. In practice, this standard is quite difficult to apply to the wide variety of arrangements commonly carried on.

Four of the principal transactional patterns are:

(1) Intercompany loans which are interest-free or carry interest above or below prevailing rates;
(2) Facility sharing arrangements without proper allocation of costs in proportion to benefits received;
(3) Transfer of rights to use tangible or intangible property—by lease, license or otherwise—for less or more than an adequate consideration; and
(4) Sales or services transactions where the price or other consideration is inadequate or excessive.

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In all these transactions, whether by design or not, non-arm’s-length dealing enables taxpayers to divert income or deductions from one related party to another, with a reduction in the overall tax burden. A prime example is the shifting of income from a United States taxpayer to a related foreign entity, with the end result being the avoidance of current United States taxation.

From the viewpoint of the United States, the legal basis for applying the arm’s-length standard to international transactions is rooted in Section 482 of the Internal Revenue Code. It grants discretion to the Commissioner of Internal Revenue to “distribute, apportion, or allocate gross income, deductions, credits or allowances” between business entities “owned or controlled” directly or indirectly by the same interests; but only where he determines that such adjustment is necessary to prevent evasion of taxes, or to reflect clearly the income of the organizations involved. The “control” concept for purposes of Section 482 goes far beyond the basic parent-subsidiary ties. Under applicable regulations, the section applies to relationships involving “any kind of de facto control, direct or indirect, whether legally enforceable, and however exercised.”

The direct effect of Section 482 is to permit the IRS to adjust the income tax liability of entities that fall within its jurisdiction—including foreign corporations or other entities subject to United States income taxation. Thus, net income “effectively connected” with a foreign corporation’s United States trade or business is taxed under the Code at normal corporate rates if derived from United States sources or, in certain instances, even if from foreign sources. In addition, so-called “fixed or determinable” income from sources within the United States, e.g., interest, dividends, royalties, rents and compensation for services, is subject to a statutory 30% rate without allowance for business deductions.

As is true in the United Kingdom, the rules of the domestic tax law of the United States regarding taxation of foreign entities and individuals are overridden by specific treaty provisions. The United States is presently party to some

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2 INT. REV. CODE OF 1954, § 482, reads as follows:
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 or his delegate 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.


4 Treas. Reg. § 1.482-1(a)(3).

5 See INT. REV. CODE OF 1954, § 894(a), which reads: “Income of any kind to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.”
33 income tax conventions or treaties, which are designed to provide beneficial tax rules for transactions between citizens, residents and business enterprises of the United States and the other contracting country. The most important treaty provisions are those which allocate various categories of income to one or the other of the signatory countries, or exempt or moderate the rate of tax on certain categories of income, such as dividends, interest and royalties.

A number of treaty provisions turn on whether the enterprise of one contracting country is carrying on a trade or business in the other contracting country through a so-called "permanent establishment" situated therein. As relevant to the arm's-length standard, "industrial and commercial profits" attributable to a permanent establishment may be taxed by the country in which it is located. For example, under Article III of the United States-United Kingdom Convention,\(^6\) if a United Kingdom company has a branch office or factory in the United States, net profits properly attributable directly or indirectly to that permanent establishment will be subject to United States taxation. The industrial and commercial profits attributable to the permanent establishment are computed as if it were an independent enterprise engaged in the same or similar activities and dealing at arm's-length with the enterprise of which it is a part. From the United States' perspective, this arm's-length determination is made in light of the principles of Section 482.

Section 482 principles are also relevant under another typical treaty provision which specifically authorizes allocations of income between "related persons." Article IV of the United States-United Kingdom Convention is an example.\(^8\) This provision applies to relationships between separate entities in the different contracting countries—such as that which is evident in the parent and subsidiary situation—where one entity, by reason of its participation in the management or the financial structure of the other, imposes non-arm's-length arrangements or conditions on the other in their commercial or financial dealings. Appropriate adjustment may be made to reflect any profits or income which would normally accrue to one of the enterprises but for the non-arm's-length dealing. Again, the principles of Section 482 apply for purposes of making any such adjustment.

Two basic points emerge so far: First, the arm's-length dealing standard is important to both domestic taxpayers and foreign enterprises subject to United States taxation. Second, Section 482 provides the legal basis for United States taxation.

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\(^6\) INT. REV. CODE OF 1954, § 7852(a), which reads: "No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title."

\(^7\) Convention on Double Taxation with United Kingdom, April 16, 1945 [1946], art. III, 60 Stat. 1377, T.I.A.S. 546.

\(^8\) Id. art. IV.
enforcement of the arm’s-length standard, either directly or in conjunction with applicable treaty provisions. With this in mind, let us now take a closer look at Section 482 and in particular, the important regulations under that section.

SECTION 482 REGULATIONS

The basic policy behind Section 482 is the prevention of artificial shifting, “milking” or distorting of the true net incomes of commonly controlled enterprises. To effectuate this policy, the United States Treasury Department has promulgated detailed administrative regulations under Section 482, which apply to both domestic and foreign transactions.

In general, Treasury Regulations set forth the government’s interpretation of the underlying Code provision and it is this interpretation which is applied by the IRS. Although not officially carrying the force of law, tax regulations are generally accepted by United States courts as valid interpretations of the law, except in rare instances where found to be “arbitrary and capricious.”

The Section 482 Regulations are especially significant for they expound at great length upon a sparsely worded statute which grants broad discretion to the Commissioner of Internal Revenue. Not only do his findings carry the usual presumption of correctness, but his adjustments under Section 482 will be upheld unless the taxpayer can show that he abused his discretion. With this in mind, it becomes obvious that these regulations must be carefully considered in planning any transaction between related entities.

The basic thrust of the Section 482 Regulations is succinctly stated in the following passage:

[T]he purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining—according to the standard of an uncontrolled taxpayer—the true taxable income from the property and business of the controlled taxpayer... The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s-length with another uncontrolled taxpayer. (emphasis added.)

Detailed guidelines are set forth in the regulations on how to apply the arm’s-length standard to five categories of transactions: (1) loans or advances; (2) services; (3) use of tangible property; (4) transfer or use of intangibles; and, (5) sale of tangible personal property. The first four can be dealt with rather briefly. The last category, which raises the so-called “intercompany pricing” issue, warrants more extended discussion because of its substantial impact on international transactions.

9 Treas. Reg. § 1.482-1(b)(1).
10 Treas. Reg. § 1.482-2(a)-(e).
Loans or advances

Any credit extended from one related entity to another must reflect an arm's-length interest charge. Under a "safe-haven" provision, if the creditor is not in the business of making loans, the arm's-length standard is considered met if the interest rate charged is between 4% and 6%. If no interest is charged, or the rate is less than 4% or more than 6%, the Regulations provide that simple interest of 5% shall generally be set. However, in all cases, taxpayers retain the right to demonstrate that the appropriate arm's-length rate is more or less than the "safe-haven" rate.

A special rule applies for loans obtained at the situs of a controlled entity for purposes of relending to that entity. Here, the appropriate arm's-length rate is the rate actually paid by the lender, plus any borrowing costs. This exception applies, for example, to United States companies which borrow foreign funds to re-lend to foreign affiliates, frequently at rates different from the domestic rate.

I might note that there has been a recent flurry of litigation in the United States concerning the use of Section 482 to impute interest where none has been charged. The legal argument is that Section 482 authorizes only the "reallocation" of existing income and not the "creation" of income. Despite what might be described as limited taxpayer victories in some courts, the IRS has generally managed to successfully withstand this challenge.

Services

The performance of services for or on behalf of another related entity for less than an arm's-length consideration will result in an allocation reflecting "the relative benefits intended from the services." Under the regulations, the measurement of "benefits" will sometimes be with reference to the cost, direct or indirect, of the services, that is, without inclusion of a profit factor. However, a profit factor must be included if, as is often the case, the particular

11 Treas. Reg. § 1.482-2(a)(2). When interest income is added to the lending entity, the borrowing entity is permitted a deduction for the same interest expense. Treas. Reg. § 1.482-1(d)(2).
12 See Fitzgerald Motor Co., Inc. v. Comm'r, 508 F.2d 1096 (5th Cir. 1975), aff'd on other grounds, 60 T.C. 957 (Dec. 1973); Kerry Investment Co. v. Comm'r, 500 F.2d 108 (9th Cir. 1974); Kahler Corp. v. Comm'r, 486 F.2d 1 (8th Cir. 1973); B. Forman Co. v. Comm'r, 453 F.2d 1144 (2d Cir. 1972), cert. den., 407 U.S. 934 (1972). All of the above have rejected the "trace test" espoused by the Tax Court for the last 35 years. The Fifth Circuit most recently explained this departure in its opinion in the Fitzgerald Motor Co. case:

The Tax Court's tracing theory yields a two prong test: (1) Did the borrower have gross income during the year in question and (2) Was this income derived from using the borrowed funds? In addition to being needlessly complicated, this procedure adds a requirement (the debtor's gross income) to those given in both Section 482 and the applicable Regulations—neither of which requires gross income as an element. 508 F.2d at 1100.

All four circuit courts of appeals indicated above adhere to the proposition that Section 482 is applicable irrespective of whether the debtor uses the borrowed funds to produce income.

services constitute "an integral part of the business activity" of any of the related parties involved. This would be so, for example, if the performance of services for related entities is one of the renderer's "principal activities"; if the renderer is "peculiarly capable" of performing services which are "a principal element" in the operation of the recipient; or if either the renderer or recipient is in the business of rendering similar services to unrelated parties.14

Where the benefits from the services in question are so remote or indirect that unrelated parties would not have charged for such services, no allocation will be made. For example, suppose an international airline has a subsidiary which owns and operates hotels in cities serviced by the airline. If in conjunction with airline advertising the subsidiary's hotels are pictured and identified with the airline, a Section 482 allocation will be made. But if the subsidiary and its hotels are not specifically mentioned in the advertisements, any incidental benefits from increased patronage by airline customers is too remote to support an allocation.

A case decided in 1969 points up another exception to the allocation requirement for services.15 A United States advertising corporation performed, without charge, various management and administrative services for foreign subsidiaries, and the IRS asserted a Section 482 allocation reflecting a charge for these services. The court disagreed, finding that individual employees of the parent company had not performed specific managerial services for any of the subsidiaries. Rather, it characterized the parent's underlying activities merely as "general supervision" relating solely to keeping control over its corporate family.

The Section 482 Regulations similarly recognize a type of activity in the nature of "stewardship" or "overseeing" functions undertaken for the corporation's own benefit as an investor in a related corporation.16 Despite this, however, examining revenue agents frequently attempt to allocate to foreign subsidiaries a portion of executive salaries paid by a parent corporation, along with other costs seemingly within the "stewardship" categories. The issue, moreover, has assumed particular significance in light of recently proposed regulations17 under Section 861 of the Code, relating to the allocations of deductions for purposes of determining United States and non-United States source income. This section will be referred to in greater detail below.

**Use of tangible property**

An arm's-length rental is required on the lease or other transfer of possession, use or occupancy of tangible property—personalty or realty—

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14 Treas. Reg. § 1.482-2(b)(7).
15 Young & Rubicam, Inc. v. United States, 410 F.2d 1233 (Ct. Cl. 1969).
between related entities. As in the case of interest, if no rental is charged, one will be imputed under the Section 482 Regulations.\textsuperscript{18}

The regulations prescribe a safe-haven rental formula for use when neither the owner nor the property-user is engaged in the leasing business. This formula determines the rental with reference to the property’s depreciable basis and useful life—taking a 3% profit factor—as well as expenses paid or incurred by the owner on the property (\textit{e.g.}, taxes, maintenance, repairs, etc.). Use of the formula is not mandatory, and the taxpayer may attempt to demonstrate that another calculation is more appropriate.\textsuperscript{19}

\textit{Transfer or use of intangible property}

If intangible property rights are transferred or made available to related entities, the Section 482 Regulations require an adjustment to reflect an arm’s-length charge based generally upon the value of the benefits conferred. The definition of “intangible property” is extremely broad, including among other things: patents and inventions; copyrights, trademarks, tradenames, franchises, and licenses; formulas, processes, designs and programs; and, other forms of technical data and “know-how.” The only limiting requirement is that the property have “substantial value” independent of the services of individuals.\textsuperscript{20}

Consideration for intangibles takes many forms—including royalties, lump-sum payments and reciprocal licensing arrangements. As usual, the appropriate arm’s-length consideration is to be determined, if possible, with reference to similar transactions with third parties. But in the absence of comparable unrelated transactions, the regulations list 12 factors which may be considered.\textsuperscript{21} Among these are: prevailing rates in the same industry for similar property; uniqueness of the products; limitations in terms of transfer (\textit{e.g.}, geographical exclusivity); degree and duration of protection accorded property under laws of relevant countries; and availability of substitutes for property transferred.

With regard to reciprocal licensing arrangements, multinational corporations with manufacturing and research facilities in both the United States and foreign countries often utilize royalty-free cross licensing of developed intangibles. If the “reciprocity” is truly arm’s-length, no other consideration is necessary.

Along similar lines, members of a related group sometimes enter into a “cost and risk sharing arrangement” in developing specific intangible

\textsuperscript{18}Treas. Reg. § 1.482-2(c)(1).
\textsuperscript{19}Treas. Reg. § 1.482-2(c)(2)(i).
\textsuperscript{20}Treas. Reg. § 1.482-2(d)(3).
\textsuperscript{21}Treas. Reg. § 1.482-2(d)(2)(iii)(a)-(m).
property. In effect, each member is permitted to use the property free-of-charge to the extent it shared in the costs of development. Such arrangements must be in writing and reflect a good faith attempt on the part of the participants to bear their respective shares of the development costs and risks on a basis comparable to what unrelated parties would have adopted.\textsuperscript{22}

Sale of tangible personal property—“Intercompany pricing”

The most important and controversial area of the Section 482 Regulations is the so-called “intercompany pricing rules.” From an international standpoint, these pricing rules are by far of greatest interest—for IRS revenue agents propose annually hundreds of millions of dollars of tax adjustments in intercompany pricing and net income reallocations.

The regulations first offer three “specific” methods for determining an arm’s-length price for the sale of tangible personal property (typically inventory). In order of priority they are: (1) the “comparable uncontrolled price” (CUP) method; (2) the “resale price” method; and, (3) the “cost-plus” method.\textsuperscript{23} These standards are applied in sequence; and, if the standards for applying any one of the three can be met, that method must be used, unless the taxpayer can establish that another pricing method is clearly more appropriate. If none of the three is applicable, the regulations permit the use of “some appropriate” other method.

(1) Comparable uncontrolled price method:\textsuperscript{24} Under the CUP method, the arm’s-length price is that price at which substantially similar items are sold (1) by the same seller to an unrelated buyer; (2) to the same seller by an unrelated seller; or, (3) from one unrelated entity to another. The “comparability” requirement is met only if the property involved and the circumstances of the sale are so nearly identical to the controlled sale that any differences will have either a reasonably ascertainable impact upon the price of the product, such as, freight and handling charges, or, no impact at all.\textsuperscript{25}

The CUP method is the preferred method under the regulation and is applied wherever possible. But, practically speaking, truly comparable uncontrolled sales are often difficult to find. For example, where component and semi-finished goods are sold only to foreign affiliates, there may be no comparable uncontrolled sales. Beyond this, numerous possible differences—some clear, others subtle—may affect product prices to an extent not reasonably ascertainable, thus rendering the sales noncomparable. To name a few: differences in product quality; terms and time of sale; market level; and, geographic market in which the sale is made.

\textsuperscript{22} Treas. Reg. § 1.482-2(d)(4).  
\textsuperscript{23} Treas. Reg. § 1.482-2(e)(2)-(4).  
\textsuperscript{24} Treas. Reg. § 1.482-2(e)(2) (2).  
\textsuperscript{25} Treas. Reg. § 1.482-2(e)(2)(ii).
(2) **Resale price method:** This second prescribed method is designed principally for relationships where the buyer is essentially a distributor for the related seller, adding nothing of substantial value to the product by physical alteration. But it may also be used when the value added by the distributor is readily ascertainable and price adjustments are fewer and easier to make than under the “cost-plus” method. In any case, the basic idea is to arrive at the arm’s-length price by first taking the price at which the product is ultimately sold to an outsider and reducing it by an appropriate mark-up determined with reference to a similar resale of property in an uncontrolled context. Stating it another way: you work backwards from “resale price,” reducing it by a mark-up factor.

(3) **Cost-plus method:** This third prescribed method is designed for use when prior to resale the buyer makes a significant contribution in value to the product purchased from the related seller. The starting point here is the cost of producing the item, to which an appropriate “gross profit” (expressed as a percentage of cost) is added and certain other adjustments are made. The gross profit factor is determined by reference to similar sales made by the related seller to unrelated parties, or to sales between unrelated parties under relatively comparable circumstances.

The determination of production costs and gross profit factors will, more often than not, involve delicate accounting judgments. The key requirement under the regulations is that there be consistency of accounting between the controlled sale and the purportedly comparable uncontrolled transaction. Thus, the same accounting elements which make up the cost of the product in the uncontrolled context should be reflected in determining cost for the controlled sale.

Each of the three methods specified above is in essence a variation of one single method designed to determine an arm's-length price by reference to dealings between unrelated parties. While the technical application of these methods may differ, the crucial point is that, in each, there must be some evidence of third party prices, markups or discounts in order for the method to be workable.

(4) **The “fourth” method:** If (a) none of the three specified pricing methods can reasonably be applied in a particular case, or (b) if they may be applied, but the taxpayer establishes that some other method is “clearly more appropriate,” then an alternative approach may be taken. This is the so-called “fourth” method which can be a variation of any of the three specified

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28 Id.
29 Id.
methods, or an entirely different method. In all events, it does allow for a desirable degree of flexibility in resolving these difficult pricing cases.\textsuperscript{30}

It is not unusual for the examining revenue agent to reject as inapplicable all three pricing methods specified in the regulations, thus setting the stage for the taxpayer to support its position on a purely facts and circumstances basis. The courts have also encountered difficulty in applying the three specific methods. In an effort to reach equitable solutions without expressly rejecting the administrative guidelines, a few courts have been developing new standards under the "facts and circumstances" rubric.

Frequently, the language used by the courts reflects the language of the regulations in testing the different arrangements; but, throughout, the opinions seem to be striving for a standard of "reasonableness" based upon the evidence adduced and the facts of the particular case without specific use of that term.\textsuperscript{31} One welcome development has been a category of recent cases which focuses principally upon the reasonableness of "profit-split" between the related entities, as determined through use of sophisticated accounting techniques and analysis. In making such a determination, the basic question which arises is: Do the pricing arrangements accurately reflect the contribution that each related entity makes to the combined profit ultimately realized upon sale of the items outside the related group?

The \textit{PPG Industries} case\textsuperscript{32} illustrates the profit-split approach. Pittsburgh Plate Glass (PPG), manufacturer of glass products, chemicals and paints, formed a Swiss subsidiary, International, to handle its entire export activities, including all sales to two Canadian subsidiaries which PPG had previously supplied directly. Among other things, the IRS attempted to reallocate to PPG all profit on sales to the Canadian subsidiaries. PPG successfully withstood this attack by showing not only the existence of comparable uncontrolled prices to support its prices to International, but also that based upon a detailed accounting analysis the original pricing arrangement resulted in a reasonable split of the combined profit on the export business between PPG and International of approximately 60/40.\textsuperscript{33}

While PPG's ability to adduce evidence of a reasonable profit-split was no doubt significant, the importance of the evidence on comparable uncontrolled prices cannot be underestimated. Assuming the basic validity of

\textsuperscript{30} Treas. Reg. § 1.482-2(e)(1)(iii).

\textsuperscript{31} See, e.g., Frank v. International Canadian Corp., 308 F.2d 590 (9th Cir. 1962) (adopting the standard of reasonableness). \textit{But see} American Terrazzo Strip Co., 56 T.C. 961 (1971) (specifically disclaiming the relevancy of such a consideration as "reasonableness").


\textsuperscript{33} \textit{Id.} at 993-99.
the profit-split method, if the split urged by the taxpayer cannot also be supported by reference to comparable unrelated transactions, the government may nonetheless prevail.

Thus, in another recent case, the United States Tax Court found for the taxpayer on the basis of its demonstration of a reasonable profit-split established solely upon evidence and accounting analysis relating to the taxpayer's internal operations.34 This decision was reversed on appeal, however, with the Fifth Circuit Court of Appeals holding that no matter how sophisticated the taxpayer's analysis, it could not sustain its burden under Section 482 by simply providing proof on pricing, i.e., discounts and commissions, in terms of its own marketing arrangements. Rather, the court demanded that "evidence of transactions between uncontrolled corporations unrelated to [the taxpayer] must be adduced. . ."35

PLANNING CONSIDERATIONS AND CONCLUSIONS

From the foregoing, it is clear that a number of hard, unresolved problems exist in intercompany pricing. The regulations, although a good faith attempt to provide clarification, are often very difficult to apply in a real-life context. The major bottleneck appears to be the insistence of the IRS that the specific pricing methods be applied to all intercompany pricing transactions despite the fact that in many cases there is simply no available evidence of a truly comparable arm's-length price. Another problem lies in the refusal of the IRS to formally accept pricing arrangements reflective of "net profits" derived by each related entity. As a result, allocations are sometimes proposed which have the effect of placing one or more of the related parties in loss positions. Surely, transactions between unrelated parties are normally entered into with the expectation that each will derive a profit with the amount and ratio depending on industry practices, functions performed, risks assumed and other factors. The arm's-length standard should recognize no less for "controlled" relationships.

In its present state, the situation can be most frustrating for international enterprises and their tax advisers; and it is understandable why pressure has been mounting to revise the intercompany pricing provisions of the regulations. Proposals are under study by the Treasury Department which will hopefully result in new or revised regulations. Among the changes being sought is a series of "safe-haven" rules to be applied, if feasible, on an industry-wide basis.

Pending adoption of changes, however, we must of course live with the existing rules. Several practical suggestions come to mind:


35 468 F.2d at 808.
First. To the extent possible, efforts should be directed toward the establishment of pricing arrangements supportable under the regulations, most preferably the “comparable uncontrolled price” method. However, it should be kept firmly in mind that the various pricing methods of the regulations are not mutually exclusive. It is often useful to support your pricing arrangement with evidence adduced under more than one of the specified methods.

Second. If evidence cannot be developed under any of the three specified pricing methods, other available evidence of arm’s-length price should be developed for possible application under the “fourth method,” i.e., based upon the facts and circumstances pertaining to the particular case.

Third. Analysis of the profit factors involved at each level in intercompany pricing is advisable. This includes, for example, computations of gross and net profit realized by the related companies and the division of net profit. An examining revenue agent is likely to be impressed if he finds that the company has taken the trouble to make these detailed computations as a prelude to setting the terms of intercompany pricing. Conversely, he may become suspicious upon finding that the company took no account of how much of the profit ends up in each related company.

Fourth. The terms of intercompany pricing arrangements should be fully set out in written contracts executed at the time transactions are entered into. Steps should be taken on a continuing basis to assure that such contracts are actually carried out and that the responsible personnel have a full understanding of what the pricing arrangements are.

Fifth. Finally, the importance of building a contemporaneous, documentary record in support of intercompany pricing or, for that matter, any other intercompany transaction cannot be over-emphasized. As is well-demonstrated by a recent Treasury study concerning the application of Section 482 to international transactions and arrangements, the probability of an examining agent proposing adjustments is quite high, especially on pricing arrangements. Where potentially large tax exposure exists, it is definitely advisable for companies to seek independent professional evaluation by tax counsel, economists and accountants of existing and contemplated pricing arrangements.

No other aspect of United States tax law presents a greater challenge to lawyers and accountants both. Full cooperation between them in developing a Section 482 case is of the essence. For the accountant, his business and financial analyses must reflect the highest degree of industry, intelligence, ingenuity and integrity. For the lawyer, he must call upon his full command of the art of advocacy—assembling all the relevant facts, marshalling the evidence and legal arguments, forcefully presenting them to tax
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administrator and judge, and demonstrating his willingness to lean on competent fellow-professionals with a close understanding of the facts of the case. It is a demanding undertaking for all concerned.

RELATED TOPICS

While there are many sections of the Code which relate in some manner to allocations and "arm's-length" dealing under Section 482, two particular areas present somewhat troublesome problems which require special attention. First is the problem of "double taxation" of the same income. This can arise when the income allocation rules of one country involve conflicts with those of another. More precisely, to what extent will Section 482 adjustments be taken into account by taxing authorities of other countries in applying their tax laws to parties to the transaction?

The second relates to the impact of recently proposed regulations under the "source of income" provisions of the Internal Revenue Code, currently one of our country's most controversial topics in the foreign tax area. The proposed regulations would significantly change existing rules for allocating and apportioning deductions to United States and foreign-source income in order to arrive at "net taxable income" for purposes of other provisions of the Code.

Economic double taxation

The problem of economic double taxation in the Section 482 context can be illustrated by the following example:

"Parent," a United States company, sells to its British subsidiary ("Sub") component parts for resale to computer manufacturers in the United Kingdom and other countries. Suppose that in 1975, Sub buys 100,000 such parts at $10/unit. IRS determines that the arm's-length price is $15/unit and proposes a pricing adjustment which, if sustained, would increase Parent's 1975 taxable income by $500,000 and its United States tax liability by approximately one-half that amount.

If Parent and Sub were both United States corporations, the Section 482 Regulations would require a "correlative adjustment" to parent's increased 1975 tax liability, the theory being that if Parent's taxable income is increased by $500,000, the taxable income of Sub should be decreased by a like amount. 38

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37 INT. REV. CODE OF 1954, § 861(b), which reads:
From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States.
Source: § 119(b), 1939 Code, substantially unchanged.
38 Treas. Reg. § 1.482-1(d)(2).
This is to reflect the fact that, for tax purposes, the cost of the parts which Sub bought was $500,000 more than would be reported on its 1975 tax return.

Obviously, the fact that Sub is a United Kingdom corporation filing a United Kingdom tax return, precludes relief under the Section 482 "correlative adjustment procedure." No refund is necessarily due Sub from the British taxing authorities since the Section 482 adjustment is merely the United States taxing authority's determination that the original pricing arrangement reflected an improper allocation. Thus, without a procedure similar to the correlative adjustment rules, Parent and Sub, in effect a single economic unit, will be taxed twice on income arising out of their intercompany transactions.

One remedy is the so-called "competent authority" or "mutual agreement" procedure provided for in income tax conventions to which the United States is a party. Generally, this procedure enables the "competent authorities" of each country—typically high governmental officials—to consult together to resolve by mutual agreement any difficulties or doubts arising on application of the tax treaty.

The most important aspect of competent authority activity is double taxation from allocations of income between United States and related foreign corporations arising under Section 482 of the Code or the "related persons" provisions of the tax treaties. Problems can arise, for example, under treaty provisions requiring the attribution of industrial or commercial profits to a foreign "permanent establishment" or the allocation of income between related foreign entities. Also to be considered under the competent authority procedure are questions relating to the determination of the source of particular items of income.

The competent authority procedure recognizes the right of each contracting state to propose and make allocations in accordance with its own domestic law. If an allocation proposed or made by the United States or a treaty country is accepted for review by the United States competent authority, he will attempt to arrive at an agreement acceptable to all parties concerned, i.e., the United States, the other country or countries involved, and the taxpayers. To this end, he will be guided by the basic standard of arm's-length dealing under Section 482 and equivalent treaty provisions; but he will not be bound strictly by the detailed Section 482 Regulations. In other words, he will attempt to negotiate with his foreign counterpart on the basis of a reasonable, flexible approach, rather than stressing the technical niceties of the domestic law. Since the very nature of the competent authority process is to reconcile legitimate differences of policy and interpretation between often diverse tax

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systems, it is imperative that the competent authority be able to exercise a reasonable degree of discretion in resolving an issue.

In 1970, the IRS set forth in a published revenue procedure steps to be taken by United States taxpayers desiring aid from the United States competent authority to procure double taxation relief in Section 482 transactions. The published procedure is quite detailed. It covers arm's-length allocations proposed or made under foreign law as well as under Section 482, whether initiated by a foreign treaty country or by the IRS.

While not without its problems, the competent authority procedure carries much promise and is proving quite workable. In cases already concluded, over $30 million in adjustments have been made to provide the relief granted, and a substantial portion of this amount represents reciprocal adjustments, that is, cases where both countries agreed to make mutual concessions toward determining the relief granted.

Perhaps more important, though, is the fact that United States taxpayers are showing a greater willingness to use the competent authority procedure. Close to 140 requests for competent authority assistance had been received by the end of 1974 in cases involving international allocations. As has consistently been the case, pricing controversies head the list of principal issues in the current inventory of competent authority allocation cases.

It is important to remember that the competent authority mechanism is purely voluntary. While no treaty requires that governments reach agreement on a particular problem, such efforts should and typically will be made in the spirit of international comity.

Moreover, it cannot be overemphasized that the success or failure of the competent authority procedure depends in large part upon the degree of cooperation received from taxpayers, i.e., in promptly furnishing the substantial data and other information often required in reviewing cases of this sort. In the same vein, as soon as a taxpayer is informed that a particular tax year is under review and realizes that potential double taxation exists, the related party should be advised to take timely protective action with the foreign taxing authorities including staying the expiration of the period of limitations for refunds or other tax adjustments. In this latter connection, our most recent treaties expressly provide for waiver of the period of limitations on competent authority adjustments; earlier treaties, including the United States-United Kingdom Convention, have been interpreted as permitting a similar waiver.

The 1970 Revenue Procedure does not take care of all double taxation problems subject to competent authority consideration. Not included, for
example, are the non-Section 482 aspects of (1) the determination of the source of particular items of income; and (2) the attribution of industrial and commercial profits to a permanent establishment. New procedures covering these items are reportedly in the works and will hopefully be released shortly.

An alternative form of relief from double taxation is also available for cases involving non-treaty countries or where the competent authority procedure is otherwise not available. Another published revenue procedure sets forth the so-called “tax-free repatriation” remedy. This allows a United States taxpayer whose taxable income is increased by a Section 482 adjustment to elect to receive tax-free payment from the related entity (whether foreign or domestic) to the extent of the income increase attributable to the Section 482 allocations. The theory is that a controlled group of taxpayers should be able to adjust its accounts—without further tax consequences—so as to reflect Section 482 allocations. The repatriation procedure is available, though, only if the taxpayer can show that tax avoidance was not one of the principal purposes of the transactions giving rise to the allocation.

Proposed regulations under Section 861

In June, 1973, controversial amendments were proposed for the existing regulations under Section 861. These concern the allocation and apportionment of deductions between United States and foreign-source income.

Sections 861-864 of the Code provide rules for determining whether income shall be treated as income from United States or foreign sources. In turn, the “source-of-income” rules apply for purposes of determining tax consequences under several operative provisions of the Code, including, for example, provisions governing the taxation of foreign corporations carrying on business in the United States.

In computing taxable income from United States or non-United States sources, the taxpayer’s United States gross income is reduced by the expenses, losses and other deductions properly apportioned or allocable thereto, with a similar reduction being made against the taxpayer’s foreign-source income. For many years the position of the Treasury was that foreign-source gross income must be reduced by the full amount of deductions “definitely” allocable thereto, and by a “ratable portion” of any deductions “not definitely”

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41 Rev. Proc. 65-17, § 4.02, 1965-1 CUM. BULL. 833.
42 Rev. Proc. 65-17, § 3.02, 1965-1 CUM. BULL. 833.
43 Proposed Treas. Reg. § 1.861-8, 38 Fed. Reg. 15840 (1973). Further reference will be made only to the relevant portion of the Proposed Treasury Regulations without further notation to its source in the Federal Registry or any amendments thereto unless relevant to the discussion.
allocable. Deductions in the latter category are generally apportioned between United States and foreign sources on a gross income basis. These currently existing rules, however, are significantly altered by the recently proposed regulations under Section 861, which contain new and complex provisions aimed generally at increasing the deductions attributable to foreign-source income.

Before explaining the basics of these new rules, clarification of the interrelationship between Section 482 and the proposed Section 861 regulations is required. From a practical standpoint, there is a definite and important tie-in between the two. Application of either to a United States taxpayer with foreign income will often operate to reduce the ratio of foreign-source to worldwide income and will therefore reduce the foreign tax credit allowable in computing its United States tax. In a broad sense, moreover, both are aimed at achieving the same ultimate objective; namely, the clear reflection of taxable income, of which both income and deduction items are integral elements.

However, from a technical standpoint, the two basically operate independently. Section 482 deals with the allocation of income and deductions between related parties (whether foreign or domestic), whereas the proposed Section 861 regulations are concerned generally with the allocation of deductions between domestic and foreign-source income of a single taxable entity subject to United States tax. Thus, the proposed Section 861 regulations focus on the proper tax accounting method for matching income and expenses, while Section 482 seeks to apply the arm’s-length standard to business dealings between related entities. Yet, in a given factual situation, the two can most definitely operate in tandem.

As already suggested, the major impact of the new rules will no doubt be felt in substantial reductions of the foreign tax credit allowed United States taxpayers for foreign taxes paid. The amount of foreign tax credit is generally limited to that portion of the United States tax liability which is treated as having been imposed upon foreign-source taxable income. To the extent that the new rules shift certain deductions from United States to foreign-source income, the amount of foreign-source taxable income—and hence, the maximum allowable foreign tax credit—will be reduced. The potential

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47 Care should be taken in the interpretation of the proposed regulation as the same relates to immediate problems. The IRS has recently distributed a supplement to all IRS personnel which strictly sets forth the fact that the proposed regulation has not been adopted and therefore, should not be utilized in developing issues in derogation of the presently existing regulations. See I.R.S., Manual Supp. 42G-333 (1975).
... as provided in section 904(a)(1), the amount of the foreign tax credit for income taxes paid to a specific foreign country... may not exceed the tentative U.S. tax (i.e., the U.S. tax before application of the foreign tax credit) multiplied by a fraction, the numerator of which is the taxable income from sources within the foreign country and the
magnitude of such reductions can be well appreciated from a statement in
current comments to the proposed regulations filed on behalf of 15 of the largest
United States corporations: They believe that their foreign tax credits would
be "eliminated or substantially reduced" as a result of the new rules.

From the standpoint of the foreign entity subject to United States tax, the
foreign tax credit aspects of the new rules are of limited significance. For
foreign corporations with taxable income "effectively connected" with a United
States trade or business, however, the new Section 861 rules are more
important since income that is derived from United States sources (and in
limited circumstances, foreign sources) is subject to tax under Section 882 of
the Code. Similarly affected will be determinations for purposes of treaty
"source-of-income rules" under which profits attributed to a "permanent
establishment" situated in the United States are generally determined with
reference to the source-of-income rules of the Code. As already noted,
source-of-income problems are a specific subject for competent authority
jurisdiction under the United States-United Kingdom Convention.

In attempting to clearly reflect taxable income or loss from United States
and foreign sources, the proposed regulations take an essentially two-step
approach. The first is to allocate all deductions to one or more "classes" of
gross income, i.e., sales, rentals, royalties or dividends. If the class to which
a deduction is "definitely related" or otherwise allocated includes both foreign
and United States-source income, the further step of "apportionment" is
necessary. Such apportionment must be made on a basis reflecting as
reasonably as possible the factual relationship between the deduction and the
income involved. Except in the case of an interest deduction, which generally
must be apportioned on the basis of capital utilized or invested, the proposed
regulations do not require use of a specific apportionment method. By way
of examples, however, they do suggest appropriate bases under certain
circumstances, and also suggest situations where apportionment based on
gross income would be considered to create a distortion.

denominator of which is the entire taxable income.
Thus, a decrease in the amount of income allocated to the foreign source would result in a
smaller fraction and a reduction in the foreign tax credit available.

49 INT. REV. CODE OF 1954, § 882. Proposed Treas. Reg. § 1.861-8(f)(iv) would make § 861,
§ 864(c) and the Proposed Regulations specifically applicable to determining the amount of
gross income effectively connected and for identifying the deductions from such gross income.
See also INT. REV. CODE OF 1954, § 873, § 882(c).

50 INT. REV. CODE OF 1954, § 904(f).

51 Proposed Treas. Reg. § 1.861-8(c)(1).

52 Id. See also Proposed Treas. Reg. § 1.861-8(a)(2).


54 Proposed Treas. Reg. § 1.861-8(g), Examples (1)-(13). It is also stated therein that the bases
utilized for allocation and apportionment as suggested in the examples assume consistent usage
on a year-to-year basis. See Proposed Treas. Reg. § 1.861-8(f)(6).
Suppose, for example, a United States corporation which manufactures and sells the same product in both the United States and another country incurs deductible general research and development (R&D) expenditures in operating a domestic central research facility. Gross income from sales of the product in both countries is the class of income to which R&D is allocable. For purposes of apportioning these expenses between foreign and domestic income, the proposed regulations presume that—in the absence of an indication to the contrary—general research activity uniformly contributes to each product unit, so that apportionment on the basis of units sold would be appropriate. 55

Application of the new rules to R&D, as described in my example, has caused much dissatisfaction. Many argue that the target of most R&D is the United States market, so that to reflect economic reality, only R&D costs undertaken for a specific foreign purpose should be attributed to foreign-source income. Under the proposed regulations, however, an increase in R&D apportioned to foreign income can generally be expected. For United States corporations with substantial and continuing R&D, this circumstance may prove quite disadvantageous in terms of their ability to utilize the foreign tax credit. Barring a change in Treasury’s position, some companies are reportedly considering the feasibility of shifting R&D activity abroad so that they might be eligible to claim foreign tax deductions.

Conversely, though, the new rules could prove advantageous to foreign companies with United States plants; for attribution to United States operations of these companies’ at-home R&D, as well as other expenses, will likely result in increased United States tax deductions.

Expenses related to “home office”—type activity of a parent corporation are also specifically dealt with in the proposed regulations. If incurred for the direct benefit of a foreign subsidiary, you will recall that Section 482 may require an arm’s-length charge for services. But if such expenses are merely of a general supervisory or “stewardship” nature, undertaken primarily in connection with the parent’s investment in the subsidiary, i.e., preparation and review of internal reports, no Section 482 allocation is required. 56 Under the proposed regulations, home-office expenses would be allocable either to services income if Section 482 were to apply, or, if Section 482 did not apply, to dividends received from the subsidiary. 57 In effect, these expenses, whether “stewardship” or not, must be attributed to foreign-source income—again, probably an unfavorable result for the United States parent company, but favorable for the foreign-based company with United States’ operations.

As mentioned earlier, the application of Section 482 and the proposed Section 861 regulations may in some instances overlap; for all allocations and apportionments under the new rules must reflect related adjustments, if any, under Section 482. As an example, suppose a United States corporation sells its product in the United States and foreign markets, with all foreign sales being made to related foreign subsidiaries. A deduction for expenses incurred by the parent company's market research department is properly allocated between United States and foreign-source income on the basis of gross income from domestic and foreign sales. But suppose further that a subsequent IRS examination determines that the intercompany price charged on sales to the foreign subsidiaries was too low, so that the United States corporation's income from foreign sales is increased accordingly under Section 482. In light of this adjustment, the proposed regulations require that the original allocation of the market research deduction be re-determined, with the result that a greater portion of that deduction would be allocated to foreign-source income.

In closing, I would like to emphasize that the proposed regulations have evoked a widespread, almost uniformly critical reaction from interested parties. Many charge that the proposed rules are not only of questionable legality, but will impose severe administrative and economic burdens on United States taxpayers with overseas interests. Given this adverse reaction, substantial changes may well be made before the new rules are adopted in final form.

After public hearings on the proposed regulations held in March, 1974, the Treasury promised a revised version of the controversial regulations, including more in the way of numerical examples to serve as guidelines for permitted allocation and apportionment practices. The revision has not yet been published and, before it is, it is anticipated that the Treasury will first submit it for review by the Joint Committee on Internal Revenue Taxation. In fact, in light of the sharp public criticisms and the lengthy lapse of time since original publication, the regulations project seems to have come to a grinding halt. A recent IRS instruction to its examining personnel confirms this. They were told to "continue to develop cases as they did prior to the issuance of the notice of proposed regulation"; and that they "should not develop issues under the principles of the proposed regulation nor use them as authority for any adjustments." In publishing this instruction, the Revenue Service estimated that "considerable time will be required to resolve certain matters involving the proposed regulation." The clear implication from this is that taxpayers and their advisers should continue to rely on the rules governing Section 861 as they existed prior to the proposed regulations.